svb Asset Management

Quarterly Economic Report

Inside views on economic and market factors affecting global markets and business health

Q4 2018

Economic Report: Q4 2018

Thoughts From the Desk

U.S. economic fundamentals continue to impress with growth rates surpassing the four percent handle, an all-time high in small business sentiments, and at-trend inflationary readings. As a result, front-end interest rates continue to gradually march higher while longer term rates held steady during the quarter. The Federal Reserve followed through with its policy normalization plan and lifted overnight rates by 25 basis points to a range of 2.00 to 2.25 percent. Furthermore, policymakers further slowed the pace of their asset purchase plan.

The impact of gradual increases in front-end interest rates has been a net positive for corporate cash investors as new cash and reinvestments benefit from higher yields while credit spreads exhibit strong performance across all sectors of investment grade issues. With higher rates and anticipation for more restrictive monetary policy, the strength of the U.S. dollar is weighing on dollar-linked currencies, particularly currencies of emerging markets. As foreign currencies weaken and policymakers attempt to stabilize their local currency through interest rate hikes, fiscal restraint or direct intervention, their economic activity could slow.

Back to U.S. markets. Investors will have plenty to digest, such as the latest on trade policy disputes with China, global central bank response to U.S. policies, increasing cost of funds resulting from higher benchmark rates and mid-term elections. Although an inverted yield curve has preceded previous recessions, zero interest rate policies and quantitative easing from other global central banks should fuel demand for U.S. Treasuries, despite recent surge in issuances. While headlines and speculation of the future of fiscal and monetary policies will surely affect markets in the short term, we will continue to focus on core fundamentals. We acknowledge the U.S. economy is in the late stages of this economic expansion; however, we are encouraged by the strong cash positions and net debt levels of investment grade issuers.

Domestic Economy

Overview

Domestic economy

The U.S. economy grew by 4.2 percent in Q2 2018, the highest increase in almost four years. Growth was propelled by consumer spending, nonresidential fixed investment, exports and government spending that were partially offset by lower inventory investment and residential fixed investment. Looking ahead, trade policy changes are expected to modestly affect growth and the effects of tax reform are likely to fade moving into 2019.

Consumer activity rebounded in Q2 with a 3.8 percent increase for the quarter. The strong job market combined with the benefits of tax reform has boosted consumer confidence.

The unemployment rate touched an almost 50-year low of 3.7 percent in Q3. The U.S. labor market continues on solid footing, adding an average of 205,000 jobs per month so far this year. Meanwhile, the labor force participation rate for 25 to 54-year-olds remains steady.

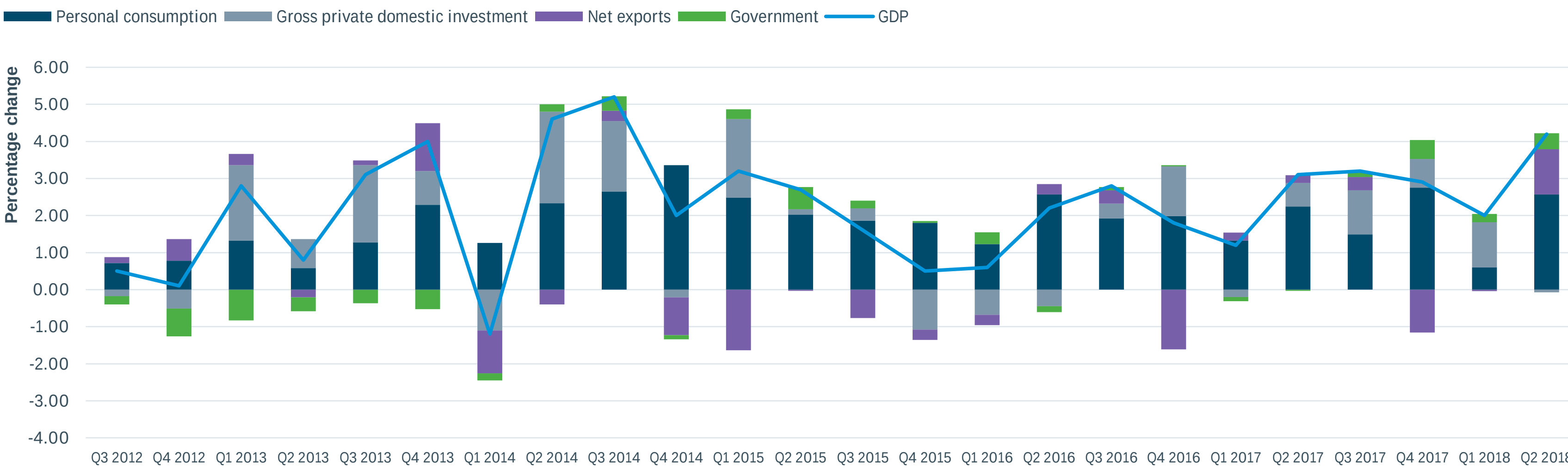
The housing market has taken a softer tone recently as climbing interest rates coupled with high home prices reduce home affordability and dampen homebuyer demand. Furthermore, home affordability will likely be under pressure as rates continue to rise.

Finally, all inflation measures are at or above 2.0 percent. The acceleration in inflation further supports the Fed's stance toward monetary policy normalization with a total of four interest rate hikes in 2018 and forecasts for three more interest rate increases in 2019.

GDP: Sustained strength, for now

The U.S. economy grew by 4.2 percent in Q2 2018, the highest increase in almost four years. Growth was propelled by consumer spending, nonresidential fixed investment, exports and government spending that were partially offset by lower inventory investment and residential fixed investment. Looking ahead, trade policy changes are expected to modestly affect growth and the effects of tax reform are likely to fade moving into 2019.

GDP and Components



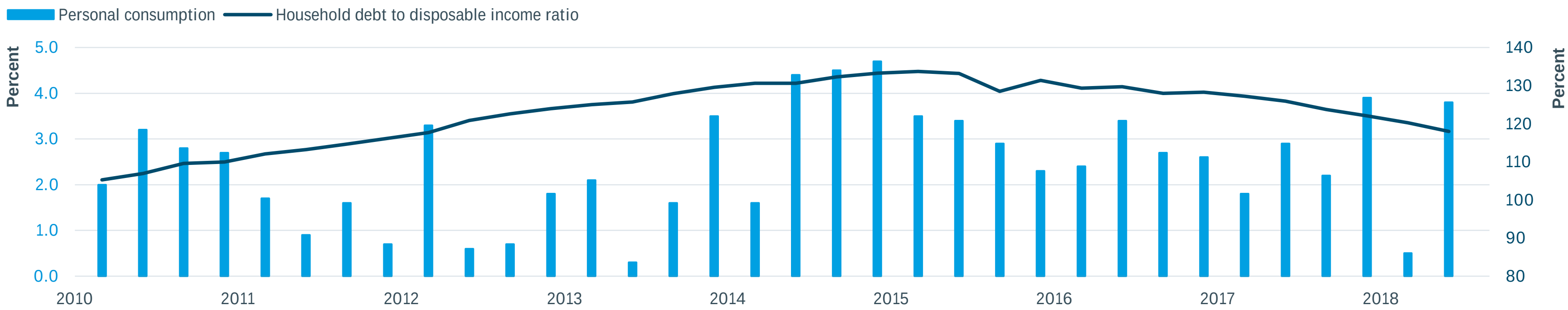
Source: Bureau of Economic Analysis, Congressional Budget Office and SVB Asset Management. Data as of 10/3/2018. GDP values shown in legend are percent change versus prior quarter, on an annualized basis.

1018-0241DMEXP093019

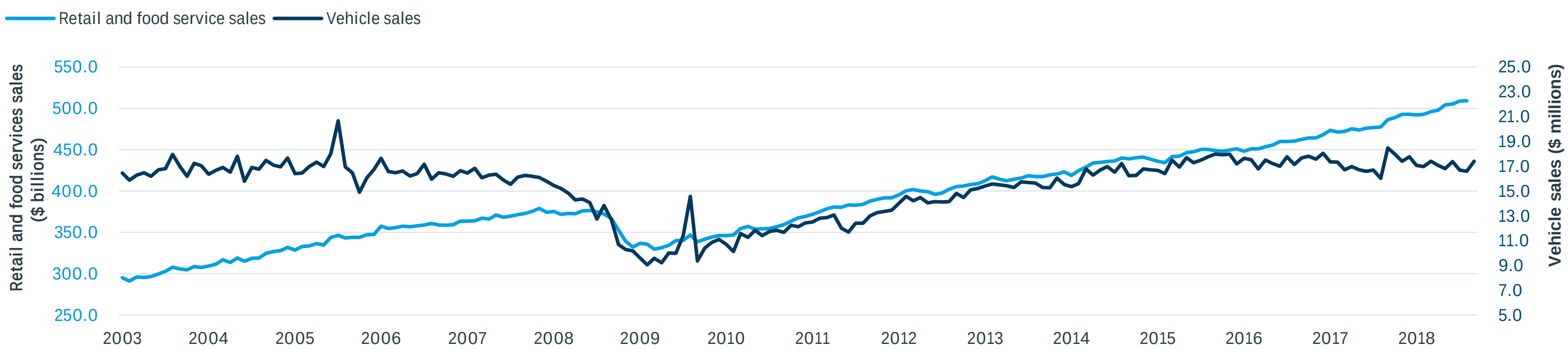
Consumption: The consumer rebounds

Consumer activity rebounded in Q2 with a 3.8 percent increase for the quarter. The strong job market combined with the benefits of tax reform has boosted consumer confidence. However, as the effects of tax reform wane, the consumer may pull back.

