

SVB Asset Management Economic Commentary

This commentary is authored by SVB Asset Management's Portfolio Management Team.

Thoughts From the Desk

We held a positive view of the economy through much of 2007. Looking forward, it seems the jobs market could deteriorate significantly, putting more downward pressure on housing and driving us toward recession in late 2008.

However, should LIBOR continue to decline, potential investment spreads could widen enough to encourage investors to reenter the housing sector softening today's housing decline and creating the potential to avoid recession.

The fourth quarter brought a new round of concerns along with aggressive Fed action, but we have certainly not turned the corner yet. In fact, we believe the economy will remain on the decline until the Wall Street wizards can find a way to finance the housing sector going forward. The fourth quarter saw the first step in this process as financial firms began taking massive write-downs and sought out capital injections as discussed in this month's *Observation Deck*.

We expect more to come in the form of homeowner defaults and the resulting slowdown in overall economic activity that market participants have been anticipating for over a year now. Through 2007, SAM retained a positive outlook for consumer spending simply due to Americans' penchant for shopping. However, now that we are through the holiday season and consumers will soon receive their credit card bills, we believe there is a very good chance they will back away from the cash register in force.

Simply put, time is running out for the Fed and Wall Street to solve the current market crises.

While we believe the financial sector will eventually survive with flying colors (from a bond investor's perspective, anyway), 2008 will be a rocky road that will include more downgrades of credit quality, more charge offs vs. earnings, and more restructuring of business lines. At the end of the day, however, financing the \$21

trillion housing market provides too many potential fees to be ignored and the rocket scientists on Wall Street will find a way to mine those fees, providing plenty of home financing in the process.

ECONOMIC DATA

In the third quarter, gross domestic product (GDP) spiked at 4.9 percent, increasing the year-to-date average to 3.1 percent, just below its long-term average. Employment growth remained positive throughout the year with nonfarm payrolls growing on average 111,000 per month. In addition, measured inflation has been contained, though slightly above the Fed's presumed long-term goal of 1.5 – 2.0 percent.

So where is all the fuss coming from? The all-important housing market, of course. New home sales have fallen more than 50 percent from their peak in July 2005, and prices, while difficult to get reliable data, are certainly headed downward. Inventories of homes are at an all-time high as financing has dried up for all but the most credit-worthy of borrowers. Economic concern going forward stems primarily from the hit—or even perceived hit—consumers will feel from the difficulties in the housing market.

MONETARY POLICY

The Fed continued to address credit and liquidity concerns as documented in the table on the next page. Throughout the second half of the year, the markets

Federal Reserve Actions

August 17: Cut discount rate by 0.50% in a special FOMC meeting after three-month LIBOR rocketed to a high of 5.58%, gaining 0.22% in five trading days.

September 18: Cut both the discount and Fed funds rate by 0.50% and shifted outlook from risk of inflation to risk to growth.

October 31: Cut both the discount and Fed funds rate by 0.25% and stated concern over recent increases in energy and commodity prices.

December 11: Cut both the discount and Fed funds rate by 0.25% and stated the outlook for inflation and growth is "uncertain".

December 12: A new "Term Auction Facility" (TAF) is introduced with the goal of more directly affecting the funding costs of financial firms.

remained convinced the Fed was behind the curve in providing liquidity. Fed funds futures have been steadily predicting deeper interest rate cuts than the Fed has provided. Today, with the Fed Funds rate at 4.25 percent, the markets are predicting rates will be cut to at least 3.5 percent by the end of the first quarter in 2008.

Some market pundits are now focused on the new Term Auction Facility (TAF) to help provide liquidity. The TAF is a joint effort by the Fed and four other central banks to lend term funds in auction form with the hope of putting downward pressure on LIBOR—the rate most tied to funding costs of the financial community. While we believe this new Fed tool could be quite useful, it will require greater participation and enthusiasm from the markets than the first two auctions received in December.

MARKET ACTION

Treasuries were once again the belle of the ball as investors continued their rush toward a "risk-free" investment strategy. One-year Treasuries returned an annualized 20 percent in the fourth quarter, closely followed by 6-month and 3-month Treasuries which produced annualized

returns of 17.7 and 13.4 percent, respectively. Of course, the bulk of this return came in the form of price movement which will not be realized by hold-to-maturity investors. Short-term corporate bonds came under pressure early in the 4th quarter, but non-financial holdings regained their footing and ended the quarter yielding a respectable 4.25 percent. Financial corporates, which make up about 75 percent of the short-term bond market, traded more thinly than in the past and some highly rated issuers ended the quarter north of 5 percent in yield terms.

SAM MARKET STRATEGY

We expect recent volatility to continue as more financial firms realize losses and execute restructuring plans. However it does feel as though we have seen the worst of it as further downgrades in the sector should slow. While relative value points toward the riskier sectors, SAM is focused on retaining our clients' principal and have been allowing portfolios to shorten organically by reinvesting maturing funds primarily into very short-term commercial paper and CDs or other overnight investments.

Looking ahead, it would take a dramatic turnaround in the economy and housing markets to encourage further risk-taking by extending portfolio average maturities using financial sector corporate bonds. We do not expect the markets to be in this situation in 2008. It is more likely 2008 will be a year of protecting capital and providing liquidity. We realize the high expectations our clients have for us in this regard and will work to protect their principal while seeking market-plus returns going forward.

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