

July 6, 2009

Second Quarter 2009 Economic Commentary

Thoughts From the Desk

Hope and optimism grew through the second quarter as the Nasdaq returned 20.3 percent, while the broader S&P 500 returned 15.9 percent. Other risk markets followed suit, including the junk bond market, which returned a whopping 23.1 percent. Many consider the current solid market rally as an indicator that the economy is moving in the right direction. Certainly investors seem to be voting for a recovery.

However, we must consider the extreme technical influences centered around massive amounts of cash sitting on the sidelines. According to the Investment Company Institute (ICI), there is close to \$4 trillion in money market funds at present compared to a more typical level of \$2 trillion. We believe investors have no desire to leave this extra \$2 trillion on the sidelines and are looking for any excuse to return into the risk markets.

Should a couple hundred billion be thrown into the stock market today, one can imagine the stress that would occur. Having blown out most potential sellers over the last several months, prices necessarily would ratchet upward in order to fill those orders.

Seeing no substantive change in the economy at this time, we believe this situation is the cause of the market's current rally. Eventually, investors will realize this to be the case, and prices will settle and then drift downward. That is, until the next mini-tsunami of cash crashes onshore.

The economy continues to deteriorate, though at a slower pace than earlier this year. It feels as if we're nearing the bottom of a riverbed and will then begin our journey to the upward slope on the other side. The problem is not knowing where the other side is or how to get there.

With today's massive government spending and investment programs, it seems logical someone in Washington would have laid out a master plan by now that will get us to the other side. However, it would be political suicide for politicians to acknowledge that it will take four or five years for the economy to recover. No elected official wants to bear this bad news, even though it is necessary if a long-term plan is to be communicated.

So we await some strength of leadership on the economic side to outline a plan showing how and when we will emerge from today's doldrums. Indeed, simply selling such a plan could turn consumer and investor confidence around, which is at least half the battle.

Economic Data

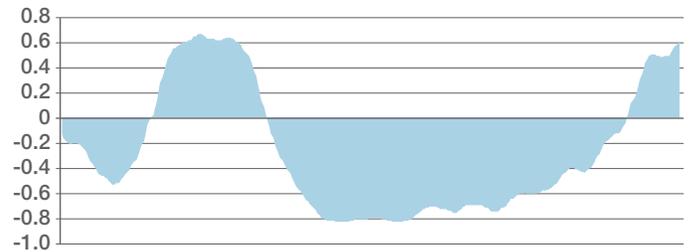
Consumer spending during the quarter seems to have held its ground despite the deterioration of the jobs market. But the issue here is one of expectations. Today, we are about \$200 billion off the long-term pace of consumer spending and there is no discernible evidence that we can return to our previous pace. In fact, with the securitization markets remaining at a near standstill, consumer lending continues to tighten even as the Fed inflates its balance sheet.

Existing home sales can be a good barometer of the economy, since most recent home purchasers tend to spend money on ancillary items and services such as landscaping and new refrigerators. This measure has held fairly steady over the last two years even as the mortgage well has dried. Further deterioration could lead to increased instability of the overall housing sector and another round of decreased investor and consumer confidence.

It is our fear that the recent and growing trend of joblessness will cause this to occur in the second half of 2009. Of the 5.7 million jobs lost (through May) in this downturn, 64 percent occurred in the last six months. In fact, the unemployment rate has risen 71 percent in the last 12 months, which is the sharpest spike since 1958's 90 percent increase. We don't believe most investors understand how this will affect the economy in coming quarters and are concerned their outlook is too optimistic.

As if this weren't enough good news, at least one indicator is showing the market losing faith in the Fed as an inflation fighter. In the nearby chart, we can see the long-term correlation between stock prices and bond yields has turned positive. One can interpret this to mean that higher bond yields merely portend higher asset prices (such as stocks). The negative correlation during the prior 20-year period implied inflation was not a concern as higher yields were simply an added cost of doing business as opposed to a reflection of higher asset prices. Should the Fed lose this credibility in widespread fashion, higher inflationary expectations would stall the productivity miracle Greenspan made famous.

