svb Asset Management

Quarterly Economic Report

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

Q3 2018

Economic Report: Q3 2018

Thoughts From the Desk

Volatility in the U.S. bond market retreated in the second quarter while the U.S. Treasury curve flattened 15 basis points as a result of additional Fed tightening and increased geopolitical uncertainty. With strong economic fundamentals, labor market tightness and inflationary readings arriving at the Fed's preferred target — after a long and slow march, the Fed delivered another 25 basis points in June and a hawkish tone that was more than markets had anticipated. Policy makers' new economic assessment now sets the stage for two additional rate hikes by the end of the year. The Fed also implied, through its dot plot, it expects to raise rates three times in 2019. Although strong economic performance garnered headlines during the quarter, it was largely upstaged by increasing political tensions abroad.

From tariffs on imported European steel and aluminum to an escalating tit-for-tat trade war between the U.S. and China, the prospects of a full-fledged trade war will bring downside risk to future growth. The tariff tiffs were initially seen as limited in size and reach, but when temporary exemptions were eliminated, retaliatory tariffs followed from the EU, Mexico and Canada. More headlines came when additional tariffs were announced against products imported from China. Early estimates indicate these tariffs could deduct one full percentage point from U.S. GDP with even more severe impact to other advanced and emerging economies. Additionally, these potentially non-growth induced inflationary factors could force the Fed's hand and accelerate the removal of monetary accommodations, which in turn would slow the economic engine.

The slope of the yield curve was a closely monitored indicator during the quarter as the spread between the yields on the two-year and 10-year U.S. Treasury notes compressed to 33 basis points to close the quarter. Thus far, the flattening of the yield curve can largely be attributed to rate increases by the Fed. As the curve flattened during the quarter, total return was mostly positive across all fixed income sectors except for corporate credit. In the quarter, total return of the broad investment grade (IG) corporate credit underperformed U.S. Treasuries as the spread widened as a result of increased M&A-induced supply in the industrial sector. Despite higher corporate yields, the additional credit income over Treasuries was not enough to overcompensate the headline risk of M&A rumors.

On balance, growth rebounded after a slow start to the year with three to four percent U.S. GDP growth anticipated in Q2. On the other hand, the synchronized global growth story is showing signs of fatigue just as Central Banks such as the ECB and the Bank of England committed to ending their asset purchase programs and rate hikes to follow in the near horizon.

The uncertainties around the impact of tax reform at the corporate and individual levels and mounting concerns around a global trade war support our strategy to favor high-quality credits. As central banks remove monetary accommodations, we will selectively add duration but with the overarching goal of staying duration defensive to help minimize portfolio volatility.

Domestic Economy

Overview

Domestic economy

The U.S. economy grew by 2.0 percent in Q1 2018, the strongest first quarter reading in three years. Growth was driven by nonresidential investment. The economy continues to benefit from reduced taxes and steady wages propelled by a tight labor market. However, the recent trade conflicts have the potential to hamper future growth.

The unemployment rate touched an 18-year low of 3.8 percent in Q2. However it closed the quarter at 4.0 percent as more participants entered the workforce. The United States continues to add jobs, with an average of over 200,000 jobs per month added in the first half of the year.

The U.S. housing market continues on stable footing; existing home supply has improved from earlier in the year and, despite rising mortgage rates, total home sales are steady.

As the second half of the year kicks off, all inflation measures are finally at or above 2.0 percent. The acceleration in inflation further supports the Fed's stance towards monetary policy normalization and the shift towards a total of four interest rate hikes in 2018.

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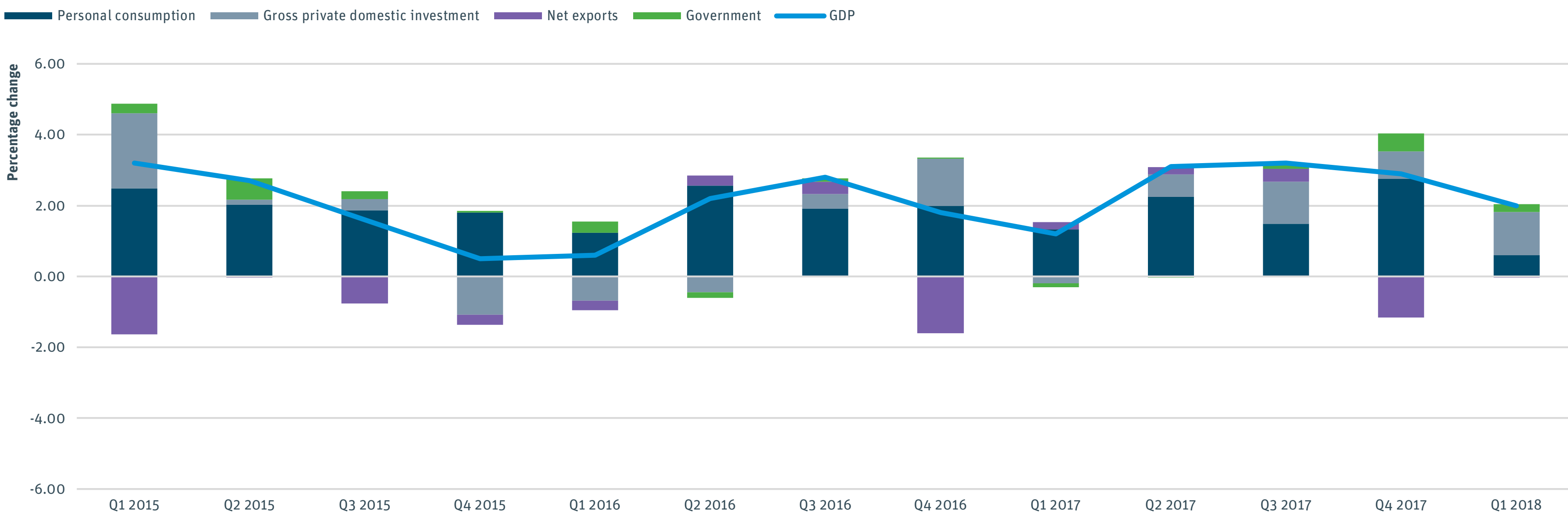
GDP: Strong start to the year

The U.S. economy grew by 2.0 percent in Q1 2018, the strongest first quarter reading in three years. Growth was driven by nonresidential investment. The economy continues to benefit from reduced taxes and steady wages propelled by a tight labor market. However, the recent trade conflicts have the potential to hamper future growth.

GDP and Components

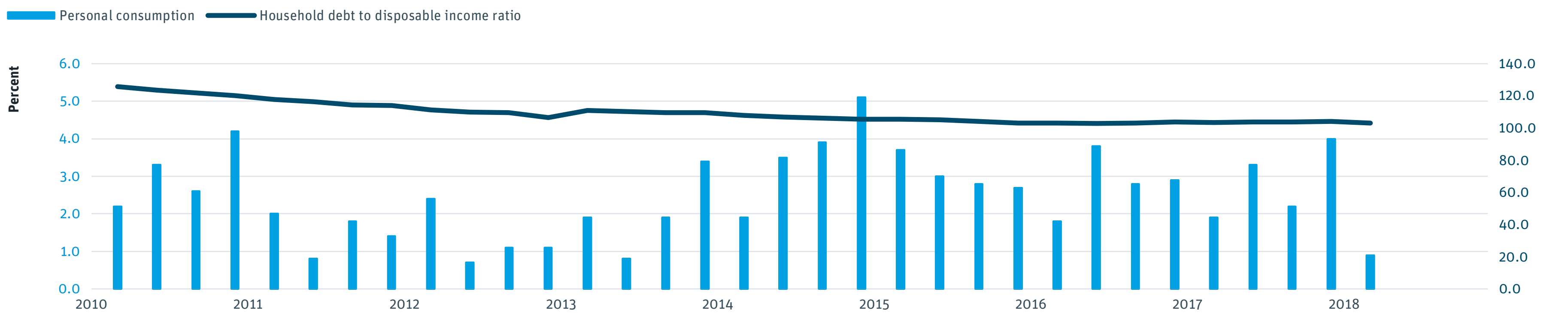


Source: Bureau of Economic Analysis, Congressional Budget Office and SVB Asset Management. Data as of 7/3/2018. GDP values shown in legend are percent change vs. prior quarter, on an annualized basis.

