Quarterly Economic Report

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

Q3 2019
Quarterly Economic Report
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Thoughts From the Desk

Momentum from the first quarter continued in US equity markets in the second quarter of the year, with the S&P 500 increasing 3.79 percent on a total return basis. At the same time, bond markets rallied in anticipation of lower interest rates and impending monetary policy support with the 10-year Treasury moving lower by nearly 40 basis points from end of March to end of June. Similarly, policy-sensitive 2-year Treasury yields ended lower by nearly 51 basis points as the market began pricing in anticipation of steep reductions in the federal funds rate for the remainder of 2019 and into early 2020.

At the same time, trade uncertainty continued without resolution of the Sino-American trade war, despite an agreement at the G20 summit to resume trade talks. Earlier in the quarter, the escalation of tariffs against certain Chinese imports along with a brief but impactful tariff-spat with Mexico shook market confidence that a near term trade solution could be around the corner. Inflation remained muted, with core PCE hovering near 1.6 percent throughout much of the quarter, weighing on the minds of Fed officials targeting 2 percent. US labor market strength remained a much needed bright spot among the data, with non-farm payrolls averaging close to 170,000 per month over the quarter.

Global growth appeared to slow, with slowing manufacturing data becoming a focal point. Central banks globally signaled their willingness to ease policy further through rate cuts or resumption of asset purchase programs if necessary. As the year progresses, economic data will provide more information about the appropriate magnitude of such central bank responses, and whether the severity of such responses will sustain economic activity.
Domestic Economy
Overview

Domestic economy

Economic data in the first half of the year continued to be mixed. The effects of tax cuts continued to fade while trade tensions escalated, further dampening the economic outlook. As signaled, the Fed shifted into dovish gear in an effort to sustain economic growth in light of increased headwinds.

The first quarter of 2019 showed strong growth with GDP at 3.1 percent; however a significant portion was driven by inventory buildup as companies added to inventory preemptively as trade tensions heightened. We expect growth to moderate in Q2 as the economic outlook is clouded by uncertainties regarding trade policies.

Meanwhile, labor remained steady with an average of 170,000 jobs per month added in the first half of the year and the unemployment rate close to a 50-year low. On the other side of the Fed’s dual mandate – inflation, price pressures have been subdued, falling below the Fed’s target range of 2 percent. Muted inflation pressures appear to be providing fuel for the Fed to cut rates before year-end.

Looking ahead, deteriorating business sentiment amid rising trade tensions, combined with muted inflation pressures and increased risk to the economic outlook, appear to support the Fed’s shift to a more dovish tone and potential rate cuts.
GDP: Growth accelerated

First quarter GDP came in strong at 3.1 percent. Growth in Q1 was largely driven by inventory investment and exports while consumption had a notably weak showing. Expectations are for growth to moderate as the year progresses now that the benefits of tax reform have faded and global growth is slowing amid ongoing uncertainty over global trade.

GDP and Components

Sources: Bureau of Economic Analysis, Congressional Budget Office and SVB Asset Management. Data as of 6/30/2019. GDP values shown in legend are percent change vs. prior quarter, on an annualized basis.
Consumption: Expect a rebound

Consumer activity continued to slow in Q1, increasing only 0.9 percent vs. 2.5 percent the prior quarter. Spending in Q1 was the slowest in a year. Meanwhile, household balance sheets remain healthy with a stable ratio of debt to disposable income. In the latter half of Q2, retail sales picked up, reflecting an improvement over earlier in the year, which should translate into stronger consumption in Q2 data. Finally, vehicle sales continue to maintain a healthy level.

Consumption Overview

Sources: Bloomberg and SVB Asset Management. Data as of 7/2/2019.
Employment: Remains solid

In the first half of 2019, the employment growth averaged about 170,000 jobs per month. While this was a deceleration compared to last year, job growth is still on solid footing. In addition, the unemployment rate continues to hover around a 50-year low at 3.7 percent, while the participation rate for prime-age labor force remains steady.

**Employment Landscape**

- **Non-farm payroll**
- **Unemployment rate**

**Labor Force Participation**

- **Labor force participation rate**
- **Labor force participation rate of 25- to 54-year-olds**

Inflation: Subdued

The downward trend in inflation leaves room for the Fed to cut rates before year-end. Hourly wages have moderated, further alleviating the potential for inflationary pressure. Meanwhile, oil prices have rebounded from this year’s lows due to geopolitical events affecting supply; however, falling demand is keeping oil prices at bay.

Core PCE

![Graph showing Core PCE, Fed core PCE target, and Average hourly earnings from 2007 to 2019.]

