Quarterly Economic Report

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

Q2 2019
Quarterly Economic Report: Q2 2019

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After a turbulent end to 2018, the first quarter of 2019 bounced back with financial conditions improving and volatility easing. Major US equity indices rebounded from negative territory with an average return of almost 14 percent. Meanwhile, the yield curve compressed by 20–27 bps beyond one year as the Fed shifted to a more dovish stance, forecasting no further rate increases in 2019 and one in 2020. However, market participants anticipate the next move may be a rate cut as the economic outlook continues to be clouded by slower global growth, uncertainty about international trade and muted inflation.

US growth in Q4 moderated as tailwinds of tax cuts have faded, and Q1 growth is expected to be lower due to the seasonal effects of weather, the government shutdown and uncertainty about trade policy. The bright spot of the US economy, the labor market, continues to be on firm footing. Inflation has been muted recently, trending slightly below the Fed’s target.

Globally, economies continue to grow, albeit at a slower pace. Expectations are for economic activity to improve in the latter half of the year as policy uncertainties are clarified and accommodative monetary policies provide economic stimulus. Consumption continues to support the global economy despite ongoing trade discussions, which are expected to slow growth.

As the year progresses, economic data will provide more information regarding the health of the economy and the direction of the Fed’s next rate move. Globally, accommodative central banks will help support growth as policy issues continue to be an ongoing negotiation. In light of the dynamic market environment, investment strategies will incorporate the shape of the yield curve, central bank monetary policy, the global growth outlook and the health of credit fundamentals. We anticipate a year of greater volatility, and advocate for frequent and thorough evaluation of investment options to help clients navigate market dynamics and meet their investment objectives.
Domestic Economy
Overview

Domestic economy

Economic data in the first quarter was mixed, showing signs that the US economy is slowing as the effects of the 2017 tax cuts fade. As expected, in light of the moderating data, the Fed revised forecasts downward anticipating no further interest rate increases in 2019 and only one in 2020. In addition, the Fed announced plans to reduce the balance sheet unwind starting in May and ending it in September. At the current federal funds rate, the Fed believes it is at a neutral range where the economy should remain stable.

The final quarter of 2018 showed that economic growth moderated to 2.2 percent from 3.4 percent the prior quarter. Growth in Q4 was driven by consumption and business investment, while government spending and net exports weighed it down. Headwinds continue for 2019 as the effects of tax reform sunset, the global slowdown persists and trade negotiations continue to add to the uncertainty.

A review of the labor market shows that while job growth in Q1 2019 averaged a healthy 180,000 jobs per month, passing factors such as inclement weather and the aftermath of the government shutdown resulted in a soft patch of economic data. The housing market continues to moderate with home price growth decelerating on a year-over-year basis, mainly driven by a drop in prices in metro areas.

Inflation has been muted, recently falling below the Fed’s 2 percent target and supporting the Fed’s stance to hold rates unchanged in 2019. In addition, while oil prices have risen due to geopolitical events affecting supply, the Fed mainly focuses on core inflation, which excludes volatile inputs such as food and energy.
The final quarter of 2018 showed that economic growth moderated to 2.2 percent from 3.4 percent the prior quarter. Growth in Q4 was driven by consumption and business investment, while government spending and net exports slowed it down. Overall, growth for 2018 came in at 2.9 percent, still above trend and higher than the 20-year average of 2.2 percent. Headwinds continue in 2019 as the effects of tax reform fade, the global slowdown persists and trade negotiations continue to add to the uncertainty.

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**GDP and Components**

Sources: Bureau of Economic Analysis, Congressional Budget Office and SVB Asset Management. Data as of 3/31/2019. GDP values shown in legend are percent change vs. prior quarter, on an annualized basis.
Consumption: Consumer activity wanes

Consumer activity slowed in Q4, increasing only 2.5 percent vs. 3.5 percent the prior quarter. Meanwhile, households maintained healthy balance sheets with a stable ratio of debt to disposable income. Momentum in retail sales has slowed; however, Q1 data looks better than expected with improvements in auto sales and increases in sales through online retailers.

