Silicon Valley Bank
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Third Quarter 2011 Economic Commentary

The Song Remains the Same

The economy continues to grow, but — using the Fed's language — at a "measured pace".

Neither of Federal Reserve Board Chairman Ben Bernanke's press conferences during the quarter revealed anything too earth-shattering, however the definition of "extended period" was somewhat clarified as it was at the last few Fed meetings. This implies that once the Fed drops the "extended period" language, we can expect a rate increase some 12 to 18 weeks later. But given the tone and tenor of recent Fed communications, I wouldn't expect this for some time.

In June's press conference, Bernanke hinted the Fed may be moving toward targeting an inflation rate, but with the caveat that it must still attempt to achieve full employment. This is different from other central banks that solely focus on controlling inflation — likely explaining why we've seen other countries more quickly raise their rate targets.

Turning to the current economy, we see a continuation of sluggish growth, hampered by a consumer weighed down by dropping home values and a depressing job market. These factors are not likely to change for the better soon, but the potential for a significant drop from here is equally unlikely.

Much of the bounce in activity over the past few years can be directly attributed to stimulus programs coming out of Washington. Most of these have run their course and a shift in mood from stimulus to austerity could allow consumption figures to begin to drop from here.

Pockets of strong economic behavior are balanced by great uncertainty over the debt ceiling and fiscal health in Europe. The uncertainty in both of these areas has driven yet another flight-to-quality rally in Treasuries with the 2-year declining from 0.83 percent to the mid-0.30s during the quarter. Yield in the front end of the curve will remain elusive until clear signs of an improving economy emerge.

Taking a look at personal consumption, we continue to experience the first off-trend movement in well over a generation with figures resting just 1.5 percent higher than their peak in 2008. The consumer is recovering, but unlike the sustained growth trajectory of previous recessions it is highly unlikely a recovery to the previous trendline is possible.

Credit growth for the consumer has increased, although recent gains reflect growth in student loans more than anything else. In fact, subtracting out student loans, consumer credit growth continues to decline. Returning to school after receiving a year's worth of unemployment checks may be the smart thing to do, but it does not seem to signal a recovering economy.

Employment in the first two months of the quarter grew an unimpressive 286,000, below the pace needed to keep the unemployment rate steady. While positive payrolls are good, a growing labor force demands higher growth in absolute jobs.

On the inflation side of the equation, there was much good news including a drop in commodities prices as well as continued low consumer price increases — at least as compared to producer prices.

Worker efficiency continues to increase as companies are squeezing more work out of fewer workers. The outlook is quite positive for continued technological improvements to support this trend.

Looking ahead, I would expect the economy to perform similarly in the second half of the year as the first. This view is at odds with most forecasters who continuously see improvement on the horizon, only to revise estimates downward as their self-projected oasis evaporates.

Joe Morgan, CFA
Chief Investment Officer
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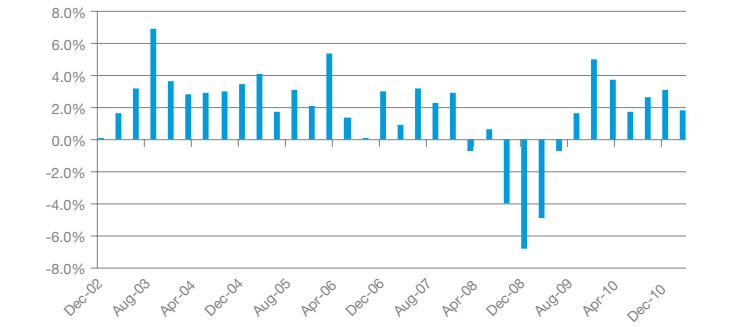
Charting the Course

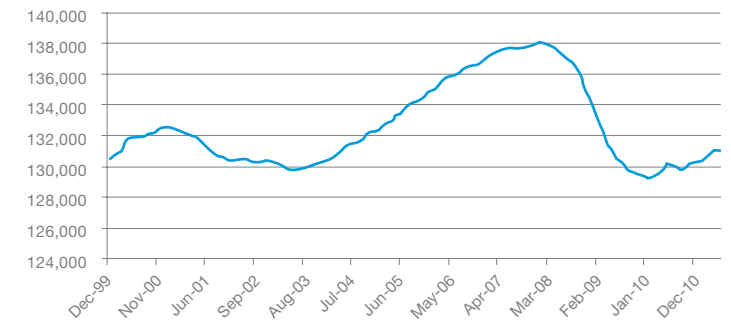
As the potential financial effects of the natural disaster in Japan faded, Greece rose to importance once again with the EU and IMF pushing for budget despite during unrest in the streets. In the U.S., the employment picture fizzled a bit with May figures disappointing even as many continued to push for a switch to restraint by the Fed. But the Fed held firm, viewing the recovery as intact, but slower than hoped for.