Oil Prices

![Graph showing Crude oil and Daily national average of gasoline prices from 2005 to 2019.]

Sources: Bloomberg and SVB Asset Management. Data as of 7/2/2019.
Business Outlook: Uncertainty looms

Escalating trade tensions are weighing on business confidence and creating a wave of uncertainty, causing companies to trim forecasts for 2019. In the last 12 months, regional Fed surveys reflect an overall decline in business sentiment.

Business Confidence Index

<table>
<thead>
<tr>
<th>Business Sentiment</th>
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<tbody>
<tr>
<td>July-18</td>
</tr>
<tr>
<td>August-18</td>
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<tr>
<td>September-18</td>
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<tr>
<td>October-18</td>
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<td>November-18</td>
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<td>December-18</td>
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<tr>
<td>January-19</td>
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<tr>
<td>February-19</td>
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<td>March-19</td>
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<tr>
<td>April-19</td>
</tr>
<tr>
<td>May-19</td>
</tr>
<tr>
<td>June-19</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, OECD, and Business Confidence Index. Data as of 7/3/2019. Heatmap colors based on the indices and time periods shown.
Global Economy
Global economy

A sluggish first half of 2019 won’t stop the global economy from achieving another year of growth, though the pace of the expansion will be slower than the prior year. Flagging economic data has prompted economists to lower forecasts and has alerted policy makers to prepare for action in support of growth. The Organization for Economic Cooperation and Development (OECD) projects global real GDP to rise by 3.2 percent, which is 0.1 percent lower than their prior forecast and 0.4 percent lower than 2018.

Trade policy quarrels have significantly impacted manufacturing, as new orders have declined due to uncertainty about the timing of tariffs, restrictions on goods and companies have contemplated changes to their supply chains. Manufacturing activity on a global basis slipped into contraction territory at the end the second quarter of the year, according to the JPMorgan Global Manufacturing PMI.

On a composite basis, the JPMorgan Global PMI indicates the global economy is still in expansion mode, supported by service activity. With capital expenditures and industrial production shaky, business consumption has lagged consumer demand, which has been supported by solid employment conditions. Retail sales in emerging economies have held up well, although growth has fallen recently in China. Spending growth was strong in most advanced economies and had a firm rebound in the second quarter.

With policy responses expected to emerge, the pace of economic activity should pick up toward year-end as the central banks manage through trade policy wrangling and political developments.
Global Trade Slows

Trade policy uncertainty has begun to weigh on trade activity. Tariff increases that are enacted and sustained will negatively impact economic growth over the medium term, although supply chains and manufacturing infrastructure should adjust longer term. The health of emerging economies, which are key destinations for exports and major sources of growth for corporations in developed economies, remain in focus.

World Trade Stalls Amid Trade Friction

Emerging Economies Are Key Consumers

Exports Decline Amid Trade Policy Disputes

The value of exports from advanced economies has fallen since the start of the year, contributing to worries that growth will decelerate. In the US, imports continue to outpace exports, leading to a trade deficit that is wider than the prior year.

Decline in Exports

US Trade Deficit Is Still a Deficit

US Dollar: A pending cut in the works

Recent comments from the Federal Reserve point toward a pending cut in the benchmark rate. The expectation is for at least a quarter-percent reduction, but many market participants anticipate there could be more for the year. The FOMC is once again at an inflection point in moderating a solid economy with strong jobs data, while frustrated that inflation remains tepid. The committee stated that trade headlines and softer global growth are weighing more on the US economy. Many opined that uncertainties and downside risks have increased, strengthening the case for a cut.

Accordingly, the US dollar (USD) has softened across the board, especially against the G10 currencies. One of the stronger performers over Q2 has been the Canadian dollar (CAD). The Bank of Canada has reiterated its policy to hold rates steady at 1.75 percent in support of the current economic expansion. The currency is up 4.1 percent year to date against the greenback.

USD to End Its Gradual Rise

CAD Helped By 40-Year Low in Unemployment

Sources: Intercontinental Exchange, Bloomberg and Silicon Valley Bank.
Data as of 7/1/2019.
Pound: Still under Brexit pressure

The pound continues to remain under pressure and has fallen to a two-year low against the dollar. Investors have grown more concerned with UK economic prospects and the likelihood of a no-deal Brexit. In addition, political headlines regarding a change in leadership have only fueled more uneasiness about the currency.

Correspondingly, the pound is trading near its low for the year. After a nice run during Q1, the currency has precipitously fallen from about 1.32 to 1.25 over Q2. This comes as the Bank of England announced that it was in no rush to raise rates and extended its neutral stance in light of the ongoing Brexit negotiations. Until more substantive talks materialize, it’s likely that investors will remain more risk-averse toward the currency.