Consumption Overview


Retail and Food Services Sales

Employment: Solid footing

While job growth in Q1 2019 averaged 180,000 jobs per month, there was a deceleration due to passing factors such as inclement weather and the aftermath of the government shutdown that attributed to only 20,000 jobs added in February. Overall, the labor market continues on solid footing with the unemployment rate at a 50-year low of 3.8 percent and the labor force participation rate for prime-age workers maintaining a healthy level.

Employment Landscape

US Housing: Price deceleration

Home price growth has decelerated on a year-over-year basis, mainly driven by a drop in prices in metro areas. Despite the deceleration, prices should continue to be buoyed by limited inventory. However, the fall in mortgage rates that started in Q4 continued into Q2, helping to improve home affordability and spur refinancing.

Home Sales and Supply

Home Prices — Indexed to 100

Sources: Bloomberg, Standard & Poor’s, Federal Housing Finance Agency and SVB Asset Management. Data as of 3/31/2019. Case-Schiller 20-City is a Standard & Poor’s composite index of the home price index for 20 major US metropolitan areas. FHFA purchase is the Federal Housing Finance Agency purchase-only house price index.
Inflation Is Muted

Inflation has been muted recently falling below the Fed’s 2 percent target and supporting the Fed’s stance to hold rates unchanged in 2019. Average hourly wages have been steady and unlikely to spur inflation. In addition, while oil prices have risen due to geopolitical events affecting supply, the Fed mainly focuses on core inflation, which excludes volatile inputs such as food and energy.

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

Oil Prices

Global Economy
Global economy

A sluggish start to 2019 won’t stop the global economy from achieving another year of growth. The pace of economic activity should pick up toward year-end as political developments may hamper demand while accommodative monetary policies drive it up. Global real GDP is estimated to rise by 3.3 percent this year, according to the Organization for Economic Cooperation and Development (OECD), which would be 0.3 percent lower than 2018.

Employment conditions marked by tight labor supply will be a key ingredient to keeping economic conditions stable in developed economies, even as employment rates in a few countries have remained stubbornly low despite recent improvements. Consumer consumption levels are uneven in developed economies, with healthy demand in the US, Germany and Spain countered by much milder conditions in Japan, Italy and Sweden.

Unfavorable demographics and fiscal restraint have been drags on consumption in some developed economies, leading to persistent current account surpluses and a reliance on demand growth from emerging economies to alleviate imbalances. Imports could get a lift with some strengthening of emerging economy currencies. Labor conditions are generally weaker in emerging economies but could be aided by monetary loosening, as central banks there have room to cut interest rates.

Policy responses are expected to emerge if economic activity does not accelerate in the second half of the year.
Global Economy on Course

The global economy remains in expansion mode despite a sluggish start to the year. While the growth rate this year will be less than 2018, hampered in part by political developments, the pace should pick up by the fourth quarter, as benign inflation allows central banks to spur economic activity with accommodative policies.

Economic Activity Is Mostly Positive

Globally Inflation Is Well Contained

Consumption Growth Underpins Global Economy

Estimates for continued consumption growth in most economies around the world are helping to sustain an expansionary economic environment. With no tightening actions anticipated for the rest of the year from most major central banks in developed economies, demand could improve in emerging economies. Emerging economies may benefit as their currencies strengthen and inflation eases, paving the way for more imports.

World Trade Endures Despite Trade Policy Uncertainties


Global Trade Expected to Slow but Grow

Sources: World Trade Organization, OECD and SVB Asset Management.
The US dollar will likely be capped by the Federal Reserve’s stance to hold rates steady for the rest of 2019, as domestic and global growth have weakened and inflation remains muted. The US dollar’s performance has been mixed against G10 currencies, and other central banks have also voiced a neutral policy stance until higher growth expectations arise.

The greenback also faced headwinds from trade policy negotiations with China, which have been ongoing for nearly a year with no firm conclusion. The renminbi is up 2.5 percent this year, falling to 6.7 from nearly 7.0 late last year. Nonetheless, concerns about mounting bad debts and slowing growth have remained in the headlines despite recent uptick in economic activities. The longer trade talks drag on, the greater the effects on the respective currencies.

