

Third Quarter 2008

SVB Asset Management Economic Commentary

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

Thoughts From the Desk

The \$700 billion bailout plan is designed to promote confidence in our financial system, but it will take several months before we know its effectiveness. The fear that has gripped the markets exceeds any prior episodes experienced in our lifetimes, and the government is attempting to provide a strong antidote. The question is whether removing these illiquid, unpriceable assets from the system will do the trick.

While we remain hopeful that this is a good step on the road to recovery, we also realize this is probably only step two of the current 12-step program we've initiated. Uncertain of future steps, we can at least see the necessary restructuring of Fannie Mae and Freddie Mac as the next debate to be had in Washington. Today, we hope for the best, but plan for the worst as we continue to protect our clients' assets from the current perfect storm.

Last quarter, we wrote that the markets and the economy were "transitioning," but that we were uncertain as to where we were headed. Today, we know. Trading in the credit markets has come to a standstill while economic indicators continue to trend downward, though not exactly at a blistering pace. Regardless of how we got into this mess, there is virtual unanimity, if reluctant, that government assistance is our only hope. While this feels like a final refuge, it also remains logical that the current bailout plan will — or should — work.

Unfortunately, even if the bailout does what it is intended, many will be disappointed. So much energy has been exerted in getting this bill passed that there is a perception it will affect both the economy and the markets in such a positive way that all our worries are over. This is certainly not the case.

The Emergency Economic Stabilization Act of 2008 is only directed at providing liquidity to the marketplace. In other words, the markets begin to function as if they were on September 12, prior to the Lehman bankruptcy. It will not solve the housing crisis. It will not boost the economy. It will not create a significant number of jobs. It is only an important step on a long road toward accomplishing these goals.

ECONOMIC DATA

The economy tottered along in the third quarter which began with high expectations of inflation due to severely elevated energy costs. According to the University of Michigan's consumer sentiment survey, American consumers had higher inflationary expectations early in the quarter than at any time in the last 26 years. This was potentially the first crack in the Fed's credibility as an inflation-fighter and the loss of this credibility

could conceivably do more damage to the economy than any temporary recession. Shortly into the quarter, however, oil corrected severely, dropping below \$100 per barrel from its \$147 high and focus returned to sluggish business activity and increasing layoffs.

Retail sales were skewed during the quarter by the Economic Stimulus Act of 2008, which provided cash in hand for millions of Americans who essentially went right out and spent it. Gross domestic product surged 2.8 percent after increasing just 0.9 percent in the first quarter. Most economists believe there was no carryover effect into the third quarter and in fact, the numbers look bleak, indeed.

The job market has held tough through the current downturn, until September. Job losses through August averaged just 75,000 per month in comparison to the 120,000 - 170,000 rate that is typically associated with recessions. However, the most recent month showed an increase to 159,000 jobs lost. This is an important statistic since most people who are being forced to sell their homes are in that position for some mortgage-related reason as opposed to loss of income. Should a trend of deep and consistent cuts in payrolls develop, the housing market could drop significantly even from these low levels as dual-income homes become single-income and these homeowners are forced to sell or abandon their abodes.

The bottom line is that while economic statistics have been marginally pointing toward recession, a decline in the job market from here will all but secure a deep recession if not depression in the overall economy as further wealth is eroded and economic stasis is presented.

MONETARY POLICY

The quarter began with the markets expecting the Fed to raise interest rates twice by year-end to 2.5 percent. Inflation fears ruled the roost, but the Fed was determined to hold steady believing a slower economy would eventually calm inflationary pressures. The Fed was proven correct and at the end of the quarter, the markets actually predicted a rate cut to 1.75 percent or even lower. In fact, the Fed cut rates by 50 basis points in early October in coordination with other central banks around the globe.

The Fed's balance sheet grew an astronomical 50 percent in the two weeks ended October 1. The \$503 billion expansion was driven by loans to foreign central banks via swap lines (+\$219 billion), loans to commercial banks to buy commercial paper supporting the money market fund industry (+\$152 billion), loans to broker/dealers via the primary dealer credit facility (\$+87 billion), loans to AIG (+\$33 billion), and discount window borrowings (+\$16 billion). No one can say the Fed is not trying to provide liquidity.

In addition to these measures, the Treasury is affecting monetary policy through the current bailout plan, essentially pumping up to \$700 billion of liquidity directly into the banking sector while removing some of the uncertainty behind the numbers on their balance sheets.

MARKET ACTION

Treasury rates dropped across the curve with the most severe declines in the very front end. Treasuries maturing within 30 days traded at the end of the quarter at yields only slightly above zero and stories circulated of investors buying Treasuries at negative yields, essentially paying the government to keep their money safe.

To say the credit markets "blew up" would be a severe understatement as yields on such venerable institutions as Morgan Stanley rose to more than 10 percentage points above Treasuries. Caterpillar issued \$1.3 billion in bonds late in the quarter, paying 320 basis points over Treasuries for its 5-year note, some 150 basis points higher than where their similar maturity securities were trading just six weeks prior. Nevermind that the company made an all-time high \$1.74 per share in the second quarter off of all-time high revenue. Buyers are simply difficult to find.

SVB ASSET MANAGEMENT MARKET STRATEGY

In September, we made the shift from prime money market funds that invest in corporate securities to Treasury and government money market funds for all of our clients. With fear feeding upon fear, we determined the appropriate move was to the sidelines — at least until the bailout plan was put in place and some solid market reaction can be seen. While we continue to believe that there are solid opportunities including 90-day commercial paper issued by the likes of Wal-Mart at 2.15 percent as of October 7, we also realize the liquidity of this paper after purchase is almost non-existent. It is our responsibility to preserve capital first, provide liquidity second, and only consider adding return third.

We are hopeful markets can recover to some reasonable level of confidence and activity soon, but our clients should also realize we plan to be late to the party. Only after we are confident in the markets' confidence, translating into an active secondary market for the generic securities we use — will we re-enter the markets.

Once again, our disciplined focus on safe investments has allowed us to protect the capital and liquidity of our clients. The conservative nature, of not only our strategies, but of SVB Asset Management as a trusted advisor, has enabled our clients to fully fund their business operations as planned without interruption their investment portfolios.

SAM PORTFOLIO MANAGEMENT TEAM

Joe Morgan, CFA, *Chief Investment Officer and Head of Portfolio Management*

Debi Hanson, *Portfolio Manager*

Ninh Chung, *Portfolio Manager*

Minh Trang, CFA, *Portfolio Manager*

SVB ASSET MANAGEMENT HEADQUARTERS

185 Berry Street, Suite 3000

San Francisco, California 94107

PHONE 1.866.719.9117

service@svbassetmanagement.com

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