Central Banks
Central banks

Dovish policy reverberated through global central banks in the second quarter of 2019, in what was a continued reversal of 2018’s more hawkish policy trajectory. Recent projections from the Federal Reserve imply consensus among the committee for no additional rate hikes in 2019, down from a projection of two in December and three in September 2018, and for a median of one rate cut in 2020. Further, at their June 2019 meeting, eight of 17 committee members forecast some sort of rate reduction in 2019 could be appropriate. The dovish pivot has been attributed to uncertain outcomes of global “crosscurrents,” sub-target inflation and continued trade tensions. Market participants continue to speculate that the Fed’s next policy move may in fact need to be a rate cut.

Synchronized global growth and inflation outlooks continued to slow in the second quarter. At its June 2019 meeting, reflecting this reality, the European Central Bank (ECB) announced its expectation that policy rates will, at a minimum, be on hold through at least the first half of 2020, contrary to previous guidance for the end of 2019. At the same time, additional stimulus in the form of refinancing operations was clarified in an attempt to stimulate the economy. No changes were made to reinvestments of the ECB’s balance sheet.

Uncertainties still persist, such as the ultimate resolution to the Sino-American trade war, Britain’s turbulent and prolonged exit from the European Union, the impact of the recent Chinese fiscal stimulus, in addition to how the Fed’s pivot will affect the trajectory of the US economy. For now, the Fed seems to have signaled its willingness to provide additional accommodation to the economy if the data warrants additional stimulus.
Historical Interest Rates

Market expectations for a more accommodative monetary policy have caused a dip in front-end fixed income yields compared to 2018. Market participants are pricing in multiple interest rate cuts by year-end, and the Fed may follow suit.

Sources: Bloomberg and SVB Asset Management. Data as of 7/2/2019.
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)

Recent projections from the Federal Reserve imply consensus among the committee for no additional rate hikes in 2019, down from a projection of two in December and three in September of 2018. The median projection highlights a potential rate cut in 2020, with a number of committee members believing more accommodation could be appropriate as early as 2019.

Median rate references forecast rate at the end of each period.
## Central Bank Economic Projections

<table>
<thead>
<tr>
<th>Economic Projections</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United States</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in real GDP</td>
<td>2.1%</td>
<td>2.0%</td>
<td>1.8%</td>
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<tr>
<td>Core PCE inflation</td>
<td>1.8%</td>
<td>1.9%</td>
<td>2.0%</td>
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<tr>
<td>Unemployment rate</td>
<td>3.6%</td>
<td>3.7%</td>
<td>3.8%</td>
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<tr>
<td><strong>United Kingdom</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Change in real GDP</td>
<td>1.5%</td>
<td>1.6%</td>
<td>2.1%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>1.6%</td>
<td>2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.8%</td>
<td>3.8%</td>
<td>3.6%</td>
</tr>
<tr>
<td><strong>Eurozone</strong></td>
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<td></td>
<td></td>
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<tr>
<td>Change in real GDP</td>
<td>1.2%</td>
<td>1.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>1.3%</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>7.7%</td>
<td>7.5%</td>
<td>7.3%</td>
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<td><strong>China</strong></td>
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<tr>
<td>Change in real GDP</td>
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<td>N/A</td>
<td>N/A</td>
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<tr>
<td>CPI inflation</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Unemployment rate</td>
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<td>N/A</td>
<td>N/A</td>
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<tr>
<td><strong>Japan</strong></td>
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<td></td>
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<tr>
<td>Change in real GDP</td>
<td>0.8%</td>
<td>0.9%</td>
<td>1.2%</td>
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<tr>
<td>Core CPI inflation</td>
<td>0.9%</td>
<td>1.3%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Central Banks: Poised to act

Most major economies remain in growth mode, but economic data for the first half of the year indicates a decelerating pace, as weak corporate demand, trade policy negotiations and political developments all weighed on activity. Central banks are now on guard to take preemptive action to prevent a sustained downturn.

Easing

Current Monetary Policy

- Policy rate: -0.1%
- Ten-year JGB target rate: 0%
- QE annual purchases: ¥80T JGB
  ¥6T ETF
  ¥90T J-REIT

Analysis

BOJ reaffirmed current policy in June, with its commitment to a low interest rate until at least Q1 2020. Inflation below target and October tax hike skew towards easing.

PBOC cut RRR 100 bps total in January. Has tepidly been easing with larger lending programs for small- to medium-sized banks and open market liquidity injections.

ECB extended its pledge to maintain interest rates into 2020 in response to trade policy risk. Open to restarting QE or cutting rates, as it cut growth forecasts.