**USD to End Its Gradual Rise**

**CNY Has Gained Along With Trade Policy Hopes**

While the GBP has gained nearly 3 percent during through the first quarter of 2019, the pound has been volatile. The Bank of England (BOE) has conceded to leave interest rates steady until there is a clearer path on Brexit, as the economic uncertainties are a real concern. The policy stance dovetails well given the recent dovish tone from the Federal Reserve. Any likelihood of a long extension for a deal will keep the pound in a tight trading range.

With the EU agreeing to extend Britain’s exit by six months to October 31 with an opportunity to review the progress in June, officials continue to be at an impasse on agreeing to an exit deal. Members of Parliament have rejected all four Brexit options that were introduced to replace Prime Minister May’s plan, which was also voted down three times in the House of Commons. The PM is still trying to create a new plan with the support of the Labour Party to submit to EU leaders. Negotiations will be a constant headwind for the pound until the situation is resolved.

**Brexit Puts Interest Rates on Hold**

**GBP Muddles Amid Brexit Debate**

Central Banks
Central banks

Dovish policy reverberated through global central banks in the first quarter of 2019, in what was a swift 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. The dovish pivot has been attributed to the Fed’s desire to take a more patient and data-dependent approach as policy nears the neutral rate, as well as in response to uncertain outcomes of global “crosscurrents.” Market participants continue to speculate that the Fed’s next policy move may in fact need to be a cut.

Synchronized global growth and inflation outlooks continued to deteriorate in the first quarter. At its March 2019 meeting, reflecting this reality, the European Central Bank (ECB) announced its expectation that policy rates will remain on hold through the end of 2019, versus previous guidance for the middle of 2019. At the same time, additional stimulus in the form of refinancing operations was announced to boost policy accommodation. 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, and how the Fed’s pivot will affect the trajectory of the US. For now, the Fed seems to have paused its tightening cycle, having raised rates nine times since 2015, while a plan to end the balance sheet wind-down has been set in motion to start in May of 2019.
Historical Interest Rates

Fed policy normalization and the resultant policy rate hikes have elevated yields in the front end of the US fixed income market. A more data-dependent approach in 2019 has caused a recent dip in yields compared to year-end 2018.

2Q18: Treasury yields marched higher, as the FOMC met expectations by raising rates at their June meeting. In contrast to March, median FOMC member projections increased to four total rate hikes in 2018, up from three in March.

3Q18: The FOMC raised rates for the third time in 2018, and 12 of 16 committee members projected they would raise rates in December 2018 as well. Median projections for 2019 were unchanged at three rate hikes.

4Q18: The FOMC raised the federal funds rate for the fourth and final time in 2018, as the committee revised downward 2019 rate hikes to a median of two. One- and two-year Treasury yields inverted as future hikes got priced out by market participants.

1Q19: The FOMC left rates unchanged at their March 2019 meeting, while communicating a shallower median projection for zero rate hikes during the year. Additionally, a plan was formalized to end the balance sheet runoff beginning in May. Markets began to speculate and position for potential rate cuts in the later part of 2019 and early 2020.

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.


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

Global growth has moderated though employment has remained strong and synchronous, while inflation has remained relatively subdued.

<table>
<thead>
<tr>
<th>Economic Projections</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
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<tbody>
<tr>
<td><strong>United States</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in real GDP</td>
<td>2.9%</td>
<td>2.1%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Core PCE inflation</td>
<td>1.9%</td>
<td>2.0%</td>
<td>2.0%</td>
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<tr>
<td>Unemployment rate</td>
<td>3.9%</td>
<td>3.8%</td>
<td>3.9%</td>
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<tr>
<td><strong>United Kingdom</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in real GDP</td>
<td>1.4%</td>
<td>1.2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>2.5%</td>
<td>2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>4.1%</td>
<td>4.1%</td>
<td>4.1%</td>
</tr>
<tr>
<td><strong>Eurozone</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Change in real GDP</td>
<td>1.9%</td>
<td>1.1%</td>
<td>1.6%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>1.8%</td>
<td>1.2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>8.2%</td>
<td>7.9%</td>
<td>7.7%</td>
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<tr>
<td><strong>China</strong></td>
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<tr>
<td>Change in real GDP</td>
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<td>N/A</td>
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<tr>
<td>CPI inflation</td>
<td>2.1%</td>
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<td>N/A</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.8%</td>
<td>N/A</td>
<td>N/A</td>
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<td><strong>Japan</strong></td>
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<td></td>
<td></td>
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<tr>
<td>Change in real GDP</td>
<td>0.8%</td>
<td>0.9%</td>
<td>1.0%</td>
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<tr>
<td>Core CPI inflation</td>
<td>0.8%</td>
<td>0.9%</td>
<td>1.4%</td>
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</table>

Central Banks: At recess

Mild inflation and decelerating growth are affording major central banks time to assess developments before taking any new action. While employment conditions remain stable, political developments, trade policy changes and the trailing effects of reversing years of monetary stimulus will push some central banks to an easing bias.

