

# Observation Deck

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## “Governments” or “Agencies”?

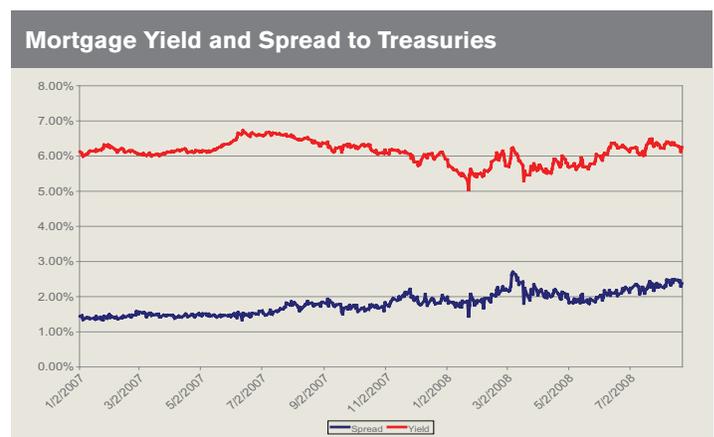
Joe Morgan, CFA, Chief Investment Officer

An agent is a person or business that acts on behalf of another entity. In the case of Fannie Mae and Freddie Mac (let's call them the “the twins” for expediency's sake), that “other entity” is the U.S. government. Founded in 1938, Fannie Mae was part of Roosevelt's New Deal and was charged with providing liquidity to the mortgage market. For 30 years this entity held a monopoly on the secondary market until Freddie Mac was born in order to provide some level of competition. Even then, these entities were truly governments.

It was not until both organizations issued stock in 1970 that they became “agents” of the U.S. government due to the fact they now had to answer to shareholders who, oddly enough, are focused on earnings. Then, the race was on as other private lenders entered the mortgage market creating intense competition even as the twins held an assumed government guarantee.

Fast forward to today and we see a mortgage market that is not functioning, and at the same time, a government urging the twins to grow. Most other mortgage lenders have either gone bust or exited the business as evidenced by the fact government agencies have accounted for over 90 percent of mortgage issuance year-to-date. This compares to just 45 percent in 2006 and 62 percent in 2007.

As the chart (to the right) shows, the yields on mortgages have hardly budged since the Fed began cutting short-term interest rates last year. This is because the twins now have no competition and potential borrowers must bend to their will. If Congress raises the maximum loan amount associated with



Source: Bloomberg, SVB Asset Management

the twins' guarantee, the twins slap a fee on such loans thereby making the loan more expensive for potential borrowers.

You can now begin to see where the agency problem arises. Management of the twins is caught between pleasing regulators, who can exercise strict control over their activities, and pleasing their owners who are concerned about tempering loan growth in these difficult times. Which would you choose?

This situation has added to the arguments of those in favor of wiping out the shareholders and taking the twins into the government once again. In this scenario, the twins could ignore or at least devalue the goal of being profitable and focus on activities directed at reinvigorating the mortgage market as a whole.

Once competition returns to the landscape, the yield spread versus Treasuries will shrink, driving down mortgage rates relative to other yields in the marketplace. Capital will once again flow to potential home buyers, but hopefully in a more manageable fashion than before.

Of course, the mortgage market will look and feel much different than it ever has in the past as the alphabet soup of off-balance-sheet conduits will have to be replaced by something a lot less risky. But that has to happen anyway.

In any case, healing the mortgage market is going to take time, measured in quarters, if not years. It is difficult to see the U.S., and perhaps even the global economy, recovering until the American consumer can return to his primary skill — spending. In turn, we will not reach this point until some stability returns to the mortgage market. Recovery in 2010? Or will it be 2011?

