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Observation Deck

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Capital Injections Pumping Up Wall Street

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In recent months, many financial institutions have been forced to write down their subprime and other investments as the valuations for these securities have steadily declined. The scale of the write-downs has affected the perceived strength of these institutions; however, in response, many savvy investors have come to the rescue, pumping billions of dollars into the sector. In this article, we review both the level of losses taken on Wall Street along with the capital injections that followed.

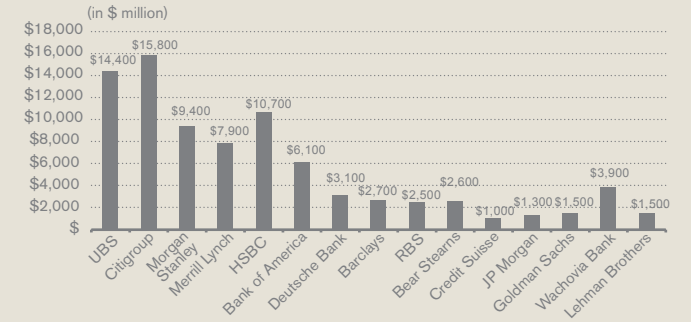
Considering recent downgrades and heightened scrutiny by rating agencies, these firms are pressured to maintain adequate capital reserves as the value of their assets decrease. So far this year, roughly $97 billion of mortgage-related securities have been written down. While there is a very high probability that we have not seen the last dollar reserved for loss we feel there is reason to remain positive about the financial sector.

Responding to these losses, many financial firms have scaled back share repurchases and restructured operations to help mitigate the problem. Companies have also looked to raise capital to further shore up their balance sheets in these troubling times. Just as there has been a steady stream of liquidity injections by federal governments into various global economies, a number of Wall Street firms have benefited from their own capital infusions, which have totaled over $52 billion to date.

Capital injections have proven to be an important source of funds to help remedy some of the devaluation of mortgage assets and to provide more cash for business growth. These additional funding sources range from foreign government entities to the public issuance of preferred stock. An example of the former is the state-run China Investment Corporation's $5 billion investment into Morgan Stanley for a 9.9 percent stake in the company. Cash injections have also come from other sovereigns, such as Singapore and Abu Dhabi. In addition, financial institutions have tapped into the equity markets to gain an extra cash boost. Freddie Mac sold $6 billion in preferred stock in late November to help strengthen its capital base. Similarly, Fannie Mae successfully raised $7 billion through preferred issuance. Both offerings were comfortably oversubscribed.

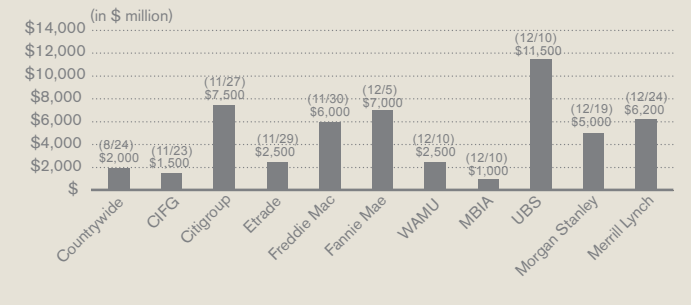
The strong demand for such issuance and the continued interest from various institutions in providing capital infusions have helped offset some of the fiscal duress that many financial firms are experiencing. It's expected that the liquidity strain and write-downs will continue until these distressed securities are thoroughly flushed out of the economic system. For now, the ability of these companies to raise capital through different sources has alleviated some of the pressure. The injections have been more than just cash, they have also been an injection of confidence. The expectation is that this, along with market-driven

Confirmed Investment Write-Downs Through 12/31/07



Source: Bloomberg, SVB Asset Management

Capital Infusions Through 12/31/07



Source: Bloomberg, SVB Asset Management

Markets

Treasury Rates	
3-Month	3.24%
6-Month	3.39%
2-Year	3.05%
5-Year	3.44%
10-Year	4.02%
December Total Returns	
ML 3-Month Treasury	0.28%
ML 6-Month Treasury	0.29%
ML 12-Month Treasury	0.22%
S&P 500	-7.86%
Nasdaq	-3.12%

Source: Bloomberg, as of 1/02/08

measures, such as dividend cuts and cost-cutting programs, will help carry companies past the current liquidity crisis.