Steady

- Refinancing rate: 0%
- Marginal lending facility: 0.25%
- Deposit facility: -0.4%
- QE ended; maintain balance sheet

Analysis

Fed now considering a rate cut this year in response to weakening economic data. Cut IOER by 5 bps in June due to funding pressures.

BOE says it is biased toward hiking rates, contingent on a favorable withdrawal from the EU, though a no-deal exit and weakening data will provoke the BOE to reconsider.

SNAPSHOT OF ECONOMIC DATA

<table>
<thead>
<tr>
<th>Japan</th>
<th>China</th>
<th>Eurozone</th>
<th>US</th>
<th>UK</th>
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<tbody>
<tr>
<td>2.4%</td>
<td>3.7%</td>
<td>7.5%</td>
<td>3.7%</td>
<td>3.8%</td>
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<td>0.8%</td>
<td>2.7%</td>
<td>1.2%</td>
<td>1.6%</td>
<td>2.0%</td>
</tr>
<tr>
<td>6.4%</td>
<td>1.2%</td>
<td>3.2%</td>
<td>1.8%</td>
<td></td>
</tr>
</tbody>
</table>

Markets and Performance
Overview

Markets and performance

US fixed income rallied in Q2 as the Fed indicated a greater likelihood of a rate cut this year. The “risk-on trade” was in full effect in Q2, driven by a seemingly accommodative Fed and a temporary impasse in the US-China trade deal. Both US investment-grade (IG) corporate and government bonds delivered higher positive returns relative to other assets classes in the aggregate.

Short-duration fixed income performance trailed its long-end counterparts as investors increased portfolio duration in anticipation of lower interest rates. Short ABS outperformed in Q2 and remains a nice defensive, high-quality option due to its relatively stable fundamentals.

Despite mixed economic data weighing on business confidence, corporate fundamentals remained broadly stable. The US IG corporate debt pile is manageable as leverage continued to stay at an adequate level. On the consumer side, credit card charge-offs edged up from their all-time low, but overall credit quality remained solid, reflecting steady employment and wage growth data.
## Broad Market Performance

### Asset class returns

<table>
<thead>
<tr>
<th>Year</th>
<th>Gold</th>
<th>REIT</th>
<th>Wilshire</th>
<th>S&amp;P 500</th>
<th>Crude Oil</th>
<th>US Aggregate</th>
<th>Crude Oil</th>
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</thead>
<tbody>
<tr>
<td>2010</td>
<td>29.67%</td>
<td>16.47%</td>
<td>33.06%</td>
<td>28.24%</td>
<td>44.80%</td>
<td>0.01%</td>
<td>28.90%</td>
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<tr>
<td>2011</td>
<td>10.23%</td>
<td>16.05%</td>
<td>7.84%</td>
<td>32.39%</td>
<td>7.32%</td>
<td>15.81%</td>
<td>18.70%</td>
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<td>2012</td>
<td>26.97%</td>
<td>8.15%</td>
<td>16.00%</td>
<td>13.69%</td>
<td>7.44%</td>
<td>17.13%</td>
<td>17.18%</td>
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<tr>
<td>2013</td>
<td>REIT</td>
<td>26.97%</td>
<td>16.05%</td>
<td>13.69%</td>
<td>7.32%</td>
<td>15.81%</td>
<td>17.18%</td>
</tr>
<tr>
<td>2014</td>
<td>10.23%</td>
<td>16.00%</td>
<td>12.70%</td>
<td>13.00%</td>
<td>12.50%</td>
<td>17.13%</td>
<td>15.12%</td>
</tr>
<tr>
<td>2015</td>
<td>28.24%</td>
<td>16.05%</td>
<td>12.70%</td>
<td>17.00%</td>
<td>12.50%</td>
<td>15.12%</td>
<td>17.12%</td>
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<tr>
<td>2016</td>
<td>44.80%</td>
<td>16.00%</td>
<td>12.70%</td>
<td>17.00%</td>
<td>12.50%</td>
<td>15.12%</td>
<td>17.12%</td>
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<tr>
<td>2017</td>
<td>21.80%</td>
<td>16.00%</td>
<td>12.70%</td>
<td>17.00%</td>
<td>12.50%</td>
<td>17.13%</td>
<td>15.12%</td>
</tr>
<tr>
<td>2018</td>
<td>US Aggregate 0.01%</td>
<td>Crude Oil 28.90%</td>
<td>Wilshire 18.70%</td>
<td>US Aggregate 17.13%</td>
<td>Wilshire 18.70%</td>
<td>Gold 13.70%</td>
<td>US Aggregate 0.01%</td>
</tr>
<tr>
<td>2019 YTD</td>
<td>Crude Oil 28.90%</td>
<td>Wilshire 18.70%</td>
<td>Gold 13.70%</td>
<td>US Aggregate 0.01%</td>
<td>Crude Oil 28.90%</td>
<td>Wilshire 18.70%</td>
<td>Gold 13.70%</td>
</tr>
</tbody>
</table>

US Aggregate refers to Bloomberg Barclays Aggregate Bond Index; US High Yield refers to Bloomberg Barclays US 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.

