

# Observation Deck

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## Finding Value in a Low Yield Environment

Minh Trang, CFA, Portfolio Manager

As hopes have risen that the U.S. economy is nearing a recovery, investors' appetite for higher-yielding securities has returned. This, combined with an aggressive monetary stimulus from the Federal Reserve and the numerous Treasury liquidity programs, has created an environment where agency and corporate yields have also declined significantly in the latest quarter.

Though the flight to quality has kept Treasury yields at historic lows throughout the year, the yield on other asset classes has declined considerably in recent months, resulting in an ever-shrinking risk premium. In particular, agency and short-term commercial paper spreads have narrowed from their high of last fall. One- and two-year agency debt is currently yielding 0.59 percent and 1.27 percent respectively, while Treasury notes are paying 0.47 percent and 1.11 percent over the same term. As for credit debt, top-tier six-month commercial paper is yielding 0.40 percent compared to six-month T-bills at 0.25 percent.

Over the past year, the risk premium for holding agency debt over Treasuries in the one- and two-year space has averaged 56 and 43 basis points, respectively. Obviously, the current spread level of 8 and 17 basis points is at an historic low. The same is true for six-month commercial paper, where the spread has averaged 98 basis points and now stands at 9 basis points over comparable Treasuries. Even money market funds have been affected by such shallow margins. According to Crane Data, Treasury institutional funds are yielding 0.03 percent. There is a slight improvement in government agency funds, averaging 0.10 percent, while prime funds are paying about 0.26 percent.

### Markets

#### Treasury Rates

3-Month	0.18%
6-Month	0.25%
1-Year	0.47%
2-Year	1.11%
3-Year	1.59%
5-Year	2.51%
7-Year	3.14%
10-Year	3.48%

#### May Total Returns

ML 3-Month Treasury	0.02%
ML 6-Month Treasury	0.08%
ML 12-Month Treasury	0.12%
S&P 500	7.55%
Nasdaq	7.86%

### Yield Spreads to Treasury



Source: Bloomberg

The dilemma that investors now face is a question of relative value. This proposition includes not just the asset allocation mix, but also how to use the mix along the curve. For example, in the money market space, there is substantial value in moving into AAA prime funds versus Treasury or even agency funds, given the difference in yield. This move can provide a more competitive return, while maintaining the same liquidity profile. Further down the curve, however, the value proposition differs somewhat. Though the allocation to agency and corporate debt in an existing, diversified portfolio may have contributed to better performance in prior months, the prospects for further improvement are limited. The narrowing spreads, however, do provide for other options. One opportunity, of course, is to realize possible gains in these positions and enhance portfolio credit quality by switching into Treasuries.

In the end, a prudent investor must carefully weigh the risk-to-reward trade-off between staying in a risk-free asset as opposed to obtaining higher returns through other allocations. Using an active portfolio management approach can help to take advantage of relative value between different types of investments over varying maturity terms, as well as take advantage of opportunities in a volatile yield market. The current conditions of stable inflation, greater investor confidence, and strong government involvement have decreased the risk premium for now. There will be a time when the environment is different and spreads will widen, and another strategy will be needed.

We recommend you confer with your investment advisor before incorporating any investment strategy. For an additional resource on active management, please refer to our recent article, "Corporate Cash: Putting it to Work," at [www.svbassetmanagement.com/pdfs/SAM\\_ADVCorpCash\\_0709.pdf](http://www.svbassetmanagement.com/pdfs/SAM_ADVCorpCash_0709.pdf).

## Economic Vista

Ninh Chung, *Portfolio Manager*

The U.S. economy contracted at a slower than forecasted 1 percent annual pace in the second quarter, compared with market expectations for a larger 1.5 percent decline. Inventory investments subtracted 0.8 percentage points from overall economic activity, plunging by \$141 billion. Consumers pulled back in their spending, which fell by 1.2 percent and subtracted 0.9 percentage points from overall growth. Finally, government spending jumped by 5.6 percent with both defense and nonfederal spending climbing higher, the most since 2003.

The pace of economic contraction slowed in the second quarter—but future recovery could be muted without the consumer leading the way as unemployment continues to weigh on discretionary spending. The unemployment rate is expected to top 10 percent and to remain high for the next few years, according to the Federal Reserve's revised forecast. With a 26-year high in unemployment, currently at 9.5 percent in June, the Fed predicted the jobless rate could reach as high as 10.1 percent, sharply higher than previous forecast of 9.6 percent.

## Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

While the economy is still contracting, confidence in the U.S. banking system has been bolstered since April by better-than-expected earnings results, a successful stress-testing exercise, a commitment by the U.S. government to stand behind the 19 largest banks, and a series of bank capital-raising that occurred without need for government backing. At the same time, banks still face major losses and there are too many risks and uncertainties to consider the banking sector to be on the rebound. The sector remains heavily dependent on the government (including systematic liquidity support moves, accounting changes, regulatory forbearance and securitization support) resulting in transfer of risk from the private to public sector. The banking system will need to manage the transition to an operating environment where explicit support is withdrawn and replaced with tighter regulation, while generating sufficient earnings to offset the credit loss. Banks will also need to address the important challenge of rolling over a significant amount of maturing short-term debt, and extension of the funding-maturity profile, at reasonable cost between now and 2012, when the federal debt guarantee program expires.

In spite of recent capital raisings by banks, there is a need to ensure adequate capital levels going forward. Future capital needs will also be determined by the viability of securitization, as well as newly proposed regulatory reform, which requires

an undetermined amount of additional liquidity and capital buffers for banks. Recent standards, FAS 166 and FAS 167 from the Financial Accounting Standards Board, and International Accounting Standards Board proposals, are expected to bring many off-balance sheet securitizations back onto bank balance sheets, and will result in additional capital needs or a reduction in earnings as lending activities contract. As explicit government support is withdrawn, it is crucial to see whether the confidence of customers and counterparties can be sustained in banks in the face of extended losses in 2009 and potentially 2010. Until there is clear evidence of sustained economic recovery, the financial sector's ability to generate sufficient earnings to offset credit losses, strengthen capital and maintain investor confidence will remain the key question.

## Trading Vista

Hiro Ikemoto, *Money Market Trader*

The month of July was probably the quietest since the credit crisis started in late 2007. The two headlines that woke the market from its doldrums were CIT—with its possible bankruptcy—and Ben Bernanke's testimony that benchmark rates will stay low. This caused Treasury prices to rally as the two-year yield went from the high 1.01 percent to the 0.90 percent range during the third week of the month. However, with the majority of corporate earnings beating estimates, money sitting on the sidelines started its migration to equities, causing Treasury yields to increase across the curve by month-end.

The two-year Treasury note finished the month at 1.11 percent, the one-year T-bill at 0.47 percent, six-month T-bill at 0.25 percent and the three-month at 0.18 percent. Agencies remained very tight to Treasuries, as yield pick-up was 2 to 10 basis points above Treasuries. One-year high-grade industrial bonds remained within the range of minus 20 to plus 10 basis points to LIBOR, while financial issuers were in the range of plus 20 to 150 basis points. Industrial corporate bonds maturing within two years were trading 15 to 50 basis points better than Treasuries and 70 to 200 basis points better than financials. 90-day commercial paper yields ended the month at 0.28, approximately 10 basis points lower than the previous month.

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