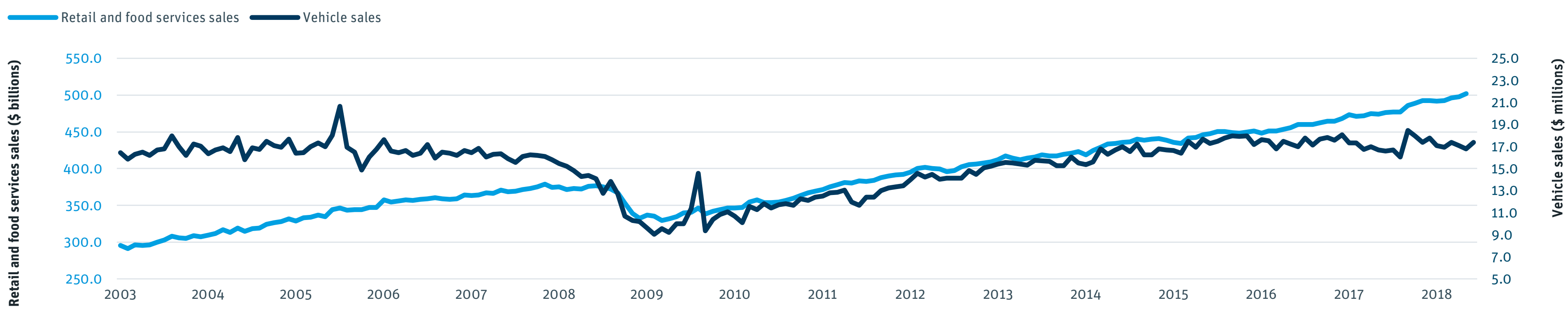
Consumption: Temporary pause

The consumer retreated in Q1; however, as the economy moves into the second half of the year expectations are for the consumer to pick up again. Recent retail sales numbers show that sales have accelerated and should drive growth as the year progresses.

Consumption Overview



Retail and Food Service Sales

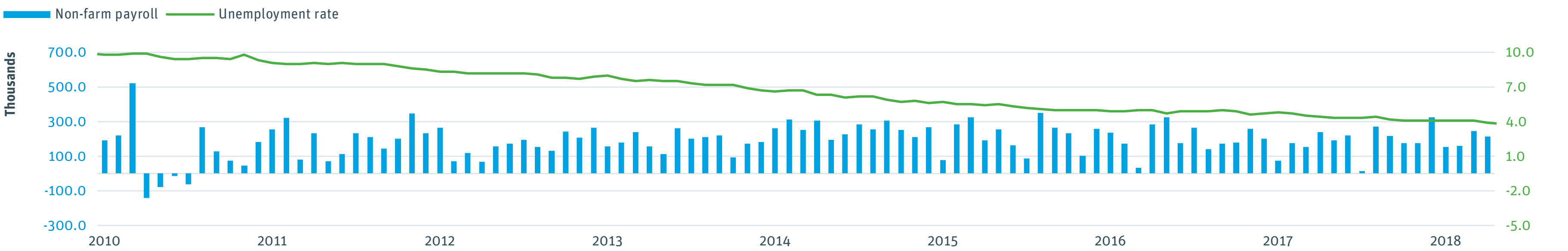


Source: Bloomberg and SVB Asset Management. Data as of 7/3/2018.

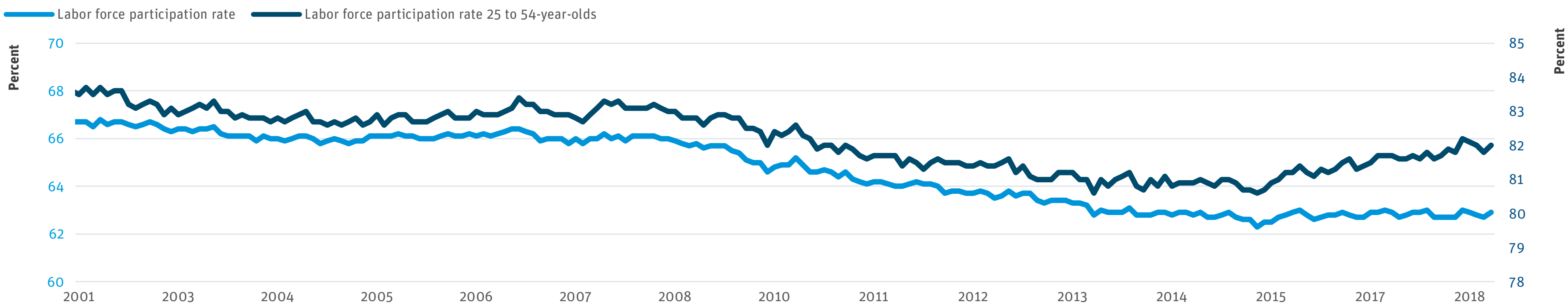
Employment: Healthy balance

The unemployment rate touched an 18-year low of 3.8 percent in Q2. However it closed the quarter at 4.0 percent as more participants entered the workforce. The United States continues to add jobs at a heathy pace, with an average of over 200,000 jobs per month added in the first half of the year. Furthermore, the labor force participation rate for 25 to 54-year-olds shows a strong pace of growth the last few years.

Employment Landscape



Labor Force Participation

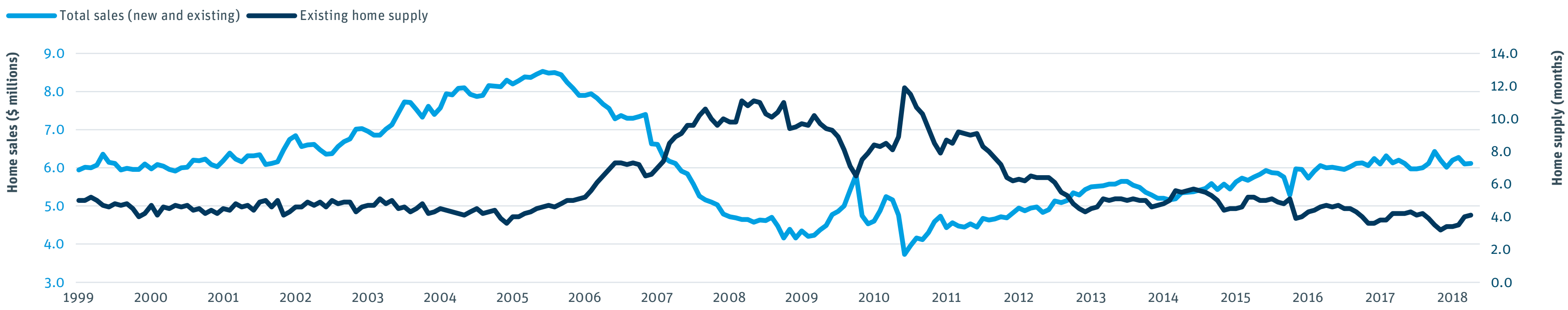


Source: U.S. Bureau of Labor and Statistics, Bloomberg and SVB Asset Management.
Data as of 7/6/2018.

