

Observation Deck

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The End of Government's Assistance?

Melina Hadiwono, CFA, *Head of Credit Research*

On May 7, 2009, the Federal Reserve released the results of its "stress test" on the 19 largest U.S. banks. The goal of the test was to ensure that the banks have enough capital to withstand losses under severe economic conditions. Another goal was to help restore investor confidence in the banking system. Projected losses in the scenario tested were \$600 billion over two years, and as a result, the government required 10 of these 19 banks to raise a total of \$75 billion in additional Tier 1 capital. The market reaction to these tests has been generally positive, as it is generally believed that the banks will be able to raise that amount of new capital. In fact, as of May 21 almost \$60 billion had already been raised (or was in the process) through stock or asset sales. When completed this will be a combination of new capital, preferred exchanges, and business unit divestment. It remains to be seen how long the equity market will remain open. By June 8, these 10 banks will need to submit a capital plan that must be implemented by November 9, 2009.

We view this government decision to provide concrete numbers for the general public to see as a good first step toward the eventual recovery of the banking industry. If the

stress test eases concerns about bank solvency and helps banks to raise capital independent from government aid, then it is a step towards addressing the central issue: the housing market. However, the quality of the capital raised is of particular importance to us. The total amount of new common equity estimated to be added as the result of the test is rather modest at around \$40 billion, which is less than 10 percent of the tangible common equity of the 19 banks. This is an important distinction as only the new capital adds to the subordination supporting bank bondholders.

Although the estimated two-year losses of 9.1 percent of loan portfolios is high (slightly higher than the historical peak loss years of 1930), certain assumptions on losses, revenue estimates, unemployment and house prices, while plausible base cases, are not as severe as some have projected. If too optimistic, the Fed faces a loss of credibility as these same banks are forced to raise further capital than the Fed anticipated. In addition, this stress test is still just a model. We have all seen our assumptions change radically over the past two years. The model's assumptions face the same risk.

While some of the recent economic data could be viewed as "green shoots" of recovery, we don't expect major bank profitability to return to a robust level any time soon. The market needs to show steady improvement in bank asset-quality indicators for several quarters, and sustainable revenue growth in different business lines, as well as stability in unemployment trends, consumer spending, and home prices. In the meantime, we anticipate continued market volatility and headline risk in the financial sectors. With our client objectives of principal safety and liquidity in mind, we continue to recommend relatively high liquidity positions primarily by overweighting select money market funds. We continue to invest in high credit quality non-financial issuers, and selected financial issuers with a limit of around 3 percent of invested assets in any single issuer. With the evolving market risk and board perspectives of the past few quarters, expect continued direct communication on your portfolio options.

Markets

Treasury Rates

3-Month	0.13%
6-Month	0.28%
1-Year	0.44%
2-Year	0.92%
3-Year	1.40%
5-Year	2.34%
7-Year	3.05%
10-Year	3.46%

May Total Returns

ML 3-Month Treasury	0.01%
ML 6-Month Treasury	0.04%
ML 12-Month Treasury	0.07%
S&P 500	5.59%
Nasdaq	3.47%

Source: Bloomberg, as of 5/29/09

Economic Vista

Ninh Chung, *Portfolio Manager*

The Conference Board's index of leading economic indicators suggests the recession could end later this year. The index, which points to the direction of the economy over the next three to six months, increased 1 percent in April, for the biggest gain since November 2005. With the unemployment rate approaching double digits (currently at 8.9 percent) and benefit claims totaling 6.66 million, actual recovery may be tempered.

Minutes from the April 28-29 Federal Open Market Committee (FOMC) meeting were released on May 20 and the committee noted there were signs that the pace of contraction was slowing, although near-term economic recovery would be modest. The committee also expects that unemployment would remain elevated and inflationary pressures to remain subdued, attributed largely to the low level of capacity utilization. Should the pace of recovery become sluggish, several members reaffirmed their commitment to expanding the Fed's balance sheet.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

Following the federal government's bank stress test, debt and equity issuances kept coming at a rapid clip. Major banks have been able to issue non-Temporary Liquidity Guarantee Program (TLGP) debt in five- or 10-year tranches. Investment grade, non-financial sector new issuance continued to be robust with nearly all deals oversubscribed and priced at the high end of the range or beyond. There appears to be more optimism with regard to the Term Asset-backed Securities Loan Facility's (TALF's) ability to reignite the securitization markets. Despite the cautiously optimistic view coming back into the financial markets, there are still long term-uncertainties for the U.S. banking sector. The financial industry continues to face challenges presented by different trends such as the increase in regulatory oversight, greater focus on capital adequacy, the uncertainty about the market demand for preferred stock or hybrid securities, and the heightened importance of franchise stability.

For example, on the regulatory front, a new array of legislation and regulatory changes are designed to increase consumer protection, at the expense of the banks, such as credit card reform. The credit card "bill of rights" will require lenders to apply payments to balances with the highest interest rates first, prohibit increasing a consumer's rate on existing balances based on late payments to other lenders (universal default),

and provide better disclosure on the interest amount and time required to pay off the balance. The bill also prohibits "arbitrary" interest rate increases and requires the issuer to periodically review and decrease a rate if indicated by the review. It also would mandate 45 days notice before raising rates and would prohibit retroactive increases on existing balances unless a consumer was 60 days late with a payment. The issuer will also be prohibited from increasing rates in the first year and teaser rates would be required to last at least six months. While these changes are positive for consumers, the limitations on repricing risk will impact the profitability of the banks, especially monoline card issuers. This change is occurring while issuers are reeling from record default rates. Recent S&P data on credit card performance shows that the 8.8 percent peak in credit card losses in March 2009 was the largest ever, well above the 7.3 percent level reached in the 2001–2002 recession.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

Bonds in the short-end firmed up in May as three-month LIBOR slid 34 basis points to a record low 0.66 percent. LIBOR, which is used to set borrowing costs on about \$360 trillion of financial products globally, is usually an indicator on the strength of the credit market. However, the drop has been fueled this month by surging customer bank deposits, as much as increased confidence among banks. Deposits at U.S. banks are up almost \$400 billion since December 2008.

Industrial high-grade corporate bonds have maintained their spreads of minus 20 to plus 10 to the curve, which would equate to 0.65 to 0.85 percent for one-year maturities. Three-month commercial paper issues were being offered at 0.30 percent by month-end, with six-month maturities in the 0.40 to 0.50 percent range.

Even with the supply increasing in May, Treasury bills were relatively unchanged for the month with the three-month yielding 0.13 percent, six-month at 0.28 percent and the one-year at 0.44 percent. Because of limited issuance in May, agency spreads remained tight to Treasuries, with agency discount notes picking up only 2 to 10 basis points against Treasury bills.

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