### Markets

#### Treasury Rates

3-Month	1.71%
6-Month	1.95%
1-Year	2.16%
1-Year	2.37%
5-Year	3.09%
10-Year	3.81%

#### August Total Returns

ML 3-Month Treasury	0.16%
ML 6-Month Treasury	0.21%
ML 12-Month Treasury	0.28%
S&P 500	1.45%
Nasdaq	1.92%

Source: Bloomberg, as of 08/31/08

## **Economic Vista**

Ninh Chung, *Portfolio Manager*

The U.S. economy grew at a 3.3 percent annual pace in the second quarter thanks largely to a jump in exports, but second half growth will face strong headwinds. Challenged by falling home prices and tighter credit standards, consumers are expected to curtail personal spending. Although crude oil prices have fallen since their peak in July, consumers will not reap this benefit for several months due to the lag effect.

Sales of previously owned homes rose unexpectedly by 3.1 percent in July to an annualized rate of 5.0 million units; however, further drilling into the data reveals a less rosy picture for the housing sector. While this is the second increase in sales in three months, foreclosed properties made up at least one-third of the sales data. Additionally, the median price tumbled by 7.1 percent over the past year and existing inventory now represents an 11.2 month supply.

The Fed's preferred measure of inflation, core personal consumption expenditure (PCE), increased by 0.3 percent in July and rose by 2.4 percent over the past year. Historically, the Fed has stated a comfort range of 1.0-2.0 percent for core PCE and would raise overnight rates to keep this inflation measure in check. Recently however, the Fed has paused on raising rates in fear of dragging the economy deeper into a recession and anticipates that the economic slow down would ease inflationary expectations. Thus far, declines in commodity and crude oil prices have validated the Fed's view. The question remains—how much longer the Fed can stay on the sidelines?

## **Credit Vista**

Melina Hadiwono, *CFA, Head of Credit Research*

The current credit crisis has impacted financial markets and the U.S. economy substantially, and not without repercussions to other parts of the world as well. Economic momentum is decelerating in Europe at varying speeds, and while it is to a lesser extent, Japan's economy is slowing as well.

Emerging markets are holding strong, partially supported by high commodity prices. However, they could come under pressure if commodity markets suffer, or if world aggregate demand deteriorates faster than anticipated. Housing-related declines are the primary theme of the growth slowdown in the major markets, including the U.K., Ireland and Spain. The U.S. housing correction, well into its second year, has yet to stabilize.

The housing market appears to have exerted a significant drag on bond and equity markets worldwide. The second wave of credit losses is already spreading through banks' loan

portfolios, including consumer lending. On the other hand, revenue strength, asset divestitures, regulatory moves and capital-raising have been the positive side. Unfortunately, to date, capital raised continues to lag behind banking losses.

Credit conditions remain a challenge as banks tighten their lending standards. Forward-looking credit metrics based on outlooks and ratings on CreditWatch show that ratings for firms with a negative bias are elevated; this foretells future downgrade pressures as the economy continues to weaken. Going forward, a bank's ability to raise capital will be essential in keeping its ratings unaffected. In response to the difficult credit environment we have experienced since third quarter 2007, we have removed a large number of financial issuers from our approved issuer list. We continue to invest in high-quality, non-financial issuers and selected financial issuers. Finally, we remain vigilant to ensure we are able to react quickly to credit events.

## **Trading Vista**

Minh Trang, *CFA, Portfolio Manager*

The two-year Treasury note experienced some volatility during August as market participants reacted to the Fed's decision to hold rates steady. Over the last several weeks, market expectations for Fed rate hikes have steadily declined. The two-year Treasury yield ended the month at 2.367 percent, after starting at 2.495 percent. Lower yields were also influenced by oil prices dropping below \$113, after hitting \$145 in July. Corporate issues in this term traded from 75 to 150 basis points over two-year treasury yields, while agency spreads remained wide at around 90 basis points over. The government-sponsored enterprise (GSE) solvency discussion has continued to be a daily headline in the financial markets, and has kept agency levels at historically wide spreads.

The yields on the front end of the curve were more stable as one-year LIBOR held around 3.05 percent throughout August. Higher quality industrial corporate notes traded between minus 15 to 5 over LIBOR, while financial issues remained wider from 15 to 50 over. Three-month commercial paper traded at about 2.70 percent and three-month agency discount notes decreased by 2.49 percent. As the right opportunities arise, we will continue to take advantage of these levels.

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