Analysis

Skewed toward further easing, with the BOJ far from its 2% inflation target, weak wage growth, slowing demand for exports, and a scheduled tax hike in October.

PBOC cut RRR 100bps total in January, with further easing likely to cushion slowing growth and negative effects of trade policy changes.

ECB plans to keep interest rates unchanged in 2019 and start a new two year loan program for banks to keep credit flowing and support sliding economic conditions.

BOE policy to remain unchanged until there is clarity around the terms of the UK’s withdrawal from the EU. A rate hike could follow a favorable exit.

No further rate hikes anticipated in 2019 to help offset economic weakness during Q1 and tightening conditions from the Fed’s balance sheet reduction program.

ECONOMIC SNAPSHOT

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>China</th>
<th>Eurozone</th>
<th>UK</th>
<th>US</th>
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<tbody>
<tr>
<td>UNEMPLOYMENT</td>
<td>2.3%</td>
<td>3.8%</td>
<td>3.9%</td>
<td>3.8%</td>
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<tr>
<td>INFLATION</td>
<td>0.7%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.9%</td>
<td>1.8%</td>
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<td>GDP</td>
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<tr>
<td>BENCHMARK RATE</td>
<td>-0.1%</td>
<td>-0.4%</td>
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</table>


SVB Asset Management | Quarterly Economic Report Q2 2019
Markets and Performance
Overview

Markets and performance

Financial markets rebounded in the first quarter of 2019 as the fears that drove the markets lower in the fourth quarter of 2018 have somewhat eased. The US government reopened from the shutdown, the US and China are coming to the table to work a deal to end the trade war, the Fed has indicated no interest rate hikes this year, and worries about a US slowdown have diminished.

In Q1, the US Treasury curve continued to flatten and even invert in certain spots, while spread products rallied and generated positive total returns.

While corporate debt has been on the rise and reached a new high relative to US GDP, the debt level for large companies remains significantly below what was seen during the financial crisis, especially net of cash and relative to the ability to pay.

Despite weakening economic outlooks, corporate credit fundamentals remained stable over the past 12 months.
## Broad Market Performance

All returns above are on a total return basis. YTD 2019 returns are on an aggregate basis up to 3/31/2019. 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.

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<tbody>
<tr>
<td>Gold 29.67%</td>
<td>Gold 10.23%</td>
<td>REIT 16.47%</td>
<td>Wilshire 33.06%</td>
<td>REIT 28.24%</td>
<td>S&amp;P 500 1.40%</td>
<td>Crude Oil 44.80%</td>
<td>S&amp;P 500 21.80%</td>
<td>US Aggregate 0.01%</td>
<td>Crude Oil 33.30%</td>
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<td>REIT 26.97%</td>
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<td>Wilshire 17.18%</td>
<td>US Aggregate 7.84%</td>
<td>S&amp;P 500 16.00%</td>
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<td>Crude Oil 15.10%</td>
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<td>S&amp;P 500 15.06%</td>
<td>S&amp;P 500 2.11%</td>
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<td>Gold -10.50%</td>
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<td>US Aggregate 6.54%</td>
<td>Wilshire 0.98%</td>
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<td>Gold -28.26%</td>
<td>Crude Oil -45.76%</td>
<td>Crude Oil -30.50%</td>
<td>US Aggregate 2.65%</td>
<td>US Aggregate 3.54%</td>
<td>Crude Oil -25.30%</td>
<td>Gold 1.30%</td>
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</tr>
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</table>

Sources: Thomson Reuters and Bloomberg Barclays indices. Past index performance is no guarantee of future results.
Fixed Income Returns

The broad US bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, rallied in Q1. Investment-grade corporate credit delivered the strongest returns relative to other fixed income assets. Tightening spreads and falling US Treasury yields contributed to the positive returns in Q1.