All returns above are on a total return basis. YTD 2019 returns are on an aggregate basis up to 6/28/2019. Past index performance is no guarantee of future results.

Sources: Thomson Reuters and Bloomberg Barclays indices.
Fixed Income Returns

Investment-grade corporate bonds delivered the strongest returns in Q2, followed by US Treasuries and agency bonds. US mortgage-backed securities (MBS) lagged as lower rates could spur refinancing, thus increasing prepayment risks. Short-duration assets trailed its long-end counterparts as investors increased portfolio duration in anticipation of lower interest rates. Short asset-backed securities (ABS) outperformed in Q2 as the fundamentals remain supportive to mitigate against broad market swings.

Corporates: Debt growth is manageable

While there has been talk of corporate debt reaching new heights as a percentage of US GDP, the debt for large companies still remains significantly below what was seen during the financial crisis, especially net of cash. Furthermore, the rise of debt has been modest and remains significantly below 2008 to 2009 levels, relative to the ability to pay as a ratio of earnings before interest, taxes, depreciation and amortization (EBITDA).

Corporates: Stable credit fundamentals

Despite weakening economic outlooks, corporate credit fundamentals have remained stable for the past year.

S&P 500 Debt to Assets

S&P 500 Operating Margin

Corporates: Credit card charge-offs to normalize

Credit card charge-offs in the financial sector have edged higher, although they’re still remaining low by historical standards. This is a normalization from the decade low, attributable to the rapid loan growth in prior years and seasoning of the lending book. Overall asset quality remained solid, supported by the low unemployment rate and benign credit environment. Banks continue to be disciplined in managing loan growth and delinquencies.

Financial Sector: Average core US charge-off rate* (%)
Relative Value: Spread products still attractive

Spread products, such as corporate bonds and asset-backed securities, offer portfolio diversification and historically attractive enhanced income over comparable Treasuries.

During the first half of 2019, credit and ABS yields rallied approximately 70 basis points. This rally was primarily due to the dovish shift from the Federal Reserve. Risk assets, from equities to high-yield bonds, rallied as well.

Spread products with maturities over one year are currently offering the most attractive yield pick compared to similar-maturity Treasuries. This is primarily due to the front-end yield curve inversion.

Credit and ABS Yield Change

Spread Product Yield vs. Treasuries

Sources: SVB Asset Management and Bloomberg. Data as of 6/28/2019. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.
2019 Yield Curve: Continued inversion

The yield curve inversion that occurred at the end of 2018 continued into the first half of 2019. 2-year to 7-year Treasuries led the rally with yields falling more than 70 basis points.

The 3-month vs. 10-year Treasury spread inverted to a low of -26 bps in June and closed the second quarter at -8 bps. The 2-year vs. 10-year Treasury spread has remained positive in 2019 and finished the second quarter at +25 bps.

US Treasury Yields: On-the-run issues

<table>
<thead>
<tr>
<th>Date</th>
<th>3M</th>
<th>6M</th>
<th>1Y</th>
<th>2Y</th>
<th>3Y</th>
<th>5Y</th>
<th>7Y</th>
<th>10Y</th>
<th>30Y</th>
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</thead>
<tbody>
<tr>
<td>12/31/2018</td>
<td>2.361</td>
<td>2.482</td>
<td>2.599</td>
<td>2.49</td>
<td>2.459</td>
<td>2.512</td>
<td>2.587</td>
<td>2.685</td>
<td>3.015</td>
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<tr>
<td>6/28/2019</td>
<td>2.087</td>
<td>2.09</td>
<td>1.925</td>
<td>1.755</td>
<td>1.706</td>
<td>1.766</td>
<td>1.875</td>
<td>2.005</td>
<td>2.529</td>
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<tr>
<td>Change</td>
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<td>-0.392</td>
<td>-0.674</td>
<td>-0.735</td>
<td>-0.753</td>
<td>-0.746</td>
<td>-0.712</td>
<td>-0.68</td>
<td>-0.486</td>
</tr>
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</table>

Sources: SVB Asset Management and Bloomberg. Data as of 6/28/2019. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.
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