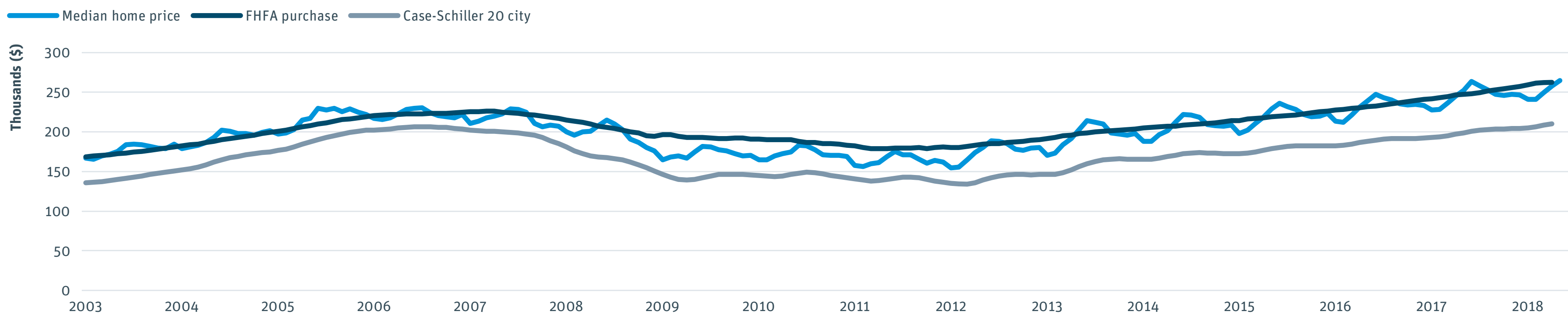
U.S. Housing: Stable footing

The U.S. housing market continues on stable footing; existing home supply has improved from earlier in the year and, despite rising mortgage rates, total home sales are steady.

Home Sales and Supply



Home Prices — Indexed to 100

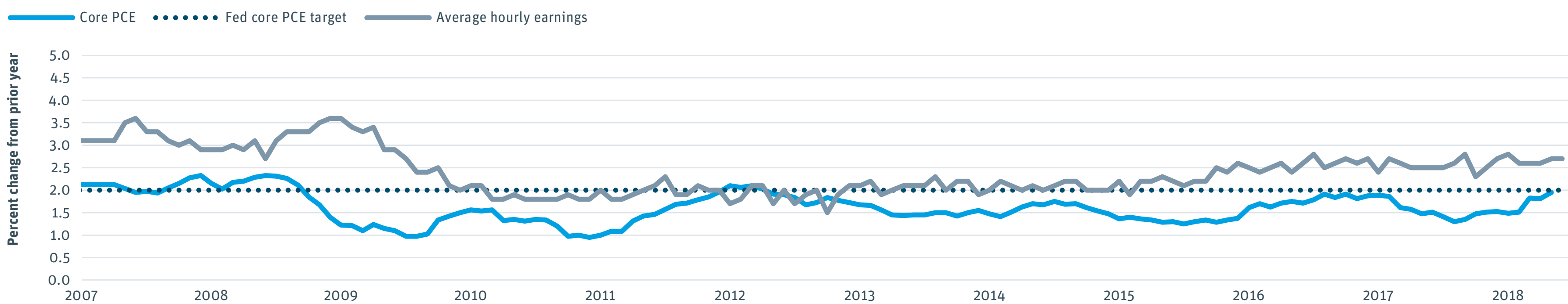


Source: Bloomberg and SVB Asset Management. Data as of 7/3/2018.

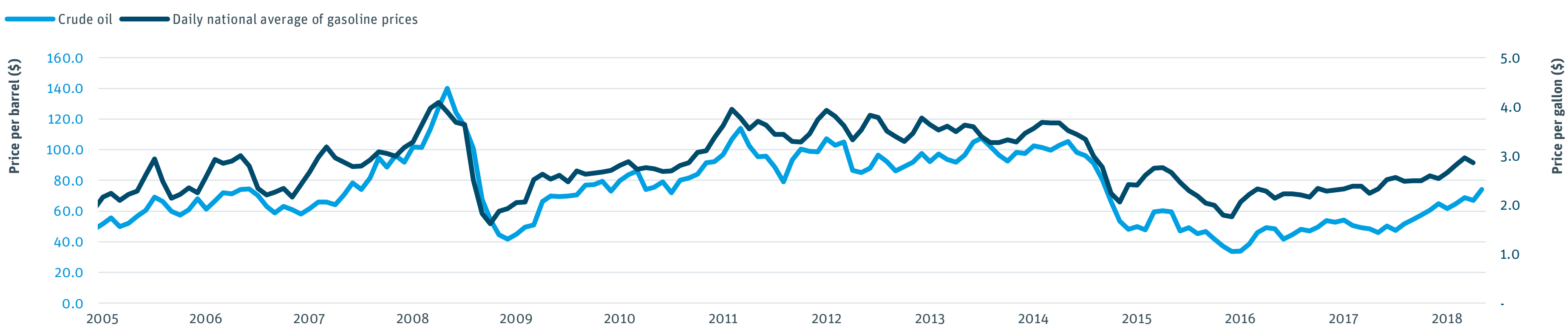
Inflation: Bulls eye

As the second half of the year kicks off, 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 and the shift toward a total of four interest rate hikes in 2018.

Core PCE Below the Fed's Target While Wage Pressure Could Pick Up



Oil Prices



Source: Bloomberg and SVB Asset Management. Data as of 7/3/2018.

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Global Economy

Overview

Global economy

Economies across developed and emerging markets are experiencing positive growth, with few exceptions. This synchronized expansion is particularly supportive for large multinational corporations who have broad geographic reach.

Mild inflation provides scope for easy monetary conditions to be normalized, though some emerging economies are facing challenges with a stronger U.S. dollar.

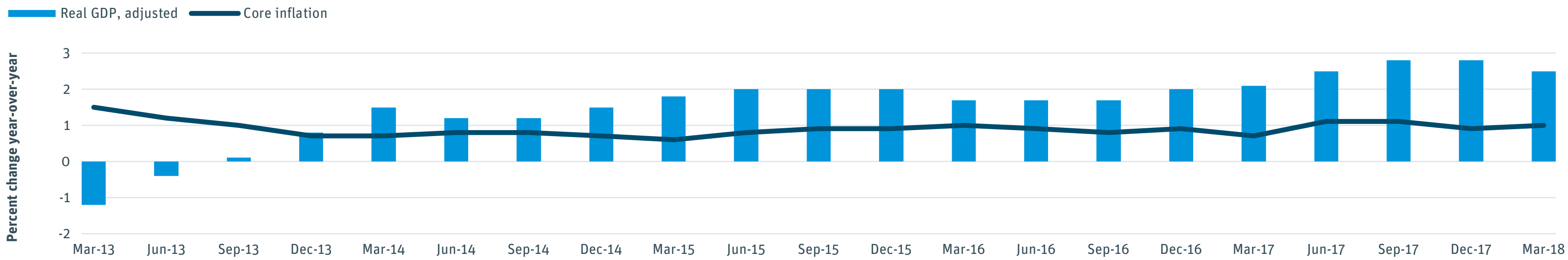
In the eurozone, all economies are in growth mode, though the pace of expansion is slower among the three largest countries.

The U.S. dollar experienced broad strength over the past few months, as the Fed's tightening actions contrast with no significant near-term monetary policy changes in other developed countries, including in the U.K. and the eurozone.