<table>
<thead>
<tr>
<th>US Aggregate Index</th>
<th>Current Duration</th>
<th>Current Yield %</th>
<th>Annual Total Return %</th>
<th>Non-annualized Periodic Total Return %</th>
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<tr>
<td></td>
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<td>YTD 2019</td>
<td>2018</td>
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<tr>
<td>US Treasuries</td>
<td>6.21</td>
<td>2.38</td>
<td>2.11</td>
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<td>Corporates</td>
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<td>1.77</td>
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<td>US CMBS</td>
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<table>
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<th>US Short Duration</th>
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<tr>
<td>1-3 Year US Treasuries</td>
<td>1.92</td>
<td>2.31</td>
<td>0.99</td>
<td>1.55</td>
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<td>1-3 Year Corporates</td>
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<td>&lt;1 Year Corporates</td>
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<td>AAA Credit Card ABS</td>
<td>2.35</td>
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<td>1.67</td>
<td>1.49</td>
<td>1.34</td>
<td>0.45</td>
<td>0.36</td>
<td>-0.48</td>
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<tr>
<td>AAA Auto ABS</td>
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<td>1.39</td>
<td>1.05</td>
<td>0.53</td>
<td>0.43</td>
<td>-0.25</td>
</tr>
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</table>

Sources: Bloomberg Barclays indices. Data as of 3/31/2019. Heatmap colors based on periodic return percentage for time period shown. Past performance is not a guarantee of future results.
US Consumer ABS: Lifted by strong employment

The performance of asset-backed securities (ABS) collateralized by credit card and auto loans has been strong, as consumers’ payment capacities have been buoyed by low unemployment, mild wage gains and sensible debt profiles. While credit performance is expected to normalize, delinquencies and defaults should stay at prudent levels after reaching historical lows.

Credit Card Delinquencies Remain Low

Credit Card Charge-Offs Remain Low

Auto Loan Delinquencies Rising, but Not for All

Auto Loan Default Incidents Are Steady

*Average delinquency rate of 720-759 and 760+ credit score buckets.

Corporates: Debt growth is manageable

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

Corporates: Stable credit fundamentals

Despite a weakening economic outlook, corporate credit fundamentals have remained stable for the past year, with notable improvements in both leverage and operating margin in the energy and communication sectors.

**S&P 500 Debt to Assets**

- February 2018
- February 2019

**S&P 500 Operating Margin**

- February 2018
- February 2019

The yield curve inversion that occurred at the end of 2018 continued into the first quarter of 2019. One-year to 30-year Treasuries rallied over 20 basis points in the first quarter, while 3- and 6-month T-bills barely changed.

Increased T-bill supply is keeping front-end yields higher, while slower expected US GDP growth, tame inflation expectations and slowing global growth are causing longer yields to rally.

2018 Yield Curve: Continued inversion

US Treasury Yields: On-the-run issues

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<th>1Y</th>
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<td>-0.279</td>
<td>-0.200</td>
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Sources: SVB Asset Management and Bloomberg. Data as of 4/4/2019. Past performance is not a guarantee of future results. The information above is not to be construed as a recommendation for your particular portfolio.
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 quarter of 2019, credit and ABS yields rallied approximately 30 basis points. This rally was primarily due to dovish comments from the Federal Reserve. Risk assets from equities to high-yield bonds rallied as well.

Spread products with maturities greater than one year are currently offering the most attractive yield pick compared to Treasuries with similar maturities. This is primarily due to the yield curve flattening and inversion occurring after the March FOMC meeting.

Credit and ABS Yield Change

Spread Product Yield Vs. Treasuries

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Our Team and Report Authors

Ninh Chung
Head of SVB Asset Management
nchung@svb.com

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

Renuka Kumar, CFA
Head of SAM 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

Kevin Li
Fixed Income Trader
kli@svb.com

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

Fiona Nguyen
Sr. Credit Risk & Research Officer
pnguyen@svb.com

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

Guest contributor
Minh Trang
Senior FX Trader
mtrang@svb.com
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