Consumption Overview



Retail and Food Services Sales

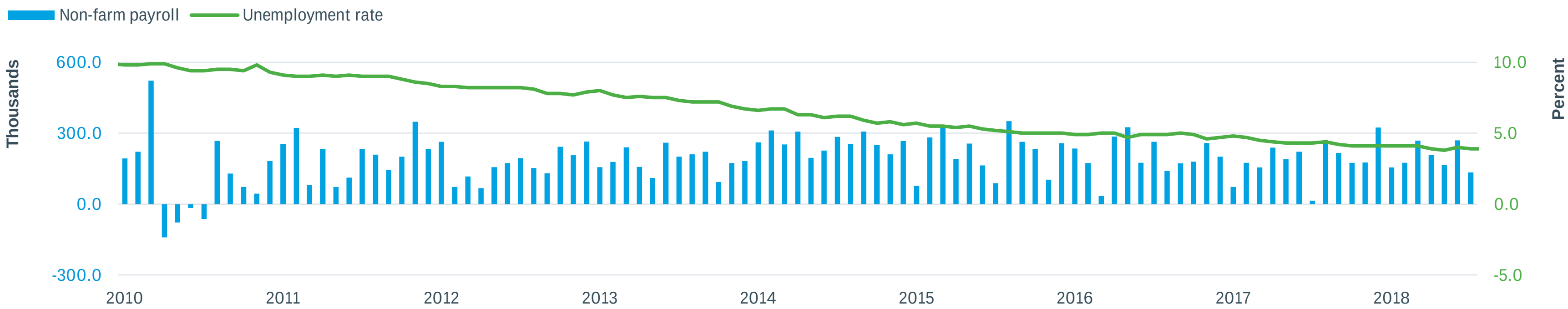


Source: Bloomberg and SVB Asset Management. Data as of 10/4/2018.

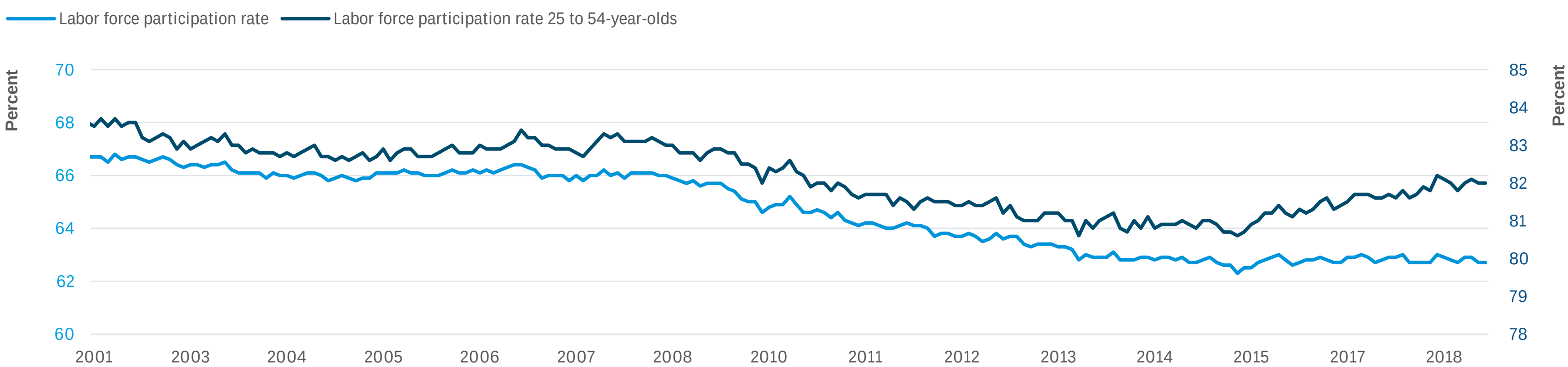
Employment: Touching lows

The unemployment rate touched an almost 50-year low of 3.7 percent in Q3. The U.S. labor market continues on solid footing, adding an average of 205,000 jobs per month so far this year. Meanwhile, the labor force participation rate for 25 to 54-year-olds remains steady.

Employment Landscape



Labor Force Participation

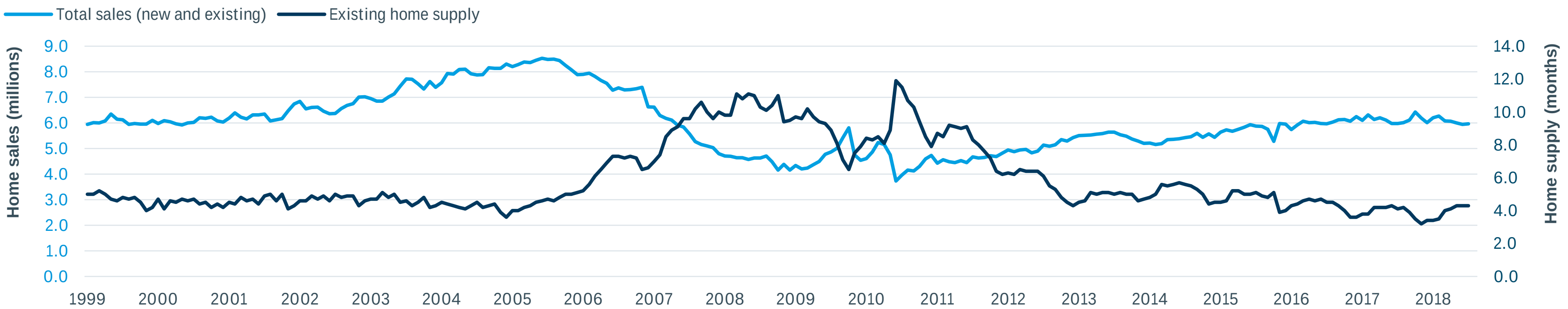


Source: U.S. Bureau of Labor Statistics, Bloomberg and SVB Asset Management.
Data as of 10/5/2018.

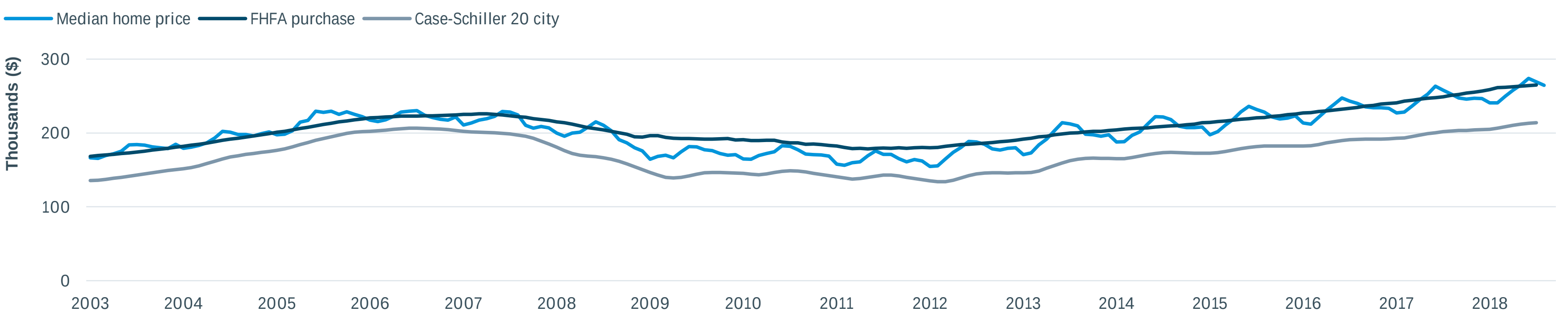
U.S. Housing: Softening

The housing market has taken a softer tone recently as climbing interest rates coupled with high home prices reduce home affordability and dampen homebuyer demand. Furthermore, home affordability will be likely under pressure as rates continue to rise.

Home Sales and Supply



Home Prices – Indexed to 100

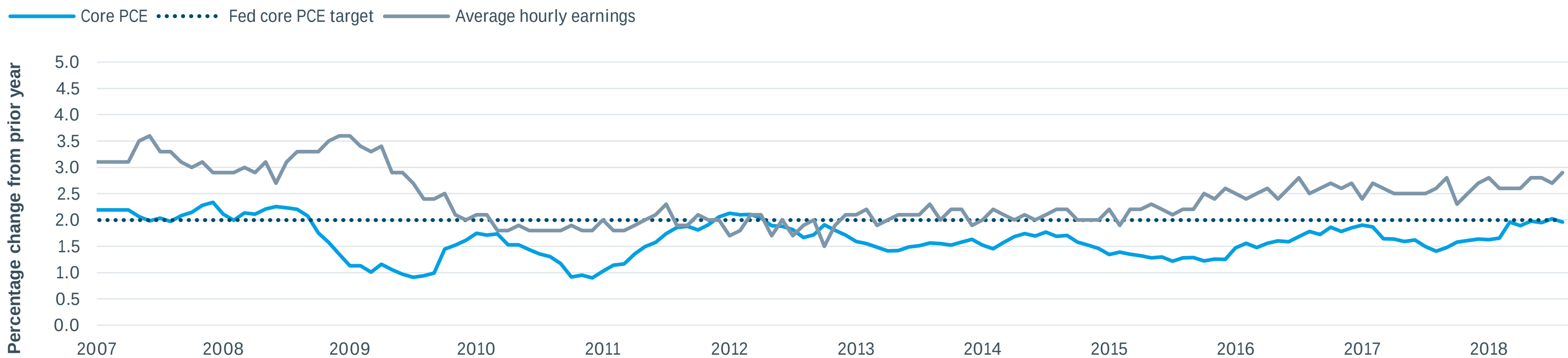


Source: Bloomberg and SVB Asset Management. Data as of 10/4/2018.