10-Year Correlation Between the S&P 500 and the 5-Year Treasury



Source: Bloomberg, SVB Asset Management

Monetary Policy

Today, monetary policy is about the supply of money, rather than its price. In fact, very little thought is given to the regular FOMC meetings with regard to possible interest rate information, while most investors clamor for information regarding such new measures as the size of the Fed's balance sheet, disbursement of funds under the stimulus package or the potential for a third stimulus package.

In any case, money transactions are slowing, bringing the velocity to near zero. If investors and consumers lack confidence in a long-term outlook, they will hoard cash and other forms of liquidity no matter how much money is injected.

Because injections are coming from both the Treasury and the Fed, it will be very difficult to rein in these programs as the economy struggles to recover. The punch bowl will need to be taken from the party a bit early in order to keep inflation in check. An independent Fed can perform this function far from public political pressures, but the Treasury Department may have more difficulty during this time. Perhaps setting the stage for such activity, the Fed seems to be heading in this direction already, having trimmed back a few of its liquidity programs while extending others.

Market Action

The yield curve steepened significantly during the quarter as fear of deflation faded into history. Taking center stage was fear of inflation, but also fear of the unknown.

Two-year Treasury rates rose slightly from 0.80 percent to 1.11 percent, while ten-year rates rose from 2.66 percent to 3.53 percent. Typically, a steeper curve leads to recovery as banks become more willing to borrow short-term and lend long-term.

In addition, the cost of credit decreased as measured by the Merrill Lynch indices. Investment grade debt yields declined from 7.95 percent to 6.15 percent, while high yield debt dropped from 18.73 percent to 13.06 percent.

Investors took time in the second quarter to rebalance some of their cash back into the risk markets across the board. Correlations among the stock, high yield and other risk markets remain high, but a tremendous amount of cash is yet to be deployed.

We expect market volatility to remain high, if not increase, through the end of the year. Antsy portfolio managers at insurance companies and endowment funds will move prices around aggressively as they attempt to reenter the markets.

SVB Asset Management Market Strategy

Our investment strategy for SVB Asset Management clients has changed little in the second quarter. We remain focused on liquidity, holding some 50 - 60 percent of our individual portfolios in money market funds and have recently added a prime fund to our menu — the first since September. Lately, we have taken advantage of the steep yield curve by actively trading on behalf of our more risk-tolerant clients, given our view that short-term rates will remain stable at 0 - 25 basis points for the next several months.

Our non-government guaranteed corporate allocation remains small at around 30 percent, depending on issuer availability. At the present time, our credit team is comfortable only with about 20 issuers that actively trade in the marketplace. Given the team's incredibly skilled results — including not one dollar of lost principal or lost liquidity in this cycle — along with our view of a continued deterioration in the overall economy, we are comfortable remaining almost entirely on the sidelines until the fog begins to lift.

SVB  *Find a way*

SVB Financial Group

SVB Asset Management

185 Berry Street, Lobby 1, Suite 3000 San Francisco, California 94107 U.S.A.

Phone 1.866.719.9117 service@svbassetmanagement.com

This material, including without limitation to the statistical information herein, is provided for informational purposes only. The material is based in part on information from third-party sources that we believe to be reliable, but which have not been independently verified by us and for this reason we do not represent that the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation, recommendation to acquire or dispose of any investment or offer to engage in any other transaction.

SVB Asset Management, a registered investment adviser, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products offered by SVB Asset Management are not FDIC insured, are not deposits of other obligations of Silicon Valley Bank, and may lose value.

©2009 SVB Financial Group. * All rights reserved. Member Federal Reserve. SVB, SVB> and SVB>Find a way are all trademarks of SVB Financial Group. Rev. 07-06-09. 0709-0214