Silicon Valley Bank
A Member of SVB Financial Group

Fourth Quarter 2011 Economic Commentary

Recognizing Marginal Utility

Though some 27 years old, the term "foodie" is being heard more and more recently. The term refers to people who love food and seek out interesting and new places to indulge this passion. In the last year after moving into our new offices, our asset management team developed quite a few foodies due to the improved dining choices in our new location. But even foodies can get too much.

The so-called "law of diminishing marginal utility" tells us that increasing the consumption of one product while retaining constant consumption of other products creates a decline in the marginal utility derived from each additional unit.

At times, I enjoy chocolate with a glass of wine after dinner. Each additional piece of chocolate, however, is not as satisfying as the first. When I reach for the next piece, thoughts of the downside of such indulgence grow and eventually offset the pleasure of consuming it.* The Fed is now experiencing something similar.

After dropping rates 500 basis points, expanding its balance sheet in three episodes by $2 trillion and suggesting it may keep rates low until mid-2013, the marginal utility of Fed tools is decreasing.

At each step, market and economic reaction has decreased and last month's decision to "twist" was a piece of chocolate that did not taste good.

The Federal government is a massive and intertwined part of our economy — this fact, few will deny. But relying on one agency, the Fed, to bring about a turn in activity from the greatest recession on record does not seem logical.

Instead, it is time for the rest of Washington to notice the economic malaise and work together to resolve some of the challenges we face. This was the message sent by extreme market volatility after the debt ceiling discussions.

For all the vitriol S&P received after downgrading the U.S. government, I find one statement in their analysis very compelling. After stating the obvious reasons for downgrade, such as growing debt dynamics and difficulty in resolving the debt ceiling, they go on to say:

"More broadly, the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges…."

Whether or not you agree with the downgrade (I don't), it's difficult to argue that there is stability and predictability — much less effectiveness — in economic policymaking today.

A focus on uncertainty is dominating business and consumer decisions these days. My favorite search engine returns over 97 million hits for the phrase "uncertainty in business" versus just 24 million for "certainty in business."

Not knowing or understanding the rules of the game is driving both business and consumers to the sidelines and no amount of Fed "twisting" or reduction in so-called IOER will increase clarity.

It's time the "Feddies" turn their focus on the remainder of D.C.

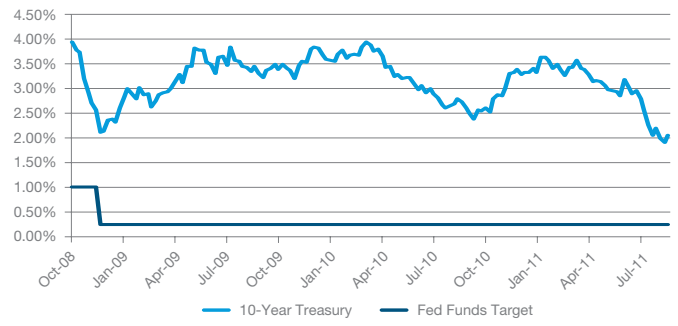
Joe Morgan, CFA
Chief Investment Officer
SVB Asset Management

**The dilution of my marginal utility of wine, however, is much less than chocolate for some reason.*

Charting the Course

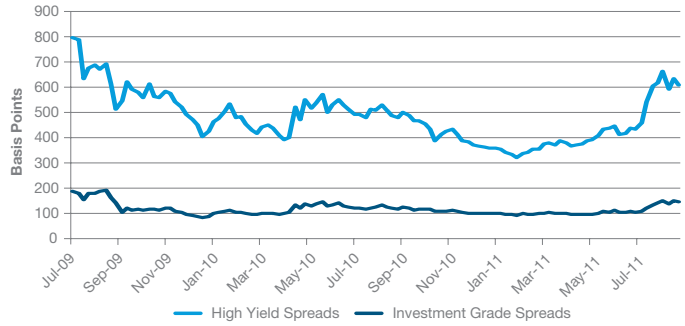
In recent months, the Fed has made it very clear that it feels it is doing its part for the economy. In August's Jackson Hole speech, Bernanke called on lawmakers to do their part as well. From a fiscal perspective we agree that less bickering and more solution-oriented action is required for an economic recovery to arise. While the Fed is not out of bullets, they are now working with a pea-shooter as compared to the opportunity for the rest of Washington to provide greater clarity and stability for consumers and businesses alike.