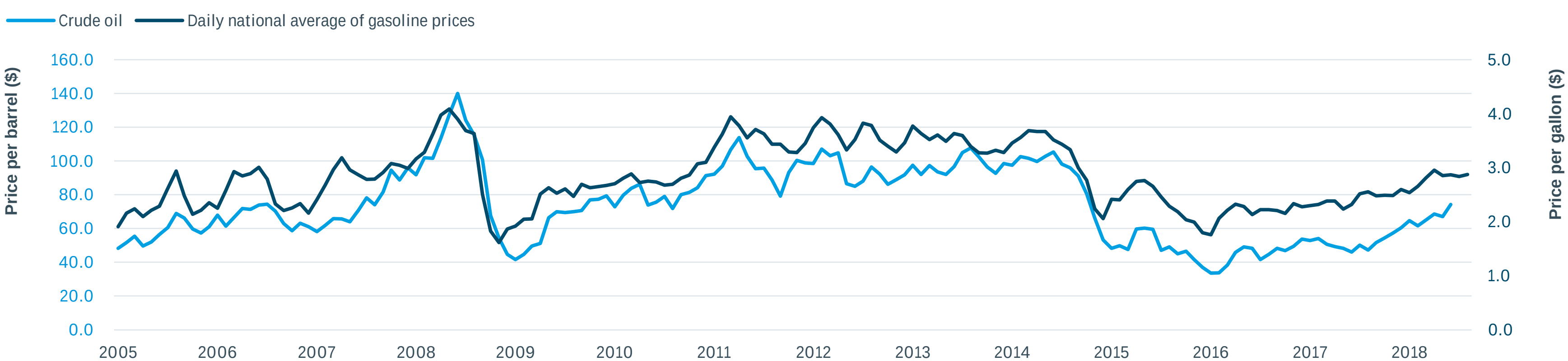
Inflation: Steady momentum

All inflation measures are finally at or above 2.0 percent. The acceleration in inflation further supports the Fed's stance toward monetary policy normalization with a total of four interest rate hikes in 2018 and forecasts for three more interest rate increases in 2019.

Core PCE at the Fed's Target with Wage Pressure Building



Oil Prices



Source: Bloomberg and SVB Asset Management. Data as of 10/4/2018.

Global Economy

Overview

Global economy

Economies across developed and emerging markets are experiencing positive growth, with few exceptions. Growth rates remain higher in emerging economies (EE) than developed economies, which are expected to grow in the low single digit range compared to the mid-single digit range for EE.

A stronger U.S. dollar, helped by fiscal expansion and monetary tightening, is putting pressure on economic conditions in some EE, as responses to falling local currencies have negative economic impacts. Continued U.S. dollar strength increases the risk of a surprise sell-off of EE currencies, which could result in policy actions that could slow economic growth. Falling EE currencies are also putting downward pressure on earnings for large multinational corporations, some of which rely significantly on EE for growth.

Recent changes in trade policies have not had a material effect on global economic activity. Negative revisions to economic growth will more likely come from the consequences of tighter monetary actions taken by central banks in both developed and emerging economies.

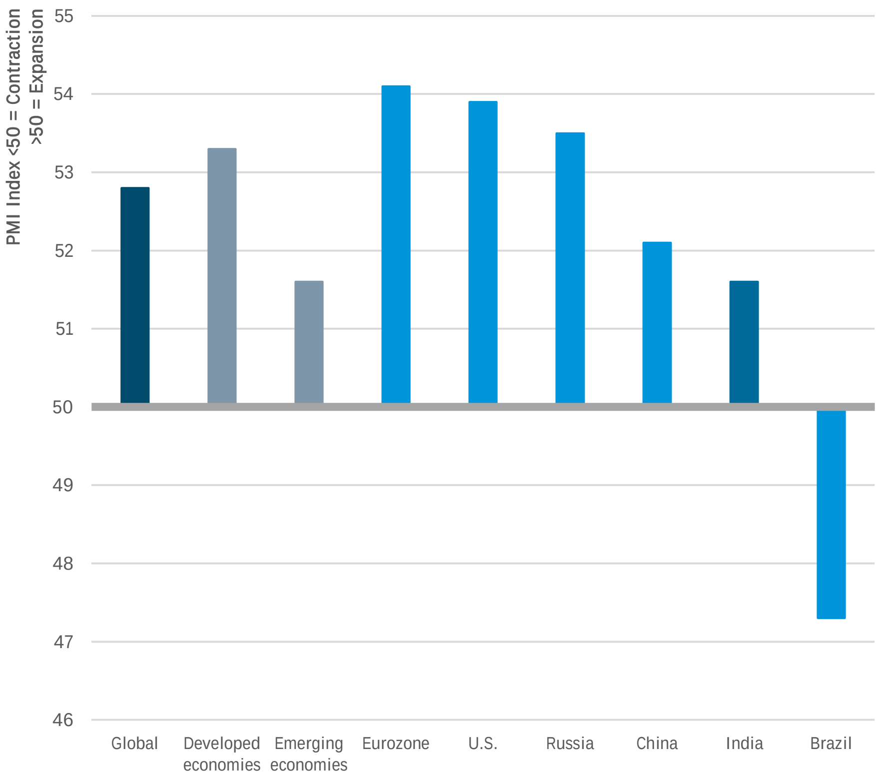
Even as some central banks have raised their benchmark interest rates, with others poised to take tightening measures, the U.S. dollar has remained strong and is expected to end the year with solid returns.

Global Growth Intact

The vast majority of countries continue to be in expansion mode despite some moderation in financial conditions, particularly in emerging economies (EE). Manufacturing and service activity have been solid this year. Even with tempered outlooks for next year, most economies are still projected to experience positive growth in 2019.

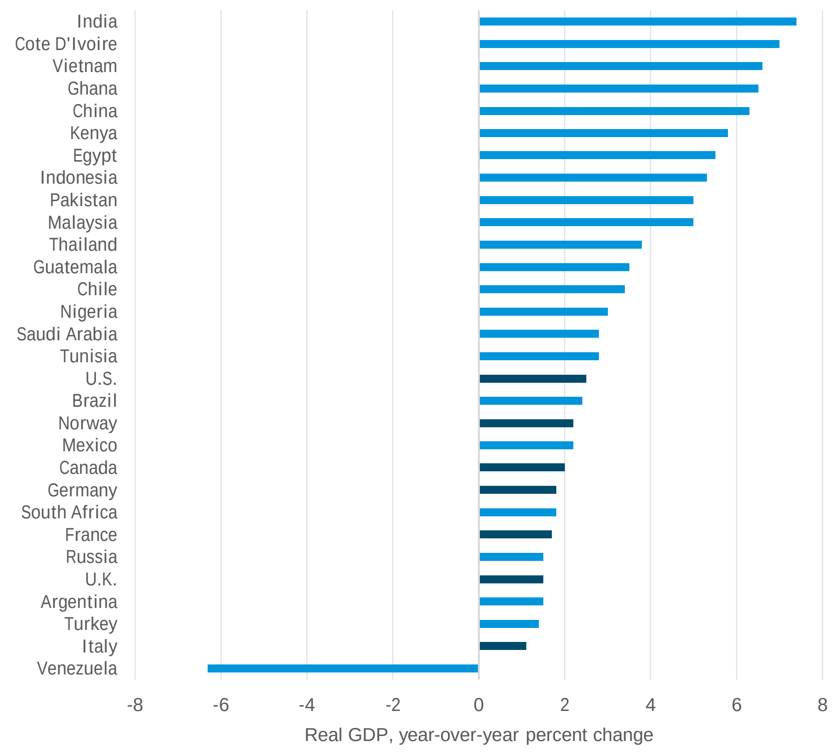
Global Economy in Expansion Mode

Composite PMI Indices - September 2018



Growth Forecast for 2019

2019 Median GDP Change Estimates



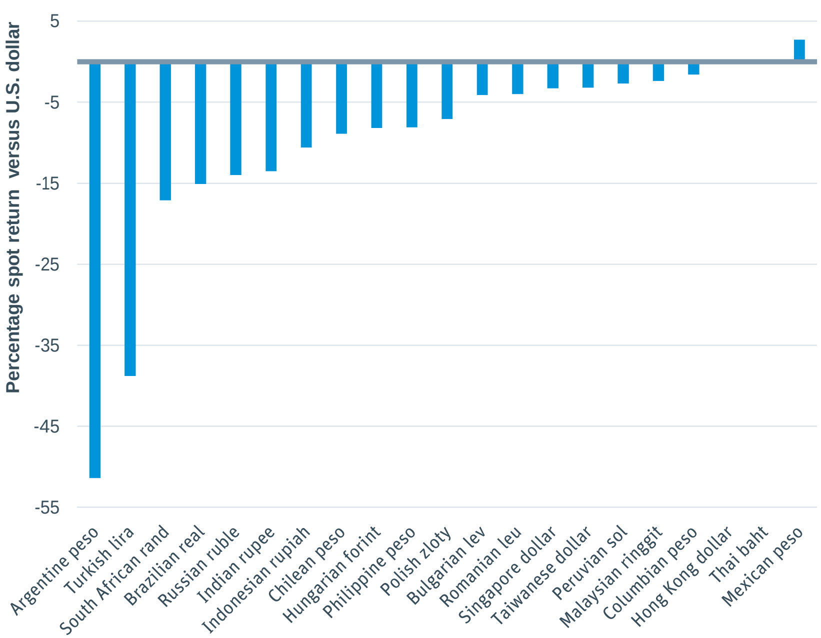
Source: JPMorgan, Markit and Bloomberg. Data as of 10/4/2018.