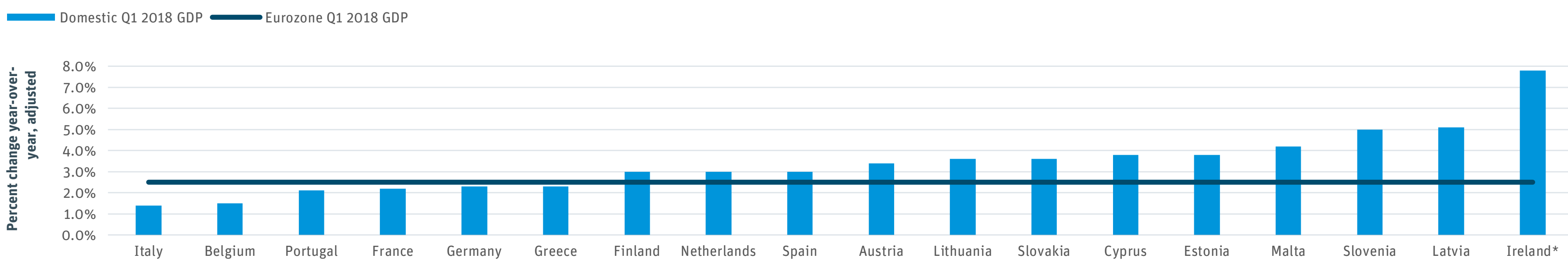
Europe: Glass is half full

The eurozone remains firmly in growth mode, with all member countries posting multiple consecutive quarters of positive year-over-year growth. The economic expansion has been slow and steady, leading to a low rate of inflation and allowing the European Central Bank (ECB) scope to continue a loose monetary policy. Growth rates within the eurozone's three largest economies are expanding below 2.0 percent recently. Spain, aided by strong exports, and Ireland, where consumer spending and construction activity are both thriving, have been outperforming. Smaller Eastern European countries remain robust contributors to the eurozone expansion.

Slow and Steady Growth With Low Inflation



Eurozone Growth: Some Faster, Some Slower



*Data for Q4 2017

Source: Eurostat. Data as of 6/28/2018.

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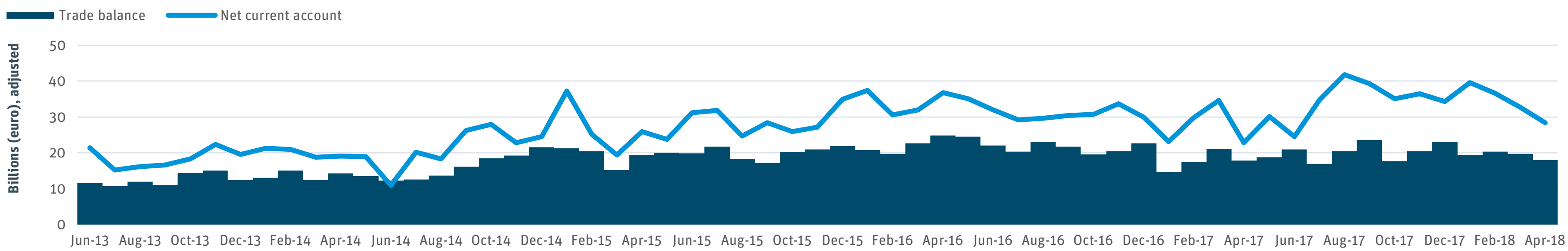
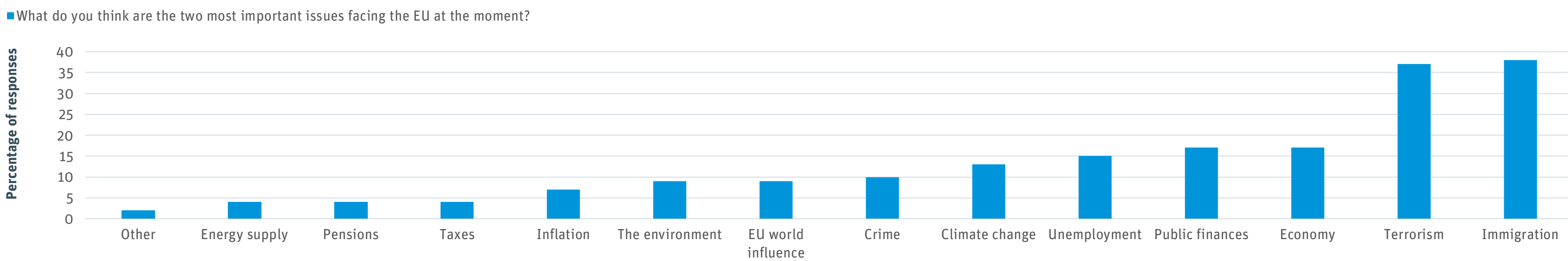
Europe: Subpar demand and politics are drags

Domestic demand has been at under capacity, reflected partially by imports consistently below exports, which has contributed to a persistent current account surplus. This surplus has been a barrier to significant euro currency weakness despite years of near zero interest rates. The relative strength of the euro has helped to keep a lid on inflation, which in turn has kept ECB policies dovish. The eurozone has also experienced political developments that have created uncertainty for financial markets, driven by concerns over immigration and terrorism.

Persistent Current Account Surplus Reflects Subpar Demand



Survey Says: Immigration and Terrorism Top Concerns For EU

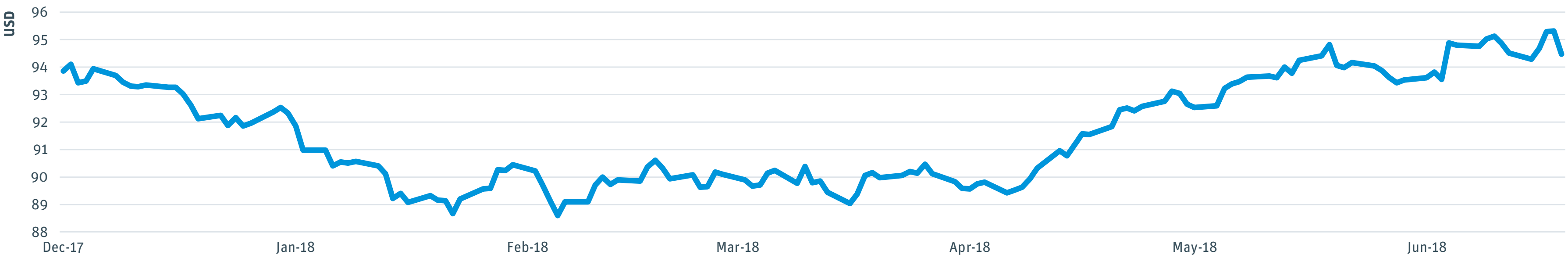


Source: European Central Bank, Eurostat and European Commission (Standard Eurobarometer 88). Data as of 6/28/2018.

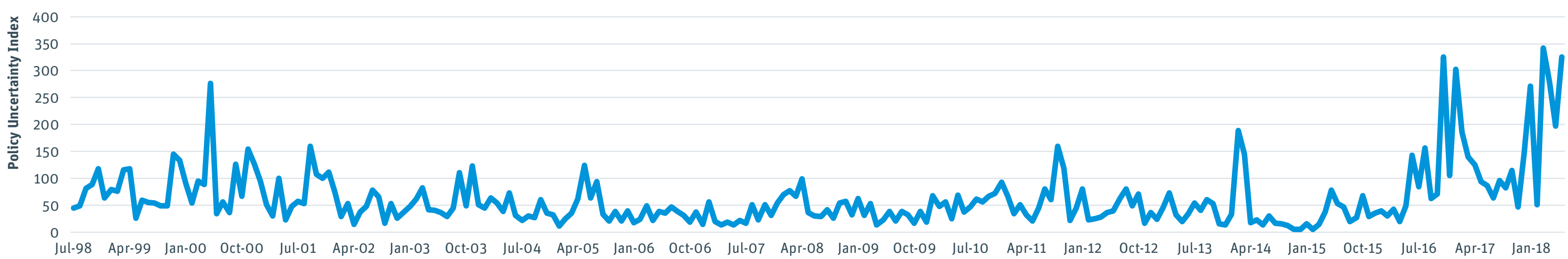
Greenback Outperforms Despite Headwind

The USD index outperformed in Q2 as solid momentum in the U.S. economy allowed the Fed to become more hawkish and lifted expectations for higher interest rates until 2020, coupled with various global regions' diverging economic growth at differing rates. The rise in trade tensions and geopolitical risks also provided support for the USD as a safe haven alternative. With heightened sensitivity to policy uncertainties, markets tend to overreact by factoring in extreme tail risk scenarios. The focus is back on the probable tit-for-tat retaliations that could transpire into an all out trade war with the potential for some countries to take extreme measures by devaluing their currencies or selling foreign assets.