We recommend conducting a regular thorough review of your investment portfolio as a means of assessing the risk profile of your assets and your investment policy. Your portfolio manager and portfolio advisor welcome the opportunity to discuss current market conditions and your portfolio details at your convenience.

Economic Vista
Ninh Chung, *Portfolio Manager*

The anticipated slowdown in consumer spending has not come to fruition as personal spending rose by 1.1 percent in November against consensus of a 0.7 percent increase. Additionally, the October spending figure was revised upwards from 0.2 percent to 0.7 percent. With November spending representing the biggest gain in more than two years, the discussion of an economic recession should be put off — at least for another month.

The Federal Reserve's preferred measure of inflation, core personal consumption expenditure, rose by 0.2 percent for a second month. On a year-over-year basis, the core PCE rose by 2.2 percent, which is above the Fed's established comfort range of 1.5 to 2.0 percent. The acceleration in inflation could give the Fed reason to pause on further rate cuts, although the risk to economic growth seems to outweigh the risk to inflation.

In an attempt to directly inject liquidity into the market, the Fed and other central bankers introduced the Term Auction Facility (TAF) with which depository institutions can bid for term funds with a broader range of collateral than its traditional open market operations. The first auction resulted in a 28-day term loan of $20 billion at 4.65 percent. A total of 93 bidders participated in the auction. Another $20 billion auction at 4.67 percent completed the year for the Fed. Time will tell if this will be one of the Fed's preferred tools for influencing interest rates.

Credit Vista
Melina Hadiwono, *Manager of Credit Research*

The close of 2007 saw continued volatility in the credit market. We expect that market nervousness will remain strong and that uncertainty and a continued repricing of risk will likely keep volatility elevated for some time. Financial firms are getting support from the Fed's liquidity injections through rate cuts and loan auctions as well as from third-party capital infusions. Despite these efforts, the rating agencies have been actively issuing downgrades on a number of financial firms while putting others on credit watch. Most of the negative rating actions stemmed from the write downs that some firms have taken regarding their mortgage related assets.

In addition, the plan to orchestrate the SIV bailout in the form of Master-Enhanced Liquidity Conduit (M-LEC) has been abandoned. In many cases, the banks that were supposed to sell assets to the fund have instead decided to bite the bullet and move the assets onto their own balance sheets, alleviating a key rationale for the rescue fund. In doing so, these banks allow the SIVs to continue pursuing their current orderly asset-reduction plan and stave off further potential losses and forced sales.

While it is a good sign that these banks have decided to resolve the issue immediately, the action may pose another challenge for them in terms of their capital management. To put this into perspective, the average Tier 1 capital ratio for 30 debt-issuing banks has declined from 9 percent in 2006 to 8.5 percent as of 3Q07 which is still a healthy level. The decline was mostly due to dividend payment and share buyback programs — which averaged approximately 40 percent and 20 percent respectively, of net income over the last several years. Going into 2008, as the financial firms are faced with a continued liquidity crunch, we expect that these firms will be more conservative with share buybacks and dividend payouts which may enhance their loss-absorption capacity.

Trading Vista
Hiroshi Ikemoto, *Money Market Trader*

LIBOR remained inverted throughout the month, with the peak in the 3-month area at 4.70 percent and sloping downward to 4.22 percent in the 1-year. Treasuries rallied as Bear Stearns and Morgan Stanley reported their first ever quarterly losses (and with other financial institutions reporting less than stellar earnings). One-month Treasury bills were yielding 2.92 percent and the 2-year was at 3.05 percent at year-end. With the anticipation of more write-downs in the new year, we expect continued volatility.

During much of the month, top-tier commercial paper rates followed the LIBOR curve with yields hovering at 5.15 percent to 5.20 percent in the 30 to 40-day area and at 4.80 percent going out three months. Spreads on one-year financial bonds widened to plus 50 bps to LIBOR and two-year bonds were at plus 180 bps to the Treasury. However, non-financials tightened up, with one-year spreads at plus 10 bps to LIBOR. Though we still do not see stabilization in the credit environment in the near future, we remain confident in the ability of bond issuers on our approved list to meet their upcoming liabilities.

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