Vulnerabilities In Emerging Economies

Higher interest rates and a stronger U.S. dollar have contributed to significant depreciation of emerging economy (EE) currencies. Weaker currencies have particularly hurt economies with a current account deficit and a budget deficit. Attempts to stabilize currencies, including the use of interest rate hikes, currency intervention, fiscal restraint and regulatory changes, have had a negative effect on domestic economic activity.

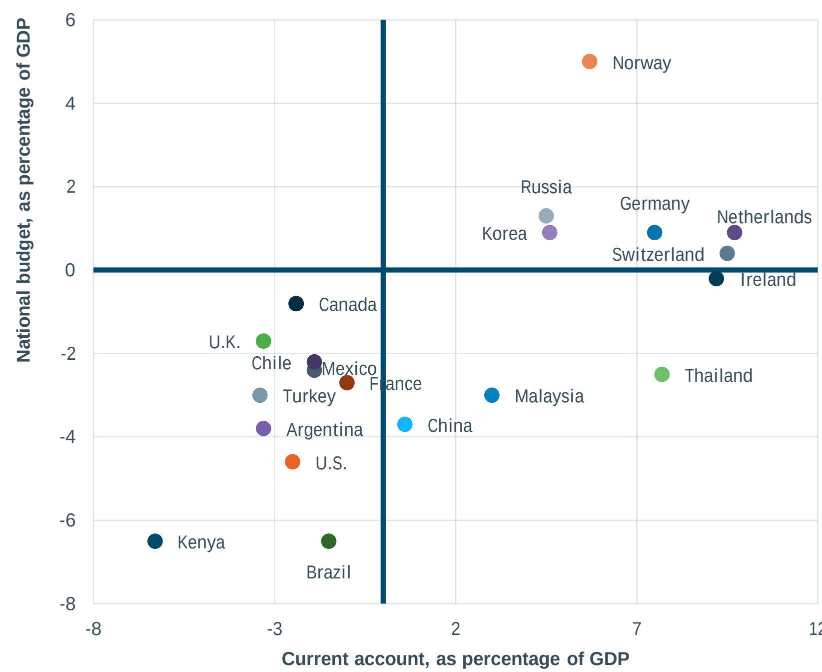
EE Currencies Have Slumped This Year

EE Currency Performance



EE With Twin Deficits Are More Susceptible

2019 Median Estimates for Fiscal and External Account Positions



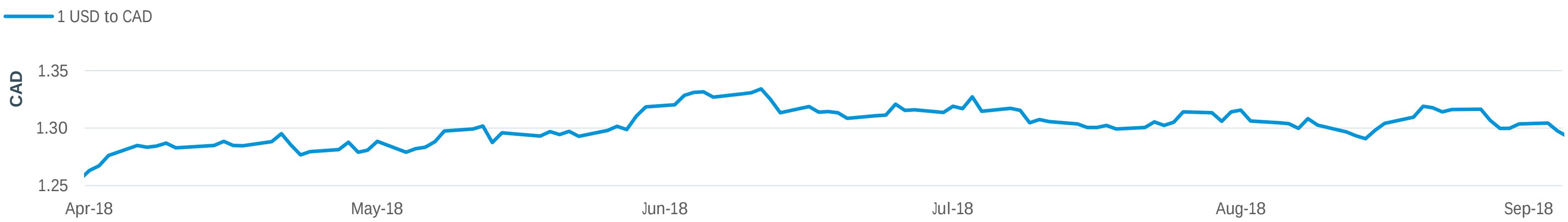
Source: Bloomberg. Data as of 10/4/2018.

FOMC Hike Boosts the Dollar

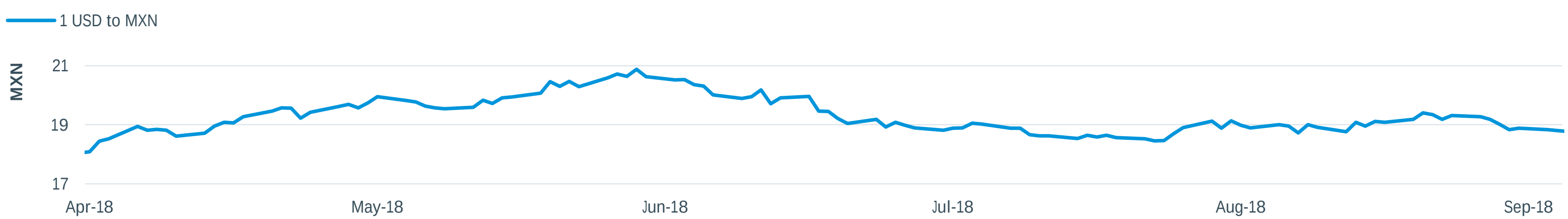
With another rate hike in Q3, the U.S. dollar got more lift against most of its counterparties. Economic metrics continue to be solid with a robust labor market and anticipation of further growth. The bullish outlook for the economy and expectations for another hike in Q4 should give the greenback more support to finish the year with solid returns.

The "new NAFTA," or United States-Mexico-Canada Agreement (USMCA), was reached after many months of negotiations. Most of the key provisions won't start until 2020, as it needs to be authorized by the legislatures in all three countries. The two major winners from the pact will be automobile parts manufacturers and dairy farmers. The Mexican peso and Canadian dollar have both benefited from the headlines. The peso is up six percent and the loonie has gained three percent since the beginning of July.

Canadian Dollar (CAD) Per One U.S. Dollar



Mexican Peso (MXN) Per One U.S. Dollar



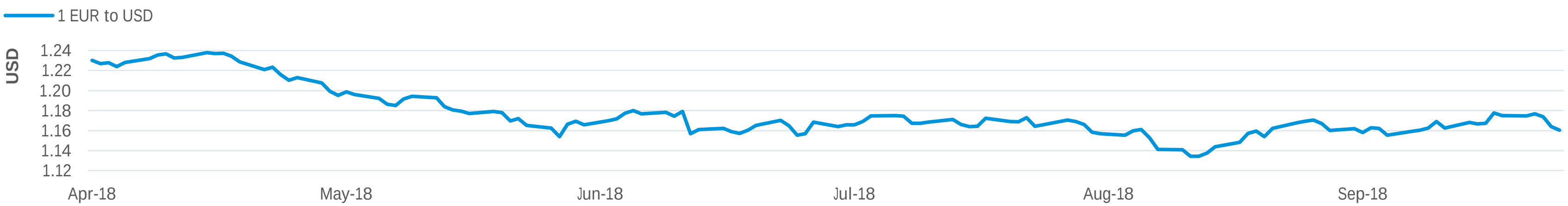
Source: Bloomberg, Silicon Valley Bank and SVB Asset Management. Data as of 9/28/2018.

Euro and Pound: Brexit remains the focus

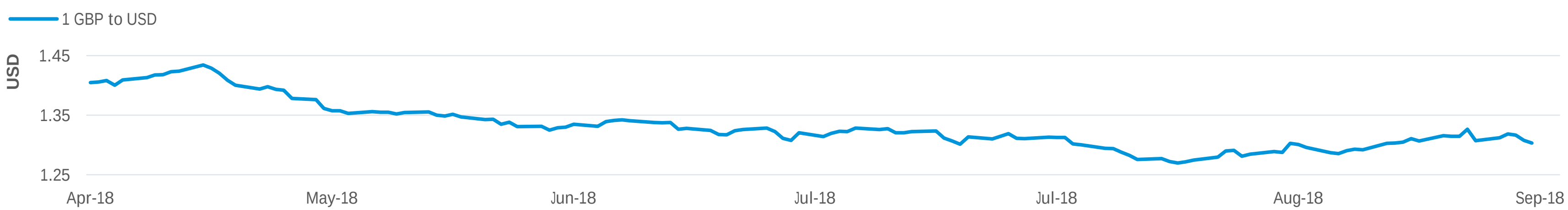
Internal squabbles between Prime Minister Theresa May and some Conservative party members are highlighting divisions over the Brexit agreement. Talks between U.K. and EU officials have not fared much better. Tension has been running high, as each side lobbed criticisms against their counterparts over various issues. The next major milestone is on January 21, 2019, when the British government must make a statement within five days on what the U.K. plans to do. As a result, the pound has dropped about one percent over the past three months.

Despite a more hawkish tone in recent European Central Bank (ECB) statements, concerns over Italy's deficit are weighing down the euro. The ECB is expected to end quantitative easing (QE) soon and potentially hike rates towards the latter half of next year. European officials commented that "labor markets are tightening" and predict a "pickup in underlying inflation." Regardless, the benchmark rate variance between the FOMC and ECB continues to widen, and the euro has weakened further in recent months.

U.S. Dollar Per One Euro (EUR)



U.S. Dollar Per One British Pound (GBP)



Source: Bloomberg, Silicon Valley Bank and SVB Asset Management. Data as of 9/28/2018.