U.S. Dollar Index (DXY)



U.S. Trade Policy Uncertainty



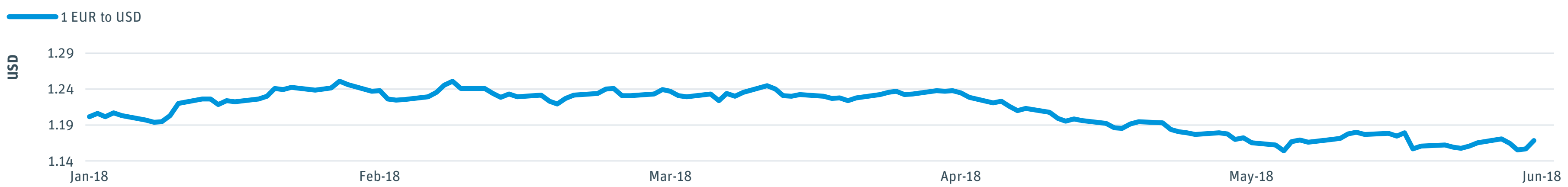
Source: Bloomberg, Silicon Valley Bank and SVB Asset Management. Data as of 6/29/2018.

Euro and Pound: Geopolitical risks ahead

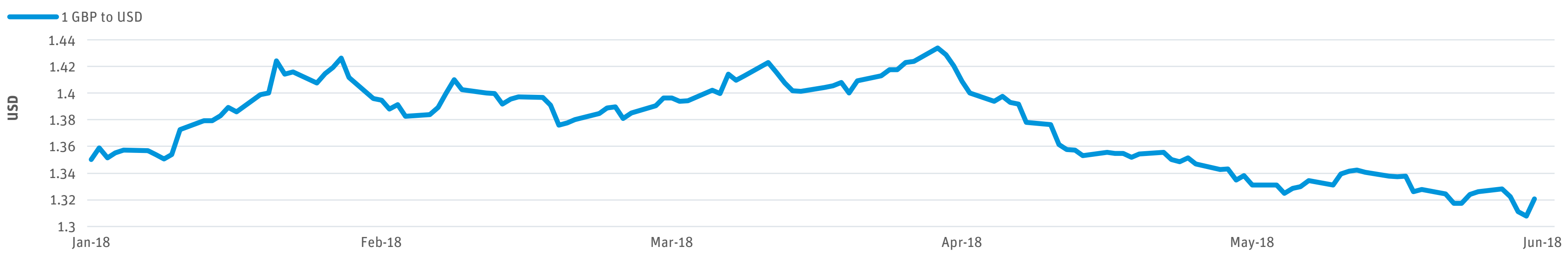
EUR/USD has retraced lower in Q2 due to USD strength and slowing growth outlook in recent months. On June 14, the ECB announced that they would end asset purchases in December but at the same time lowered growth and inflation forecasts. Interest rates are not expected to rise until at least mid 2019, which caught the market by surprise as it was a unanimous vote. Meanwhile, uncertainties over migration policies in Europe, Brexit and politics in Germany and Italy have elevated tail risks for the common currency.

In the U.K., the reversal in GBP/USD has been just as devastating, with cable reaching a seven-month low. USD strength, softer U.K. growth and inflation plus the lack of confidence over Bank of England's ability to raise rates with ongoing Brexit negotiations have leveled the pound. With only nine months left until the end of the EU transitional period and with a divided U.K. cabinet, it has become a gargantuan task to make any meaningful progress on Brexit.

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 6/29/2018.

Central Banks

Overview

Central banks

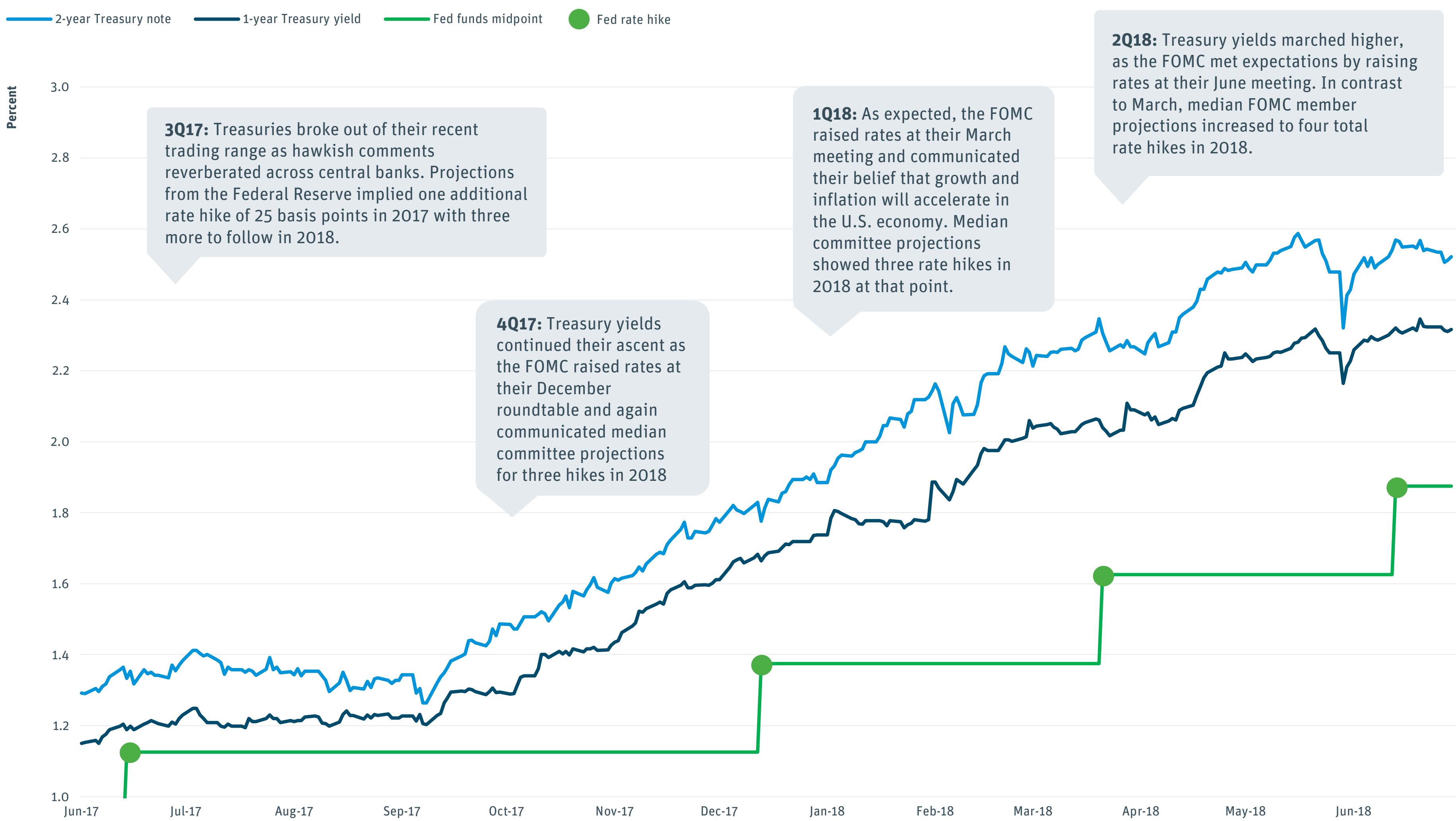
Hawkish sentiment continues to build across the global monetary policy landscape. Recent projections from the Federal Reserve imply two additional rate hikes of 25 basis points in 2018, for a total of four hikes, with three more hikes penciled in for 2019. Front-end Treasury yields continue to rise as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

A synchronized global recovery and improving growth outlooks have tempered versus the start of the year as trade tensions bubble up and monetary policy accommodation has surpassed an inflection point. At its June meeting, the European Central Bank announced a tapering of its asset purchase program, beginning in September and concluding by December 2018. At the same time, with a dovish tilt, Mario Draghi, president of the ECB, announced that the deposit rate would remain unchanged through the summer of 2019.