Benchmark Borrowing Yields Remain Low



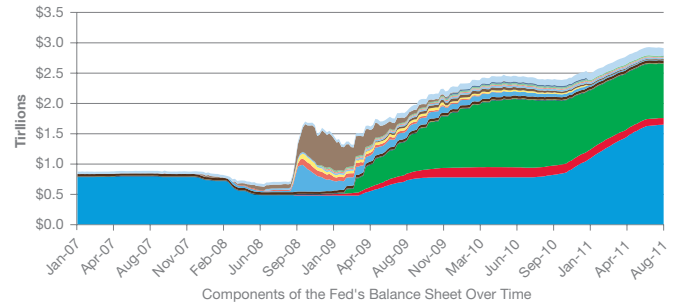
The 10-Year Treasury is the primary benchmark borrowing yield and has remained low since the onset of the liquidity crisis in 2008. The Fed has focused efforts to keep the Treasury curve low and flat in order to make it more economical for businesses to borrow and expand.

Corporate Borrowing Costs are Misbehaving



Slowing recent economic data combined with increased challenges in Europe and the prospect of lower stimulus spending are increasing corporate borrowing costs relative to 10-year Treasuries. The Fed has kept this genie in a bottle for some time, but eventually consumers and investors will need to gain confidence in a potential recovery.

The Fed's Balance Sheet as a Tool



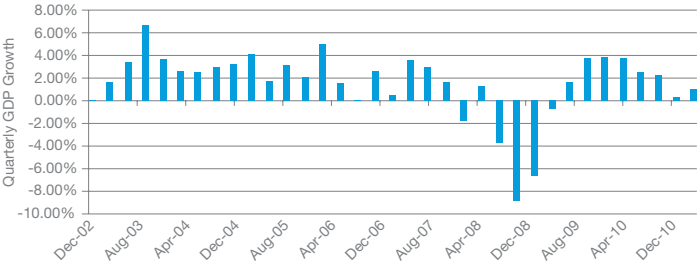
Like never before, the Fed has leveraged its own balance sheet to both bail out systemically important institutions and attempt to drive economic activity. Most recently, The Fed has been adding Treasury securities (blue) in lieu of mortgage securities (green).

Source: Federal Reserve and SVB Asset Management

Inflation Expectations Sinking

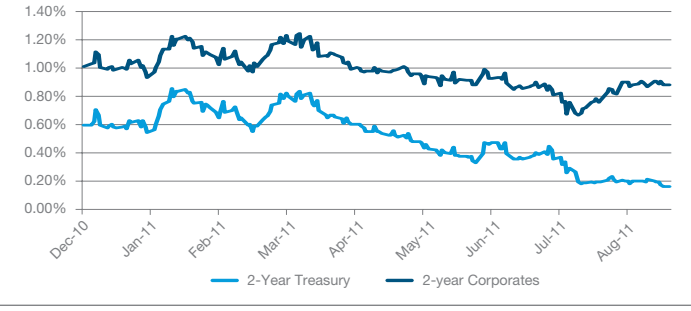
The 5-year TIPs spread is a good indication of current inflationary estimations as it represents the difference between Treasury adjusted and true fixed rate securities. Expectations are on their way back down after rising through much of the year as investors predict a significant economic slowdown.

Growth Revised Downward



Due to significant revisions to economic data, growth for the first half of the year was revised down from 1.9% to 0.7%. Also, significant revisions further back show activity in late 2008 and early 2009 were much weaker. We are a long way from steady growth at even 2%.

Corporate Bonds Look Attractive



As outlooks have dimmed, not only have corporate bond yield spreads widened, but raw corporate rates have actually increased around 20 basis points. This added yield is significant viewed through the lense of a Fed "likely" on hold until mid-2013.

Source: Bloomberg and SVB Asset Management

SVB Asset Management
555 Mission Street, Suite 900
San Francisco, California 94105
866.719.9117
service@svbassetmanagement.com

©2011 SVB Financial Group.® All rights reserved. SVB, SVB> and SVB>Find a way are all service marks of SVB Financial Group. SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value. B_SAM-11-11739. 0911-0255. Rev. 10-05-11.