Central Banks

Overview

Central banks

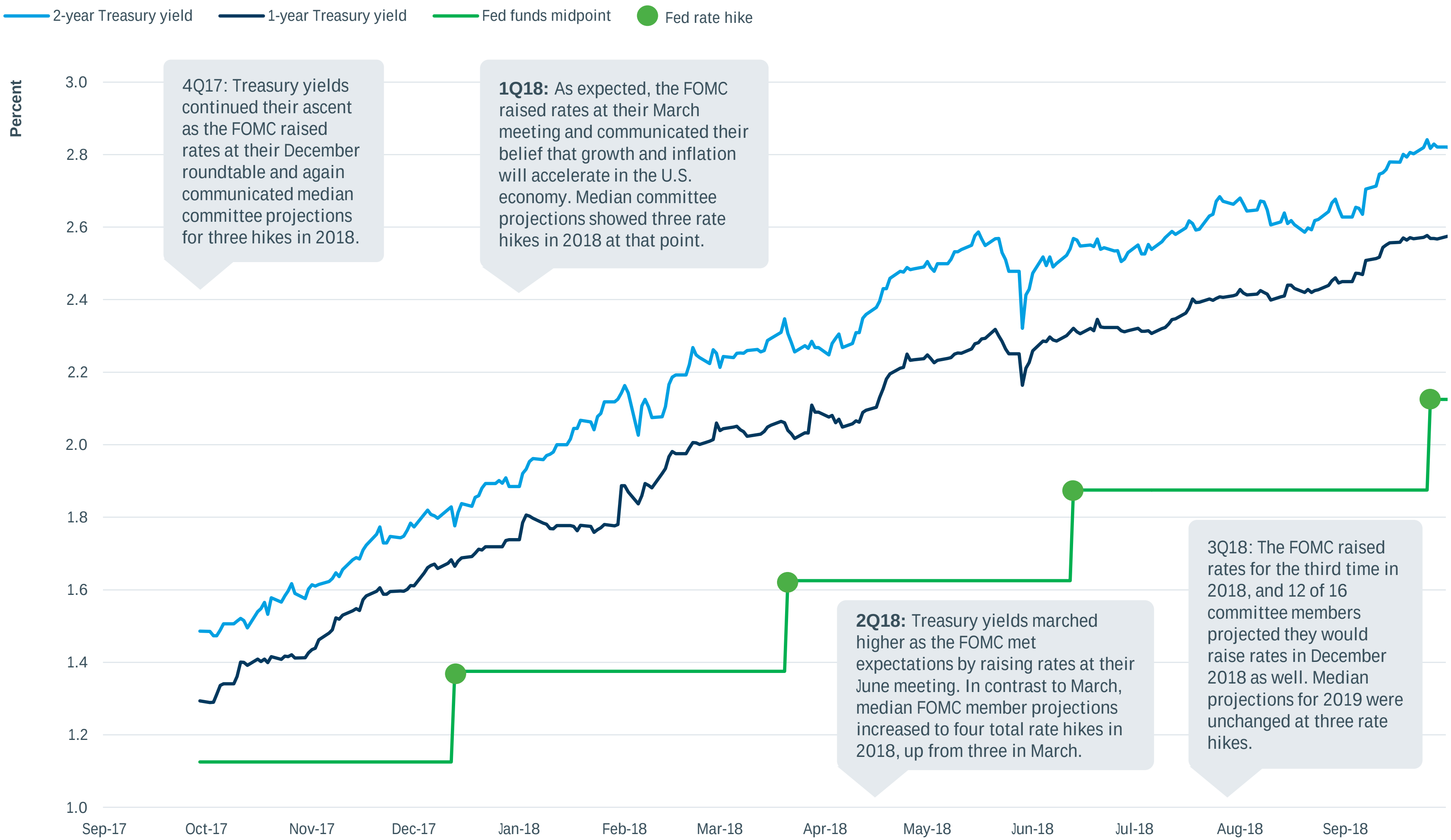
Hawkish sentiment continues to build across the global monetary policy landscape. Recent projections from the Federal Reserve imply one additional rate hike of 25 basis points in 2018, for a total of four hikes, with three more hikes penciled in for 2019. Front-end Treasury yields continue to rise as a result.

A synchronized global recovery and improving growth outlooks have slowed versus the start of the year as trade tensions bubble up and monetary policy accommodation continues to be removed. At its September meeting, the European Central Bank (ECB) confirmed the start of its asset purchase tapering, with purchases winding down by the end of 2019. At the same time, with a dovish tilt, ECB President Mario Draghi reiterated that the ECB deposit rate would remain unchanged through the summer of 2019.

Uncertainties still remain, such as the ultimate impact of trade tariffs, bilateral trade agreement negations, timing and uses of repatriated corporate cash and how the Fed progresses on its path of policy tightening. The Fed is well underway on its tightening cycle, having raised rates eight times this cycle, and its unprecedented balance sheet reduction is smoothly progressing.

Historical Interest Rates

Fed policy normalization and the resultant policy rate hikes have elevated yields in the front end of the U.S. fixed income market.



Source: Bloomberg and SVB Asset Management. Data as of 10/3/2018.

1018-0241DMEXP093019

Central Bank Economic Projections

Global growth and employment remain strong and synchronous while inflation remains relatively subdued.

Economic projections	2018	2019	2020
United States			
Change in real GDP	3.1%	2.5%	2.0%
Unemployment rate	3.7%	3.5%	3.5%
Core PCE inflation	2.0%	2.1%	2.1%
United Kingdom			
Change in real GDP	1.4%	1.8%	1.7%
CPI inflation	2.3%	2.2%	2.0%
Unemployment rate	3.9%	3.9%	3.9%
Eurozone			
Change in real GDP	2.0%	1.8%	1.7%
CPI inflation	1.7%	1.7%	1.7%
Unemployment rate	8.3%	7.8%	7.4%
China			
Change in real GDP	6.5%		
CPI inflation	3.0%		
Unemployment rate	4.5%		
Japan			
Change in real GDP	1.5%	0.8%	0.8%
Core CPI inflation	1.1%	2.0%	2.1%

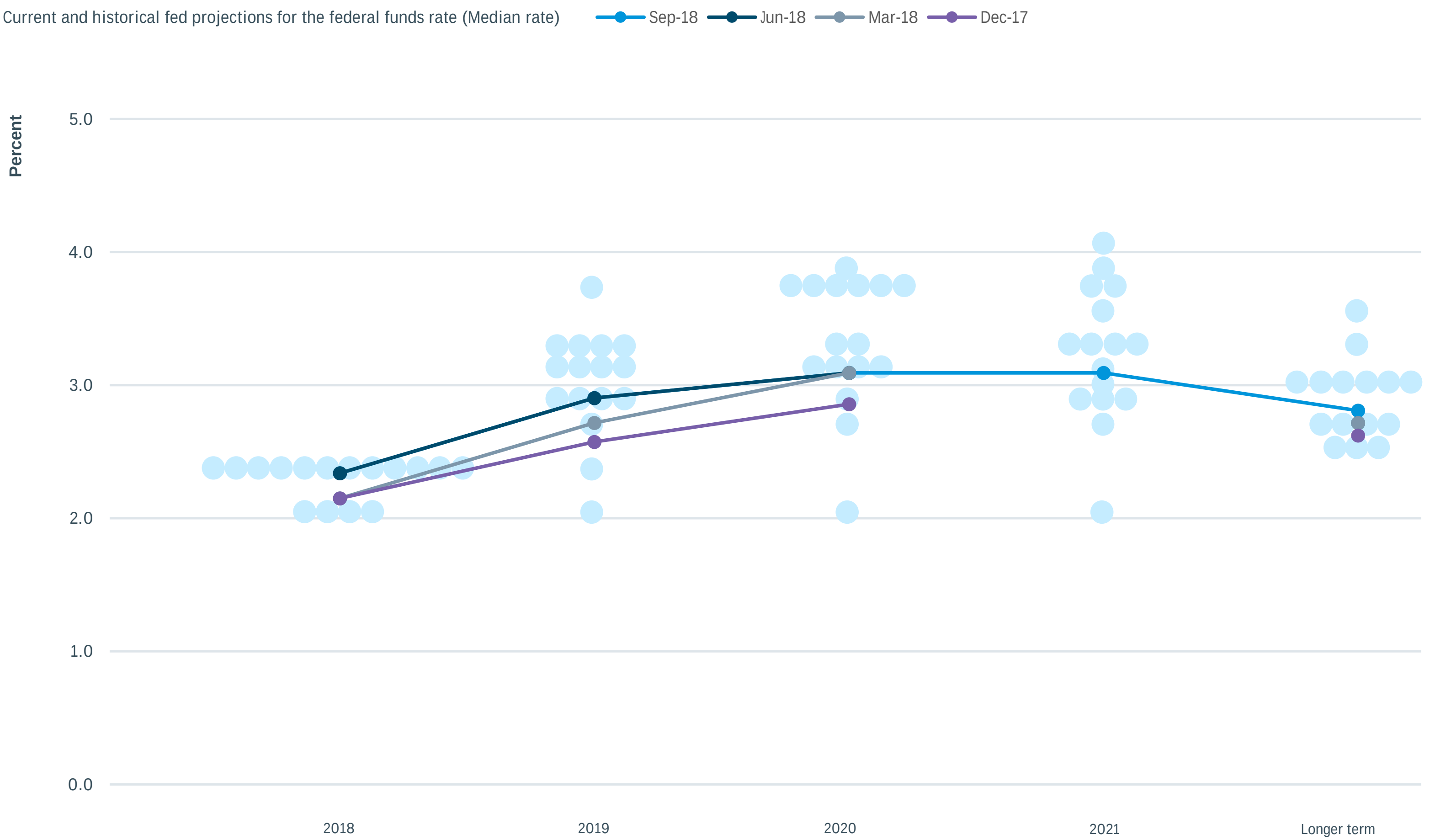
Source: Federal Reserve, European Central Bank, National People's Congress of China, Bank of Japan and Bank of England. Data as of 10/3/2018. Forecasts are not available for all periods.