Uncertainties still remain, such as the ultimate impact of corporate and individual tax reform, timing and uses of repatriated corporate cash, further policy changes such as healthcare reform and infrastructure spending and how the Fed progresses on its path of policy tightening. The Fed is well underway on its tightening 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 6/29/2018.

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Central Bank Economic Projections

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

Economic projections	2017	2018	2019
United States			
Change in real GDP	2.3%	2.8%	2.4%
Unemployment rate	4.4%	3.6%	3.5%
Core PCE inflation	1.5%	2.0%	2.1%
United Kingdom			
Change in real GDP	1.7%	1.4%	1.7%
CPI inflation	2.7%	2.2%	2.1%
Unemployment rate	4.5%	4.1%	4.0%
Eurozone			
Change in real GDP	2.3%	2.1%	1.9%
CPI inflation	1.5%	1.7%	1.7%
Unemployment rate	9.1%	8.4%	7.8%
China			
Change in real GDP	6.9%	6.5%	
CPI inflation	1.6%	3.0%	
Unemployment rate	3.9%	4.5%	
Japan			
Change in real GDP	1.7%	1.6%	0.8%
Core CPI inflation	0.8%	1.3%	2.3%

Source: Federal Reserve, European Central Bank, National People's Congress of China, Bank of Japan and Bank of England. Data as of 6/29/2018. Forecasts are not available for all periods.

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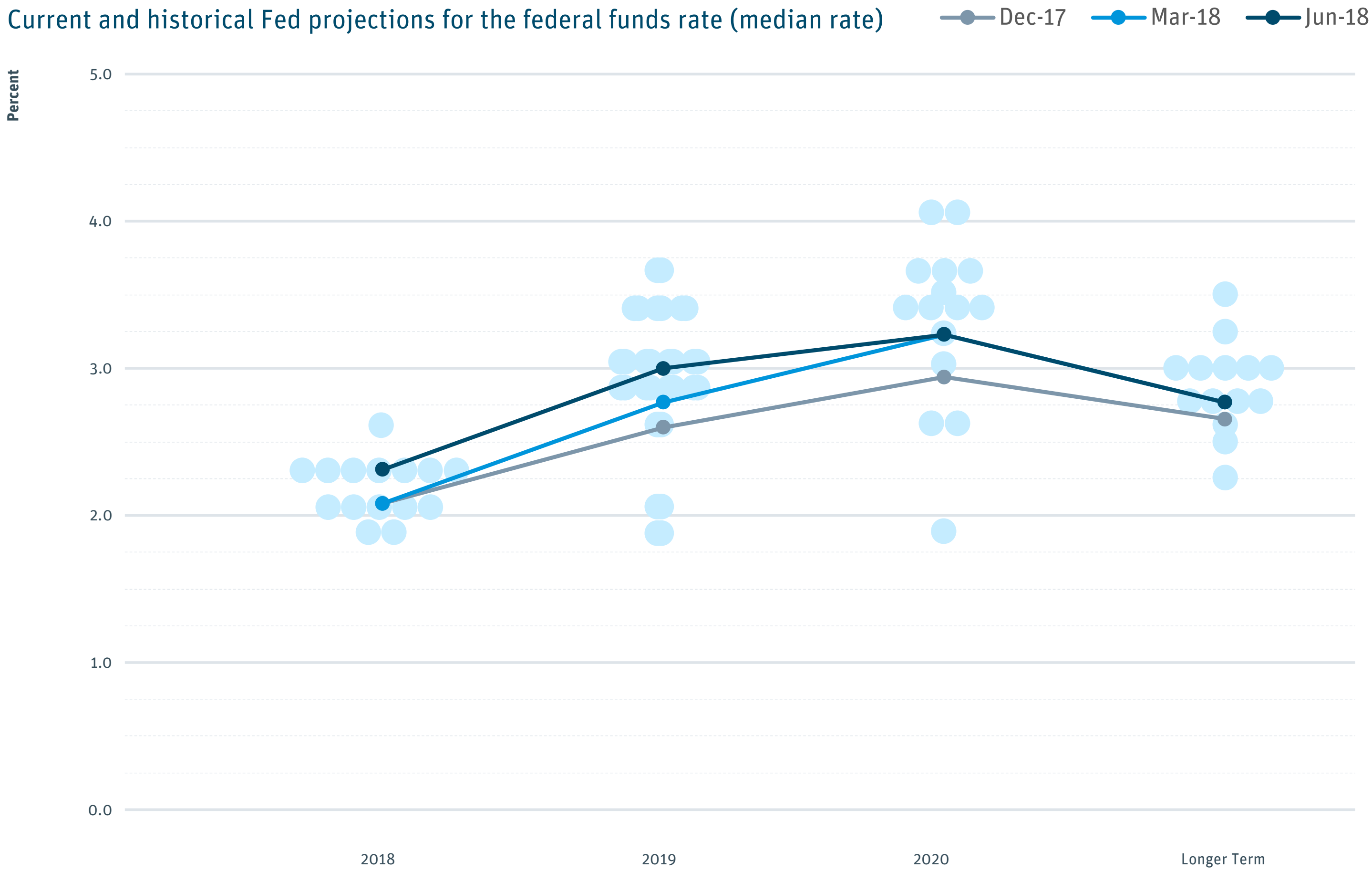
Federal Reserve Rate Projections

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)

