Observation Deck

Tipped Off

Minh Trang, *CFA, Portfolio Manager*

In the latest FOMC meeting, the Federal Reserve commented again that they felt inflation is contained and the recent rise in energy prices was "only temporary." With that backdrop, it is expected that committee members will maintain their accommodative monetary policy until stronger economic data emerges. The market, however, may not necessarily believe that inflation will remain benign given the excess amount of liquidity in the financial system. One clue into investor mentality is looking at the trading levels of TIPS.

The U.S. Treasury has been issuing TIPS, or Treasury Inflation Protected Securities, at record negative yields in recent months as investors are willing to purchase these securities at a substantial premium. Recent five-year and 10-year TIPS are trading at a negative yield of 1.15 percent and 0.31 percent respectively.

The way TIPS work is fairly simple. Unlike the typical Treasury bond, these securities are adjusted to the Consumer Price Index (CPI) and will benefit from inflationary movements. An increase in the CPI will translate into higher principal and higher interest payments. Since inception in 1997, these securities have grown to an outstanding market cap of about $750B. The spike in demand and growing popularity among TIPS investors stems from the fear that the Federal Reserve directive to maintain an extended low rate environment will spark greater consumer price volatility in the future.

Though TIPS are fully guaranteed by the U.S. government against default, they are not without risks. An investor could experience a negative return if deflation occurs or inflation underperforms, especially when some of these securities are already trading at such steep premiums. And like most other fixed income instruments, TIPS are also susceptible to losing value if real rates rise. Given that these investments are generating relatively low levels of income, the cushion against potential negative returns is thinner than years past. With five-year Treasury rates at 0.84 percent, the breakeven between a regular Treasury bond to TIPS is about two percent. This inherently means that investors are expecting an inflation rate of at least two percent to compensate for the negative yield purchase cost.

The primary gauge that the Federal Reserve uses to measure inflation is the Personal Consumption Expenditure core rate (PCE). Policy makers have an implied target at approximately two percent, and their numerous actions over the last several years are meant to boost the economy and avoid a deflationary spiral. To the latter goal, they have been successful in driving up the PCE year-over-year rate from 0.9 percent at the end of 2010 to the current level of 2.0 percent.

What some market participants now fear is that it may be difficult for the Federal Reserve to reverse its accommodative strategy quickly enough to avoid substantial inflation in the economy. Though there is some credence to that apprehension, the growing demand for these inflation protected securities – which has driven yields negative – may be tipping towards an excess.

Markets

Treasury Rates

3-Month	0.09%
6-Month	0.14%
1-Year	0.18%
2-Year	0.26%
3-Year	0.38%
5-Year	0.81%
7-Year	1.33%
10-Year	1.92%

April Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.02%
ML 12-Month Treasury	0.05%
S&P 500	-0.63%
Nasdaq	-1.40%

Source: Bloomberg, as of 04/30/2012

Economic Vista

Paula Solanes, *Portfolio Manager*

The economic recovery is showing signs of slowing down. The surprising number this month was the March non-farm payroll which came in under expectations of 205K at 120K. The lower number is attributed to a correction after three months north of 200K job growth, largely due to an unusually mild winter across the country. The additional 120K figure did not meet economists' expectations and falls short of the approximate 150K needed just to keep pace with population growth.

Home sales continue to be the soft spot in the economy. Sales of previously owned homes fell for the third time in the last four months, dropping to an annual rate of 4.48M from a rate of 4.6M, a 2.6 percent decrease. Continued foreclosures, strict lending standards and lack of price stability all impacted home sales. On a more positive note, the median price of a previously owned home climbed 2.5 percent from last year.

Another bright spot, retail sales increased close to three times what economists projected coming in at 0.8 percent. Eleven of 13 categories showed an increase, indicating that the increase in retail sales was broad-based. Items such as cars, furniture, clothes and electronics contributed to the strong retail figure.

Finally, first quarter GDP came in at 2.2 percent, below the forecast of 2.5 percent. The GDP number reflected the most robust consumer spending figure in more than a year, which was clouded by a smaller contribution from business inventories. Last quarter's GDP also had the strongest homebuilding contribution in two years.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

With the slew of U.S. corporate earnings releases on the way, large U.S. banks reported improvement for the first quarter 2012 earnings. However, revenue levels are still below pre-crisis levels. Net profits continued to be supported by reserve releases instead of a more solid revenue growth as asset quality broadly improved. While the capital levels are expected to trend higher due to regulatory requirements, banks that have received regulatory approval from the Fed are expected to increase the shareholder policy towards share repurchases or dividends. While this would be a credit negative, payout ratios are expected to be lower compared to historical average from 1999-2006, according to a Barclays research report.

Many major banks are under review for downgrade or have negative outlooks from Moody's. This rating action will impact 114 European Financial Institutions and an additional 17 banks and securities firms based on exposure to global capital markets operations. Moody's stated that the rating actions are expected to occur in May and June and the ratings of some banks might be downgraded by up to three notches. There seem to be signs that the market has weighed in on these uncertainties. In anticipation of more stringent regulatory environment and rating actions, many large banks have been taking actions to reduce their short-term funding dependency and finding other more stable alternative sources of funding. Going forward, regulatory uncertainty remains the major hurdle for strategic opportunities at the banks. As of March 2012, a total of 225 Dodd-Frank rulemaking requirement deadlines have passed with only a third that have been met with finalized rules.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

April was relatively quiet in the fixed income market as company earnings are making more headlines than both the U.S. and European economy combined. The two-year Treasury rallied as weaker than expected earnings caused equities to sell off and prompted an investor flight to quality. Corporate spreads remained flat while two-year industrial names are approximately 25 basis points cheaper than same tenure Treasuries. Within the same maturity, financial issuers, however, are 25-45 additional basis points wider. In the 2a-7 money fund world, the benchmark one-year curve, EDSF, remained at 0.50 percent for the entire month, with spreads flat. Minus 15 basis points for industrials and +5 for financials. However, there was a bit of tightening in the credit sector as six-month commercial paper yields decreased by roughly five basis points to an average of 40 basis points. With the second LTRO providing liquidity to European banks, the need for short-term funding via commercial paper has waned.

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

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