Federal Reserve Rate Projections

Committee members' projections for the path of the federal funds rate.

The FOMC Dot Plot

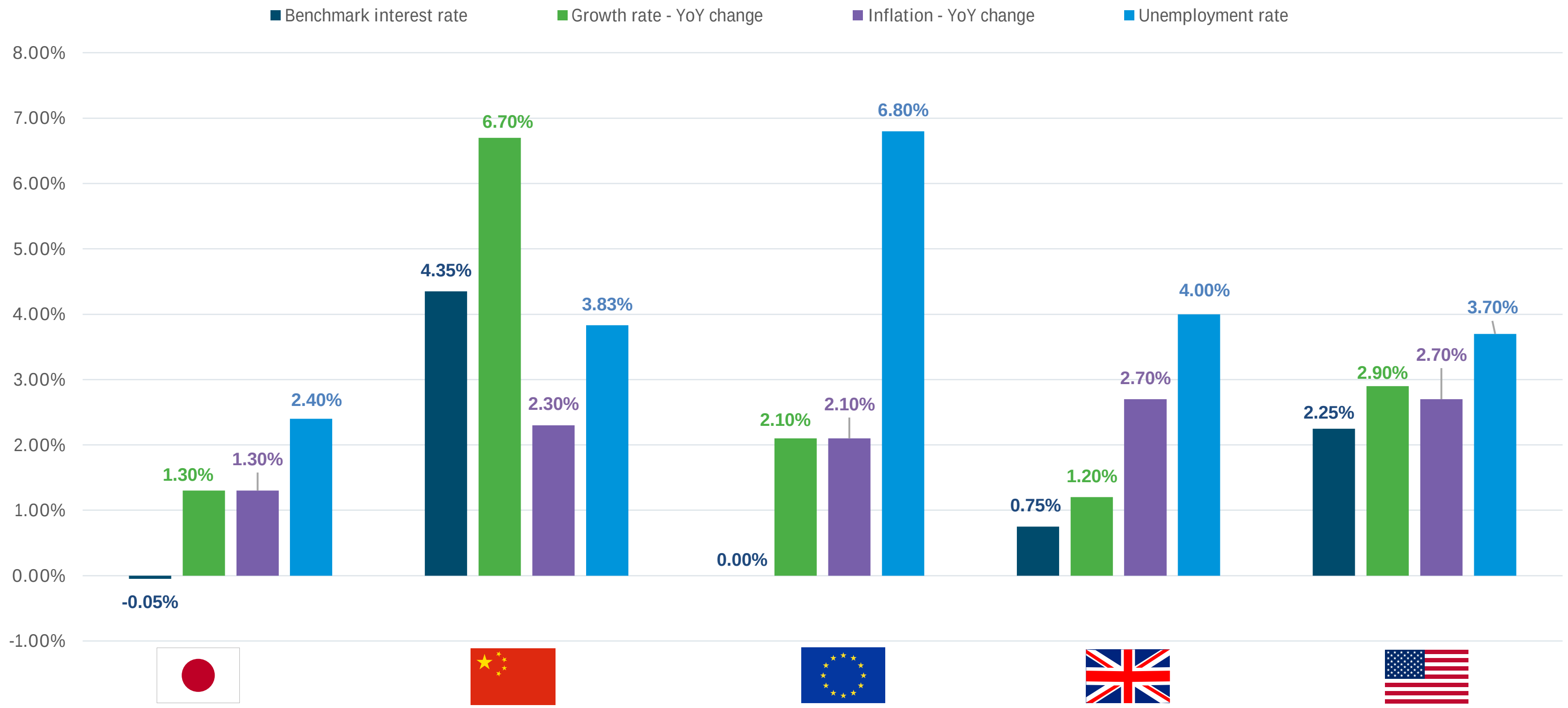
Current and historical fed projections for the federal funds rate (Median rate)



Source: Bloomberg and Federal Reserve. Data as of 10/3/2018.
Median rate references forecast rate at the end of each period. Median rate for Sep-18 included projection for 2021; prior projections did not.

Central Banks: The slow lane

Global monetary conditions remain accommodative even as central banks begin to reverse the easing policies enacted over the past decade. Positive economic growth and steady employment conditions provide scope for removing easing measures, while mild inflation, political uncertainties, and currency weakness allow for changes to be made at an unhurried pace.



Analysis				
JAPAN: Committed to current easing policies, including asset purchases, until 2% inflation target reached. Economy growing at low & uneven pace.	CHINA: Reserve requirements cut for fourth time this year in October. Easing policies partly aimed to offset weaker conditions from trade policy changes.	EU: Asset purchase program to conclude by year-end, but enlarged balance sheet to remain. Committed to not raising rates before September 2019.	UK: After hiking rates in August, BOE to pause its tightening path to accommodate uncertain policy changes surrounding the U.K. exit from the EU.	US: A fourth interest rate hike in December is likely due to strong employment conditions. Additional rate hikes expected in first half of 2019.

Source: Federal Reserve, European Central Bank, Bank of England, The People's Bank of China, Bank of Japan, Bloomberg and SVB Asset Management. Data as of 10/9/2018.

1018-0241DMEXP093019

Markets and Performance

Overview

Markets and performance

The U.S. economic backdrop remains robust as consumer confidence hit its highest level since 2000, monthly job gains continue, wages have grown to its highest level since 2009, further supporting consumer spending, while inflation continues to hover around its target. The Fed acknowledged the current strength of the U.S. economy, which has led the central bank to raise the federal funds rate a third time this year.

Against a strong economic backdrop and fading macro concerns, the U.S. Equity market was the best performer in the third quarter relative to other asset classes. On the fixed income side, returns were largely positive for the quarter as credit, particularly short duration, outperformed government bonds. The credit outperformance can be attributed to spread tightening.

After a decade of cash hoarding, excess cash for S&P 500 companies is expected to continue the gradual decline over time as tax reform passage paves the way for foreign cash repatriation. Notably, the cash deployment has been largely associated with share repurchases from cash-rich issuers within the technology sector.

While capital expenditure has picked up marginally, any boost to investment effects due to repatriation will likely take time to materialize. Debt levels have largely plateaued in most sectors. Credit implication is expected to be neutral and will be driven by any change in financial policy over time.

Broad Market Performance

Asset class returns

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 YTD
Crude Oil 78.00%	Gold 29.67%	Gold 10.23%	REIT 16.47%	Wilshire 33.06%	REIT 28.24%	S&P 500 1.40%	Crude Oil 44.80%	S&P 500 21.80%	S&P 500 7.70%
U.S. High Yield 58.21%	REIT 26.97%	Crude Oil 8.15%	Wilshire 16.05%	S&P 500 32.39%	S&P 500 13.69%	REIT 1.30%	U.S. High Yield 17.13%	Wilshire 21.00%	Wilshire 7.30%
Wilshire 28.29%	Wilshire 17.18%	U.S. Aggregate 7.84%	S&P 500 16.00%	U.S. High Yield 7.44%	Wilshire 12.70%	Wilshire 0.70%	Wilshire 13.40%	Gold 13.70%	U.S. High Yield 2.57%
S&P 500 26.46%	U.S. High Yield 15.12%	REIT 7.48%	U.S. High Yield 15.81%	Crude Oil 7.32%	U.S. Aggregate 5.97%	U.S. Aggregate 0.55%	S&P 500 12.00%	Crude Oil 12.50%	REIT 0.50%
REIT 26.27%	Crude Oil 15.10%	U.S. High Yield 4.98%	Gold 6.96%	REIT 1.26%	U.S. High Yield 2.45%	U.S. High Yield -4.47%	Gold 8.60%	U.S. High Yield 7.50%	Crude Oil -1.30%
Gold 23.96%	S&P 500 15.06%	S&P 500 2.11%	U.S. Aggregate 4.21%	U.S. Aggregate -2.02%	Gold -1.51%	Gold -10.50%	REIT 7.10%	REIT 3.70%	U.S. Aggregate -1.60%
U.S. Aggregate 5.93%	U.S. Aggregate 6.54%	Wilshire 0.98%	Crude Oil -7.08%	Gold -28.26%	Crude Oil -45.76%	Crude Oil -30.50%	U.S. Aggregate 2.65%	U.S. Aggregate 3.54%	Gold -4.60%

All returns above are on a total return basis. 2018 YTD returns are on an aggregate basis up to 9/28/2018. U.S. Aggregate refers to Bloomberg Barclays Aggregate Bond Index; U.S. High Yield refers to Bloomberg Barclays U.S. High Yield Index; Gold refers to S&P GSCI Gold Spot; Crude Oil refers to Spot West Texas Intermediate Crude Oil; Wilshire refers to Wilshire 5000 Total Market Index; REIT refers to MSCI US REIT Index; S&P 500 refers to S&P 500 Index.

Source: Thomson Reuters and Bloomberg Barclays indices.
Past index performance is no guarantee of future results.

Fixed Income Returns: Staying short

Credit broadly outperformed government bonds in Q3. Credit spreads narrowed as concerns around trade and emerging markets led to an uptick in demand, offsetting tighter Fed policy and robust corporate bond supply. Short-duration credit lead the way, outperforming the aggregate index by approximately 200 basis points on a YTD total return basis (+0.44% versus -1.60%). The large inflows into short-duration strategies contributed to the short duration's outperformance for the quarter.