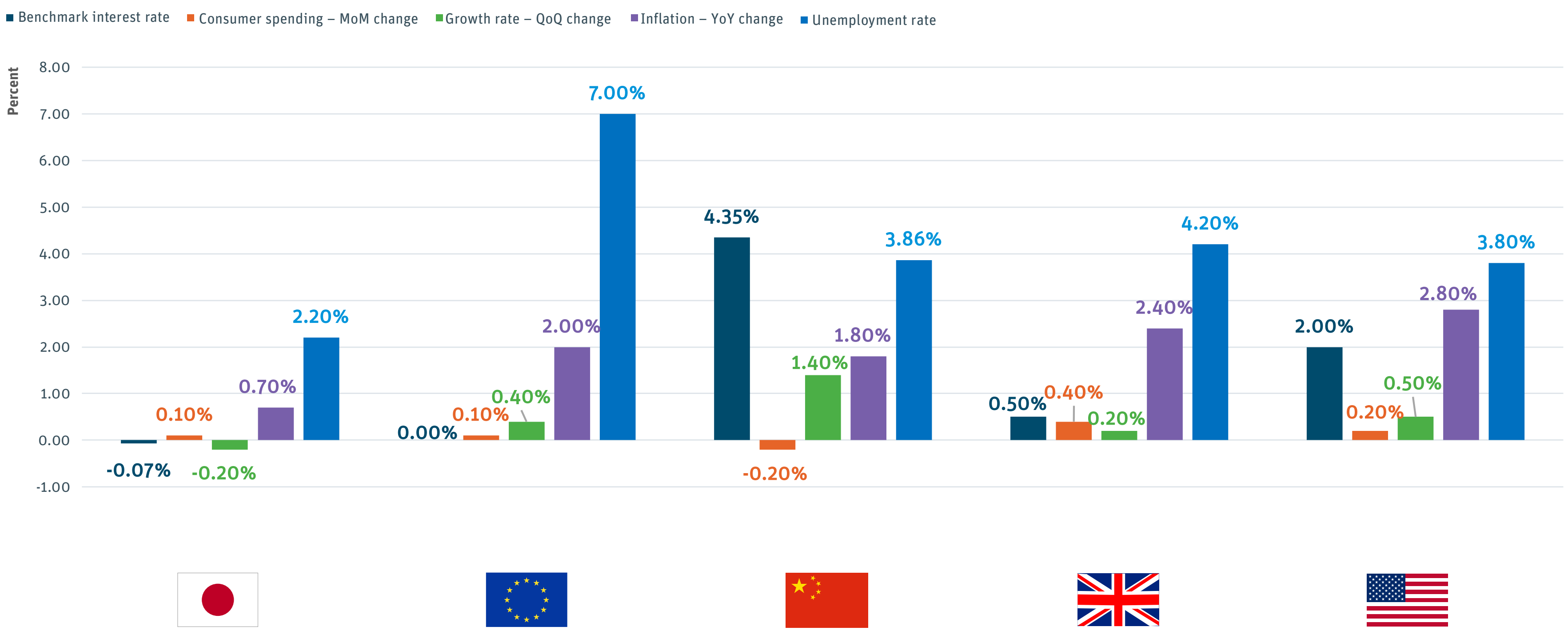


Recent FOMC meetings have indicated a steeper path of interest rate hikes, with current projections implying four rate hikes this year and another three in 2019.

Source: Bloomberg and Federal Reserve. Data as of 6/29/2018.
Median rate references forecasted rate at the end of each period.

Central Banks: No traffic on the offramp

Solid employment gains, positive economic growth and mild inflation allow central banks to maintain a gradual approach to normalization. The measured pace of change provides for accommodative financial conditions to absorb road bumps, including ambiguity arising from political developments.



Analysis	
JAPAN	JAPAN: Inflation inching up but well below target, even as unemployment is at a 25-year low. No change to easing policy.
EU	EU: ECB will end asset purchase program by year-end. Committed to not raising rates before September 2019.
CHINA	CHINA: Conditionally cut reserve requirements by 50 basis points. Chinese financial conditions have weakened recently, while small business activity has slowed.
UK	UK: Domestic demand is firm, helped by a strong labor market. Inching toward a rate hike by September. Committed to keeping monetary conditions loose.
US	US: Strong employment conditions increase odds of interest rate hikes in September and December.

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 7/2/2018.

Markets and Performance

Overview

Markets and performance

The U.S. economy continues to post solid data as positive domestic growth persists, labor markets remain strong and inflation is gaining momentum. This has led the Fed to continue its policy tightening translating to higher interest rates across the yield curve, particularly on the front-end.

The underperformance in long duration credit was technically driven by heavy bond issuance and increased risks from M&A activity, both of which add to supply, impair credit metrics and raise liquidity concerns. However, short duration assets continue to perform well due to strong demand caused by expectations for higher interest rates.

The Dodd-Frank Act rollback effort has gained traction with the enactment of the Economic Growth, Regulatory Relief and Consumer Protection Act, which provides regulatory relief for thousands of small and medium-sized banks with minimal impact to large global banks.

The legislation preserves the Dodd-Frank Act requirement for systemically important banks with over $250 billion in assets, which will continue to be subject to enhanced prudential standards. The Fed would retain the discretionary authority to apply enhanced prudential standards for banks with $100 billion-$250 billion in assets.

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%	Crude Oil 22.6%
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 3.00%
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%	S&P 500 2.60%
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%	U.S. High Yield 0.16%
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 -1.62%
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 -4.20%

All returns above are on a total return basis. 2018 YTD returns are on an aggregate basis up to 6/29/2018. 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: Volatility returns

Short duration sectors have outperformed, generating positive returns as investors position for additional rate hikes. Meanwhile, long duration assets underperformed their short end counterparts, led by corporates that have substantially lagged other risk assets in the aggregate index. Heavy credit issuance and the possibility of increased M&A activity have been the technical drivers to why credit spreads widened in Q2.

		Current duration	Current yield	Non-annualized periodic total return (percent)							
				Q218	Q118	Q417	Q317	Q217	Q117	Q416	Q316
U.S. Aggregate Index	U.S. Treasuries	6.10	2.71	0.10	-1.18	0.05	0.38	1.19	0.67	-3.84	-0.28
	U.S. Agencies	3.82	2.78	0.00	-0.53	0.06	0.82	0.93	1.13	-2.10	0.25
	Corporates	7.26	4.02	-0.98	-2.32	1.17	1.34	2.54	1.22	-2.83	1.41
	U.S. MBS	5.10	3.41	0.24	-1.19	0.15	0.96	0.87	0.47	-1.97	0.60
	U.S. ABS	2.11	3.01	0.42	-0.39	-0.01	0.42	0.60	0.54	-0.70	0.20
	U.S. CMBS	5.31	3.48	-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	2.53	0.21	-0.16	-0.28	0.24	0.19	0.27	-0.46	-0.11
	1-3 yr U.S. Agencies	1.72	2.58	0.25	-0.04	-0.21	0.27	0.28	0.35	-0.39	0.00
	1-3 yr corporates	1.96	3.20	0.47	-0.38	-0.04	0.59	0.59	0.69	-0.18	0.32
	AAA Credit Card ABS	2.22	2.97	0.36	-0.48	-0.08	0.41	0.67	0.56	-1.04	0.15
	AAA Auto ABS	1.85	3.04	0.43	-0.25	-0.02	0.37	0.46	0.41	-0.31	0.15

Source: Bloomberg Barclays Indices. Data as of 6/29/2018. Heatmap colors based on periodic return percentage for time period shown. Past performance is not a guarantee of future results.

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Regulatory Relief for Small and Medium-Sized Banks

On May 24, 2018, the Economic Growth, Regulatory Relief and Consumer Protection Act was signed into law to simplify Dodd-Frank regulatory requirements for thousands of small and medium-sized banks with minimal impact to large global banks. A key component of this bill increases the asset threshold for systemically important financial institutions (SIFI) to $250 billion from $50 billion. Key provisions are highlighted below.