Quarterly GDP



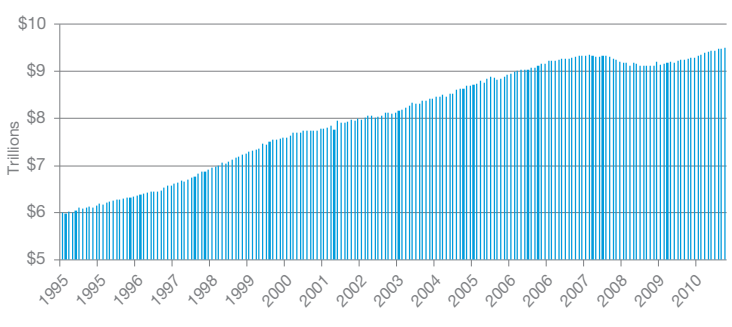
Even with all the stimulus that has been pumped into the economy over the last few years, growth remains sluggish with substantial headwinds. Currently, the Fed projects GDP growth to pick up for the remainder of the year, but the risk of this forecast is to the downside.

Total Nonfarm Payrolls



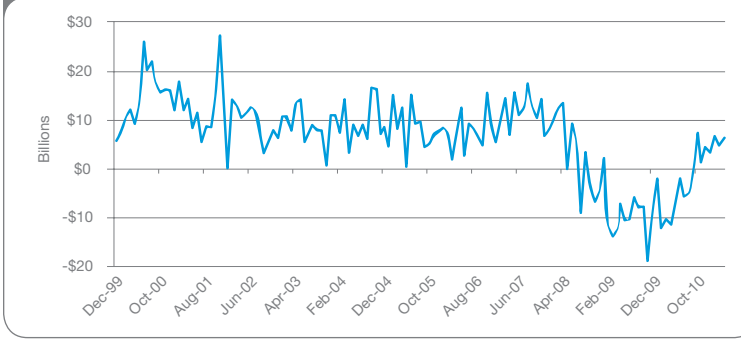
Payrolls have turned decidedly positive, although the pace of growth remains lower than needed to keep unemployment steady. Uncertainty in the business environment combined with increased efficiencies are holding back any significant recovery.

Personal Consumption Expenditures



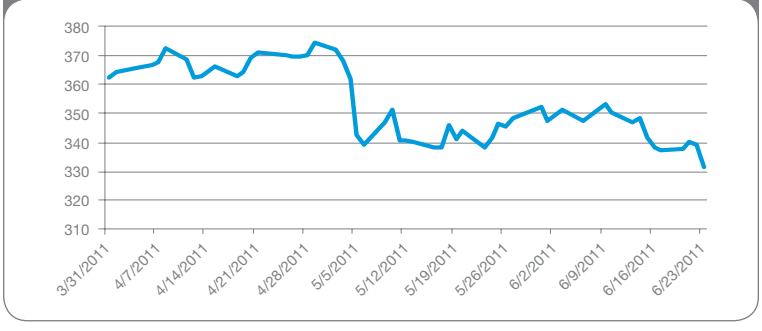
Consumption has solidly resumed its upward trend, but is failing to regain the original trend line. If it weren't for the recession, consumption would be as much as $1 billion north of where they are today. It's as if many consumers and business owners are waiting for such a recovery, and are not adjusting to accept today's "new economy."

Growth in Consumer Credit



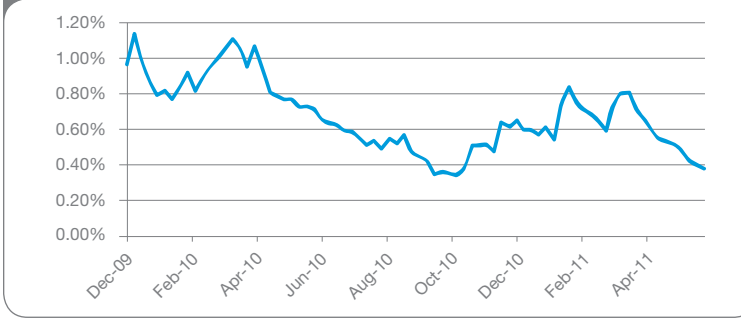
Recent consumer credit growth is more than entirely attributable to growth in student loans. For many, returning to school may be a good strategy given the long-term nature of today's employment challenges.

CRB Index



After riding a wave of growth for two years, it seems commodity prices are taking a breather. During the quarter, the CRB index dropped nearly 10 percent driven primarily by oil prices. China import activity seems to dominate price action.

Two-Year Treasury Yield



The spike in yields during the first quarter is a distant memory as the curve continues to grind lower. The two year Treasury reached a record low at the end of the quarter as the Fed provided no indication that higher rates are on the horizon.

Source: Bloomberg and SVB Asset Management

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