		Current duration	Current yield	Non-annualized periodic total return (percent)								
				Q318	Q218	Q118	Q417	Q317	Q217	Q117	Q416	Q316
U.S. Aggregate Index	U.S. Treasuries	5.99	2.95	-0.59	0.10	-1.18	0.05	0.38	1.19	0.67	-3.84	-0.28
	U.S. Agencies	3.92	3.02	-0.01	0.00	-0.53	0.06	0.82	0.93	1.13	-2.10	0.25
	Corporates	7.24	4.07	0.97	-0.98	-2.32	1.17	1.34	2.54	1.22	-2.83	1.41
	U.S. MBS	5.28	3.59	-0.12	0.24	-1.19	0.15	0.96	0.87	0.47	-1.97	0.60
	U.S. ABS	2.16	3.19	0.49	0.42	-0.39	-0.01	0.42	0.60	0.54	-0.70	0.20
	U.S. CMBS	5.28	3.58	0.46	-0.06	-1.32	0.35	0.79	1.31	0.86	-3.03	0.59
U.S. Short Duration	1-3 yr U.S. Treasuries	1.93	2.81	0.19	0.21	-0.16	-0.28	0.24	0.19	0.27	-0.46	-0.11
	1-3 yr U.S. Agencies	1.76	2.84	0.31	0.25	-0.04	-0.21	0.27	0.28	0.35	-0.39	0.00
	1-3 yr corporates	1.93	3.31	0.70	0.47	-0.38	-0.04	0.59	0.59	0.69	-0.18	0.32
	AAA Credit Card ABS	2.34	3.14	0.45	0.36	-0.48	-0.08	0.41	0.67	0.56	-1.04	0.15
	AAA Auto ABS	1.83	3.15	0.53	0.43	-0.25	-0.02	0.37	0.46	0.41	-0.31	0.15

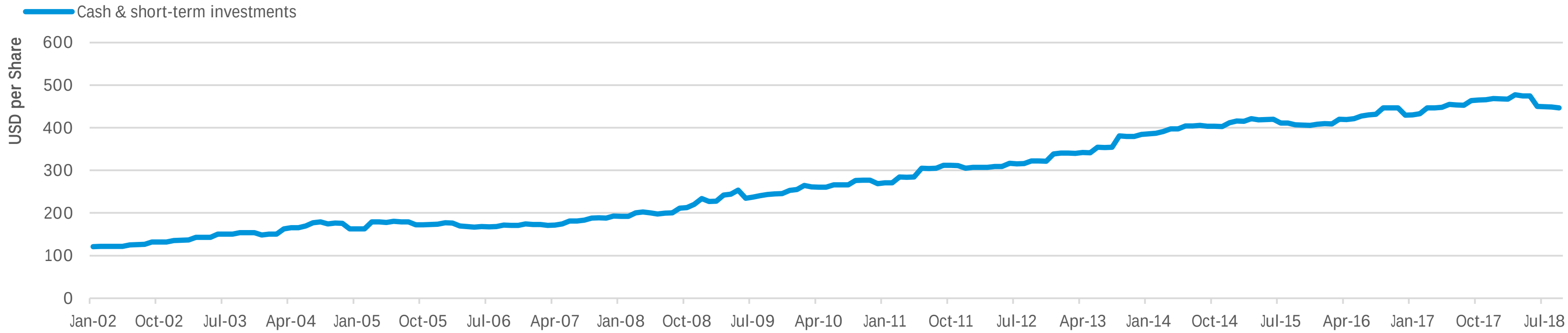
Source: Bloomberg Barclays Indices. Data as of 9/28/2018. Heatmap colors based on periodic return percentage for time period shown. Past performance is not a guarantee of future results.

1018-0241DMEXP093019

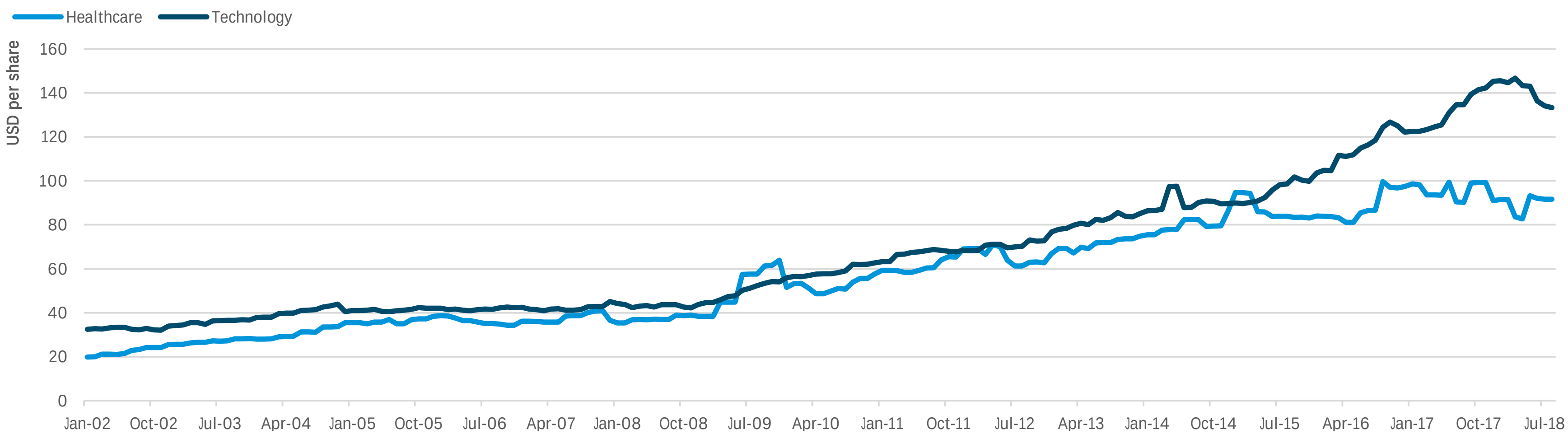
S&P 500: Unwinding of excess cash

Following the U.S. tax reform that eliminated prior tax disincentives on repatriation of foreign earnings, excess cash for S&P 500 companies is expected to gradually decline over time. The greatest impact is expected to come from issuers that previously retained most foreign subsidiary profits, particularly in the healthcare and technology sectors.

Cash Decline from Historic High Level



Cash Balance from Cash-Rich Sectors

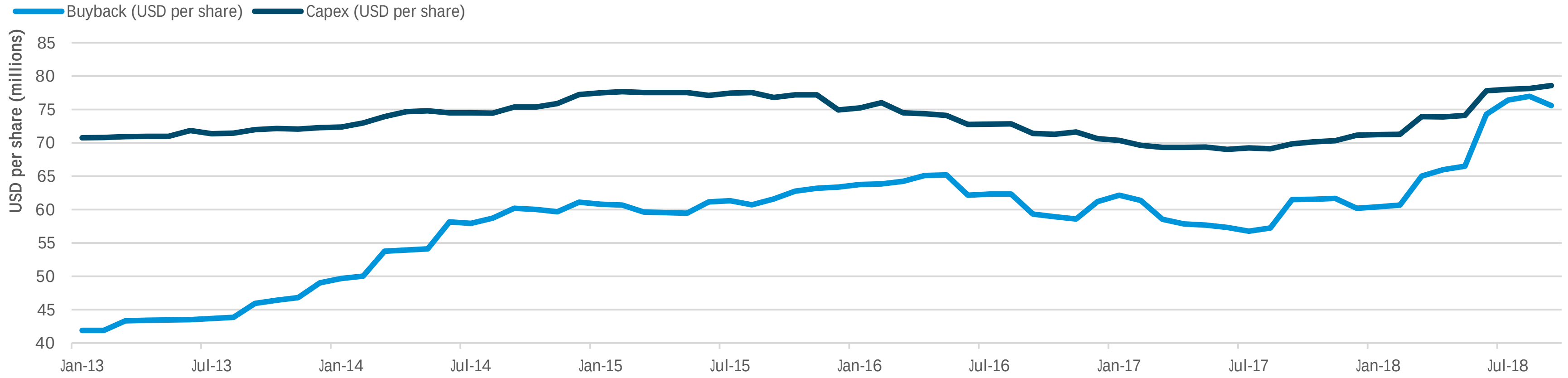


Source: Bloomberg. Data as of 8/31/2018.

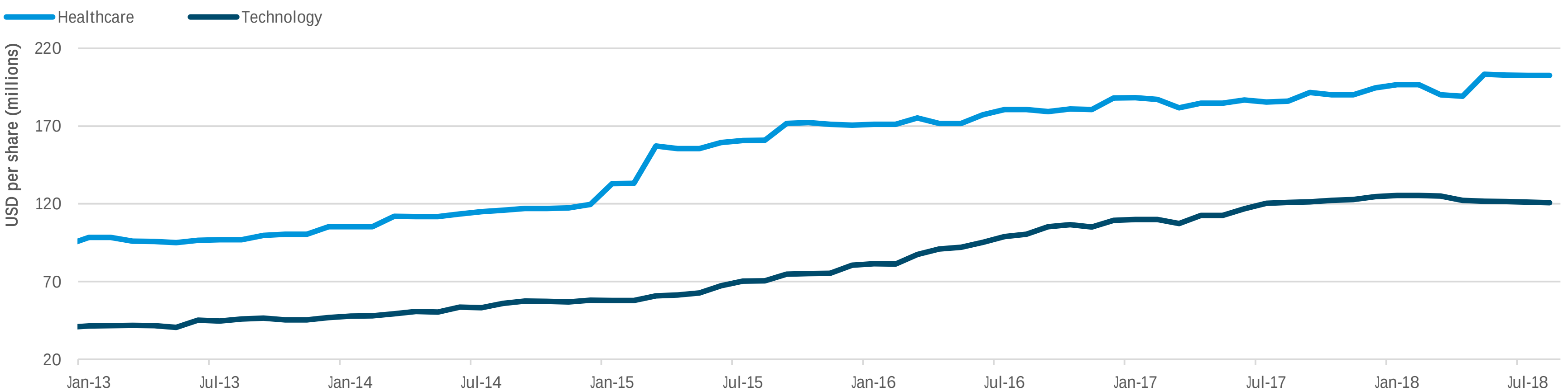
S&P 500: Cash deployment

There was a large pickup in share repurchases, reaching a record high for S&P 500 companies. However, the overall credit impact is largely neutral as companies retire upcoming debt maturities and the pace of debt issuance has slowed due to greater access to foreign cash.