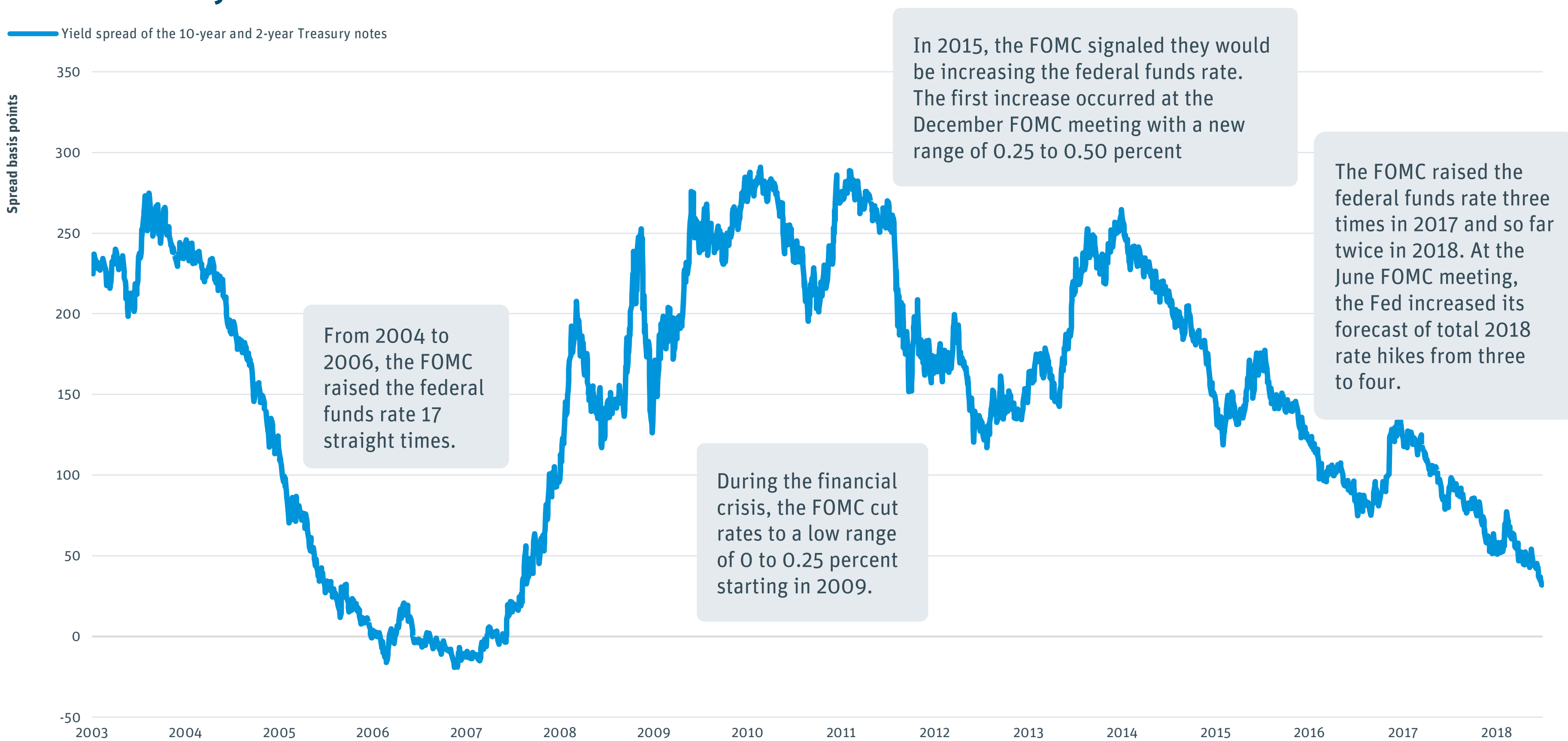
Prudential standard	• <$100 billion: Relax enhanced supervision and ease regulations • $100 billion-$250 billion: Fed has discretionary authority to apply the prudential standards • >$250 billion: No change
Stress test	• <$250 billion: End company runs of stress tests entirely • $100 billion-$250 billion: Allow regulators to design tailored supervisory stress tests and the Federal Reserve Bank is required to conduct "periodic" stress tests • >$250 billion: No change
Supplementary leverage ratio	• Exclude funds of a custody bank deposited with a central bank from the supplementary leverage ratio calculation, which would allow for increased leverage
Liquidity coverage ratio	• Direct regulators to classify investment grade, liquid, readily marketable municipal securities as level 2B liquid assets, which may incentivize banks to hold these assets
Volcker Rule	• Exempt banks with <$10 billion in assets from Volcker Rule restrictions
Community bank capital	• Simplify capital calculations for banks with < $10 billion in assets
Examination cycles	• Raise the asset threshold for banks to qualify for an 18-month exam cycle as opposed to 12-month to $3 billion from $1 billion

Source: Congress.gov

Flat Yield Curve

The 2s10s curve closed at +32 in the second quarter of 2018, which is the flattest in over a decade. 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 relative to the long end along with the Fed continuing to signal its plan to gradually increase interest rates.

2s10s Treasury Curve

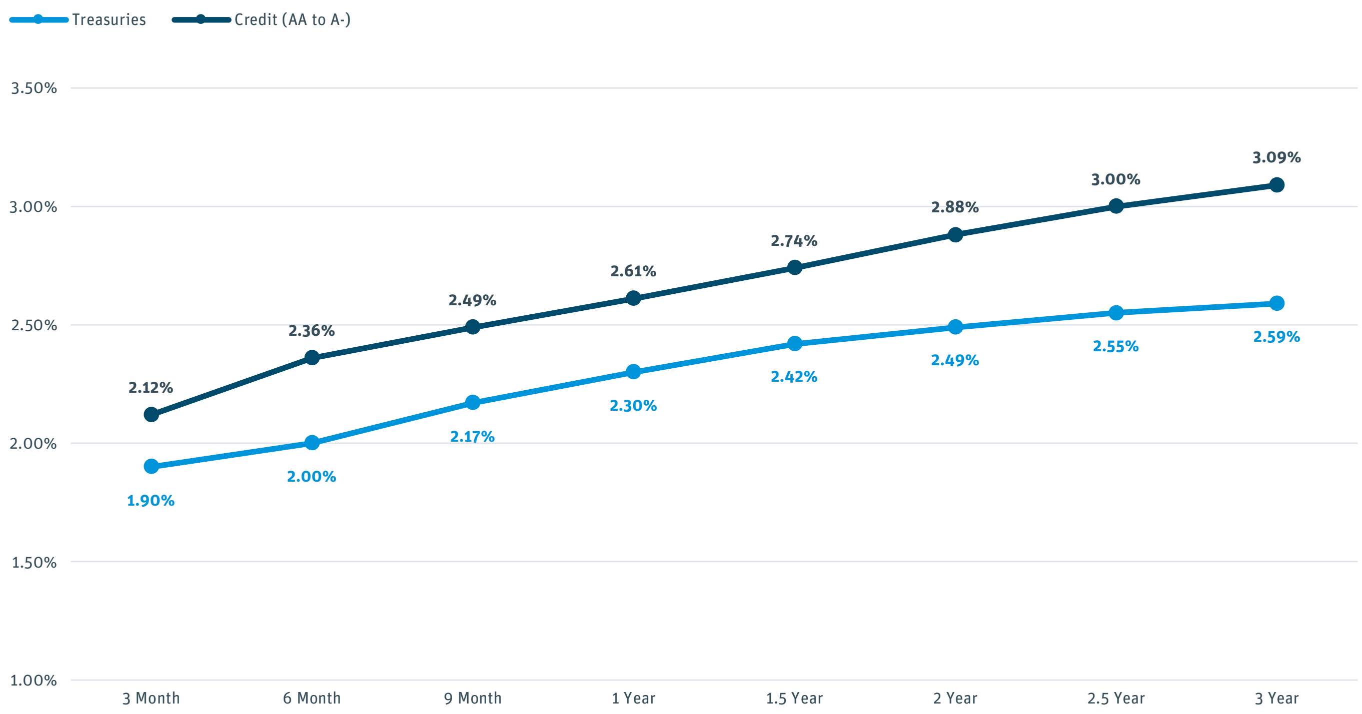


Source: SVB Asset Management and Bloomberg. Data as of 6/30/2018. Past performance is not a guarantee of future results. The above is not to be construed as a recommendation for your particular portfolio.

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



In the first quarter of 2018, the yield pickup of credit over comparable Treasuries widened to approximately 50 basis points due to market volatility and less credit buying as a result of repatriated cash from the passage of the tax reform.

The second quarter witnessed corporate bond spreads tightening relative to the rise in Treasury yields as a result of solid economic data and corporate earnings. The spread pickup averaged 30 basis points for 3 month to 2 years while 2.5 to 3 years averaged 50 basis points.

Source: SVB Asset Management and Bloomberg. Data as of 6/27/2018. 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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