Active Cash Deployment Notably in Share Repurchase and Capital Expenditure



Outstanding Debt Levels Plateauing, Notably in Cash-Rich Healthcare and Technology Sectors



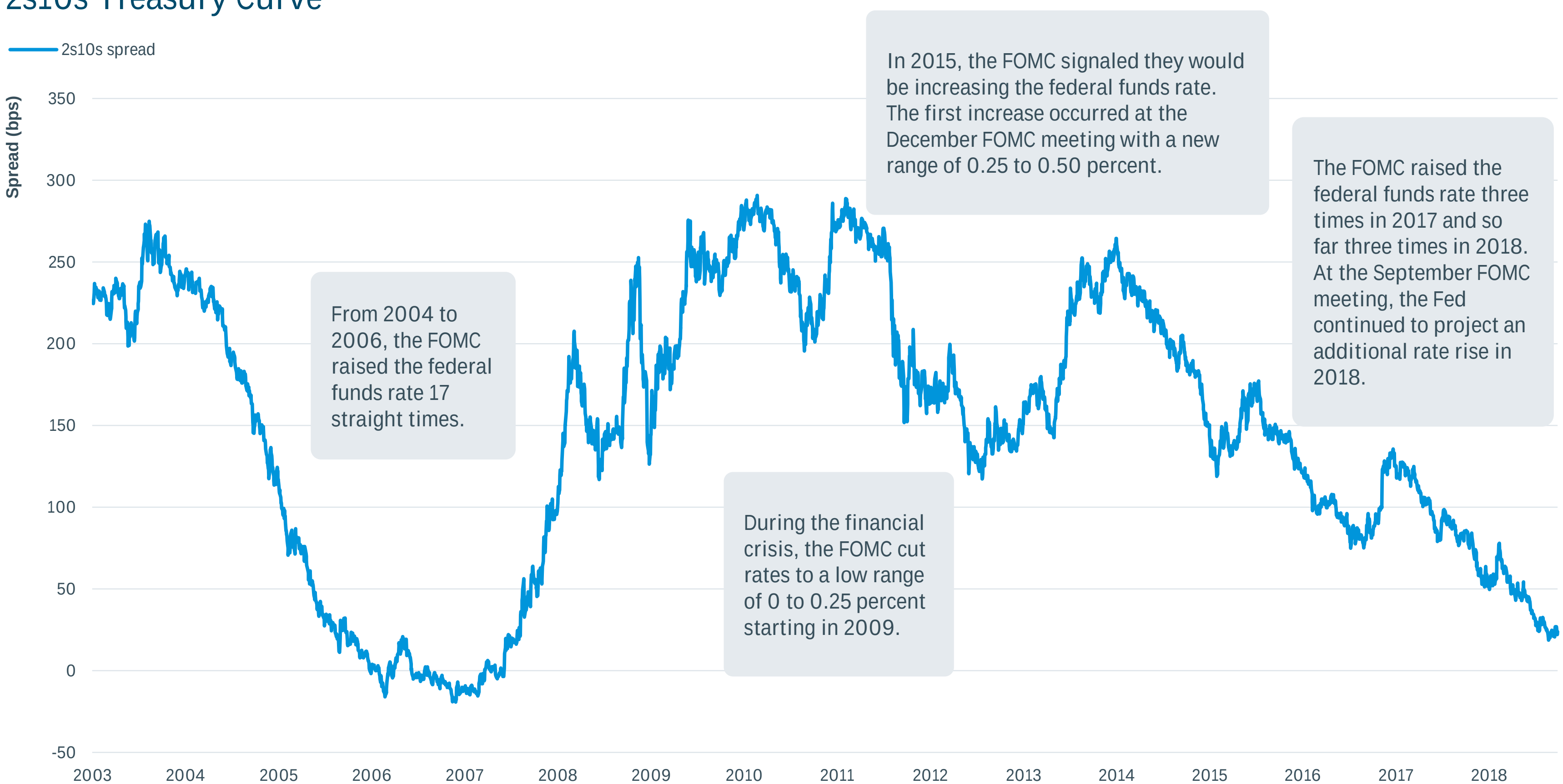
Source: Bloomberg. Data as of 8/31/2018.

1018-0241DMEXP093019

Flat Yield Curve

The 2s10s curve closed the third quarter at +24 and averaged +26 throughout the quarter. Comparing the current rate-hiking cycle to the one from 2004 to 2006, the curve has room to flatten further. Contributing to the continued flatness is larger front-end Treasury issuance, the Fed continuing to signal its plan to gradually increase interest rates, and other central banks continuing with quantitative easing, which is making the U.S 10-year yield attractive to global investors.

2s10s Treasury Curve

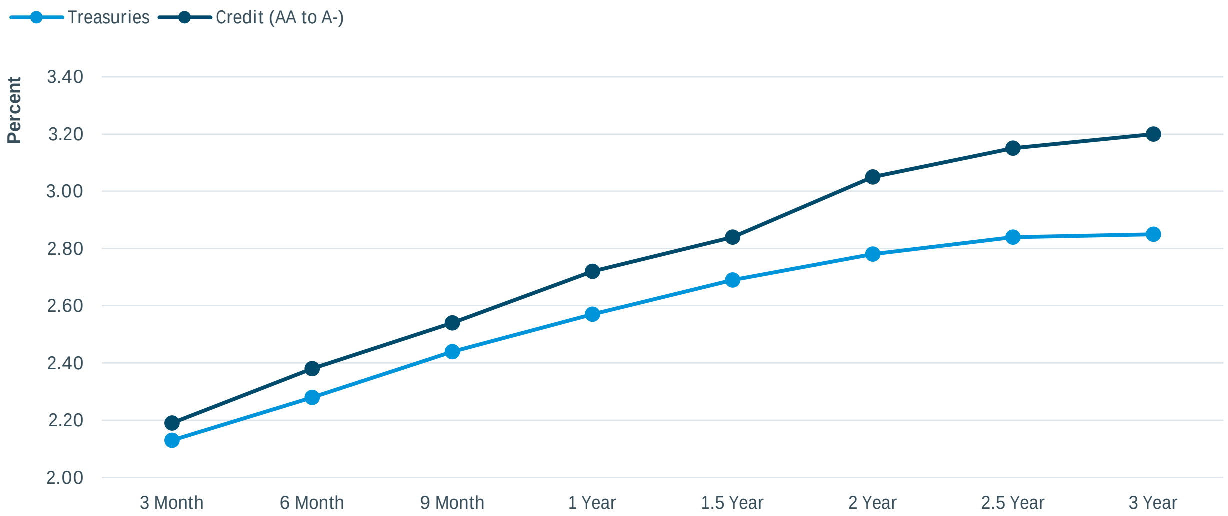


Source: SVB Asset Management and Bloomberg. Data as of 9/28/2018. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.

Relative Value: Attractive credit yields

Credit historically offers an attractive yield pickup over comparable Treasuries. In a rising rate environment, credit helps mitigate the impact from negative bond prices due to higher income.

Front-end Yields



Credit spreads tightened across the curve in the third quarter.

Front-end spreads led the rally as demand for short-duration credit in this cycle continues.

In addition, solid economic data and corporate earnings are contributing to the demand for corporate bonds and commercial paper.

Source: SVB Asset Management and Bloomberg. Data as of 9/28/2018. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.

Our Team and Report Authors

Lauri Moss
President, SVB Asset Management
lmoss@svb.com

Ninh Chung
Head of Investment Strategy and Portfolio Management
nchung@svb.com

Melina Hadiwono, CFA
Head of Credit Research
mhadiwono@svb.com

Renuka Kumar, CFA
Director, Portfolio Management
rkumar@svb.com

Eric Souza
Senior Portfolio Manager
esouza@svb.com

Jose Sevilla
Senior Portfolio Manager
jsevilla@svb.com

Paula Solanes
Senior Portfolio Manager
psolanes@svb.com

Steve Johnson, CFA
Senior Portfolio Manager
steve.johnson@svb.com

Hiroshi Ikemoto
Fixed Income Trader
hikemoto@svb.com

Jason Graveley
Fixed Income Trader
jgraveley@svb.com

Daeyoung Choi, CFA
Credit Risk Analyst
dchoi@svb.com

Tim Lee, CFA
Credit Risk & Research Officer
tlee@svb.com

Guest contributor

Minh Trang, CFA
Senior FX Trader
mtrang@svb.com

1018-0241DMEXP093019

Investment products:

Are not insured by the FDIC or any other federal government agency	Are not deposits of or guaranteed by a bank	May lose value