January 2010

First Quarter 2010 Economic Commentary

Surviving at the Bottom of the Riverbed

Many market commentators are referring to today's economic malaise in the form of letters. Are we in a "U-shaped" recession or will it be a "W?" Perhaps the worst of both worlds: the dreaded "L." The obvious extended nature of our current downturn will be much longer than that implied by these simplistic descriptors.

Instead, I prefer the analogy of crossing a riverbed. Today, we stand in the flat portion at the bottom of the riverbed, having sped down towards the bottom rather violently. Throughout 2009, it sometimes seemed as if we were hit daily with additional negative news, about topics ranging from rapidly decreasing employment to too-big-to-fail financial firms extending their hand in hopes of government aid for survival.

In 2010 we will journey across the bottom of the riverbed, though we can't yet see the upward slope on the other side. In addition, we don't know exactly how long it will take to get there, nor can we envision the obstacles that lie between here and there. However, we do know that if we continue moving forward in the right direction, eventually our economy will begin to lift us out of the muck we are in today and we will return to consistent, positive private sector growth.

Oddly enough, risk markets can continue to rally through the first half of the year. Due to a tremendous buildup of cash beginning in 2007, there are literally trillions of dollars on the sidelines still waiting to reenter the market. Don't be surprised to see the stock and other risk markets continue to rally even as the economy languishes.

Mortgage reform will finally take center stage in the first quarter when the president presents his plan for overhauling Fannie and Freddie. Since the government is involved in 9 out of 10 new home mortgages and literally owns about 4 out of 10, the debate to be kicked off by this proposal will drive an extensive restructuring of the entire mortgage market. Don't expect solid results until later in the year, but realize this is a crucial step toward home price stability and consumer activity going forward.

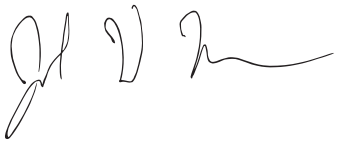
Turning to the reality facing corporate cash investors, we should expect current market yields to extend well into the year. The Fed most likely will not be concerned with inflationary pressures until the consumer can come back online, leaving their target interest rate near zero for the much repeated "extended period."

Further out the curve, volatility will ensue as investors begin to discount our trip up the other side of the riverbed, perhaps in late 2010 or sometime in 2011. We are in the latter camp and thus intend to take advantage of this volatility, searching for entry points in longer-term securities early in the year.

By the end of 2011, returns will have come from accrual more so than price movements, rewarding those investors who have both the ability and willingness to extend maturities now.

Credit continues to provide significant challenges and thorough analysis and monitoring is a must. Even so, yield-enhancing opportunities still exist in the single-A or better category, though our appetite is greatly tempered by an approved issuer list that has dwindled dramatically.

This year will continue to present unique challenges to corporate cash investors who are faced with the reality of zero yields in the safest investment vehicles along with the real potential for a second drop in the riverbed — and potential real principal losses — on the other hand. As suggested, a measured and methodical approach to investing will yield acceptable returns while avoiding the potential pitfalls on our journey forward.



Joe Morgan, CFA

Chief Investment Officer
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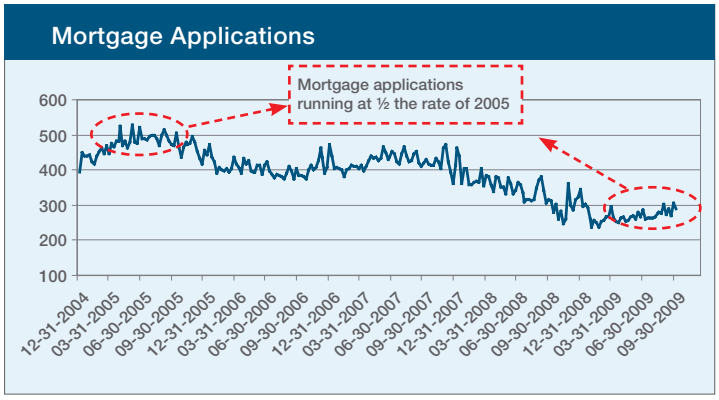
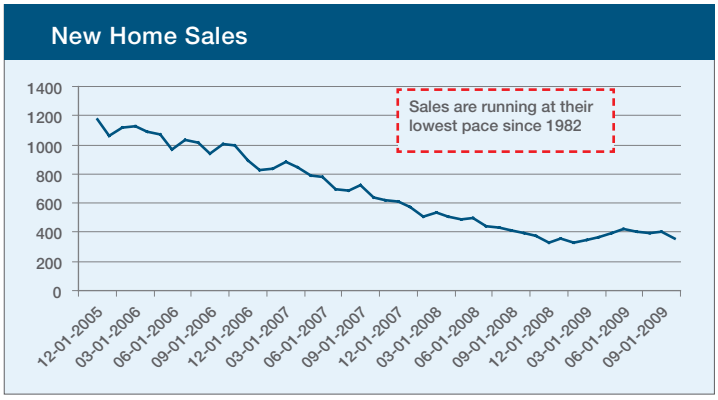
Charting the Course

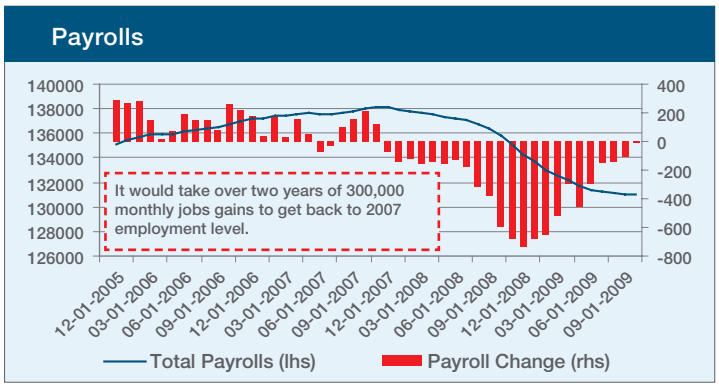
Expect the private economy to continue its slumping posture this year and consumers to remain on the sidelines. Their biggest worries of job stability and home value will continue into the first half of the year keeping interest rates low and government support programs active. Today's vicious cycle is consumer inactivity leading to low or negative job growth and creating worries on the home front which lead back to consumer inactivity. We see little impetus for this cycle to change in the first half of 2010; however, follow closely the coming debate on mortgage reform, specifically Fannie Mae and Freddie Mac. If the government can turn around the private sector mortgage market, that could help reverse this cycle in 2011.



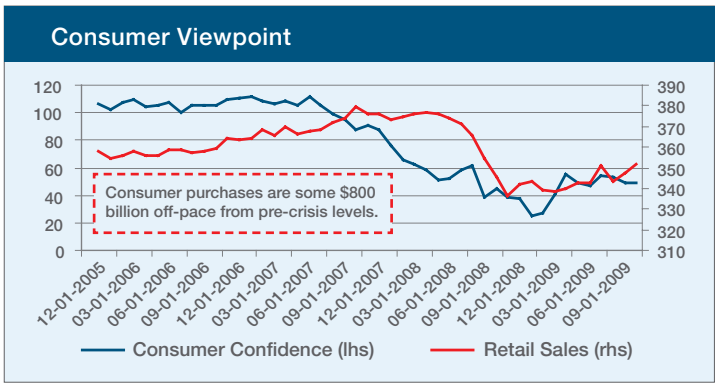
Lower mortgage activity leads to difficult price discovery in the housing sector.



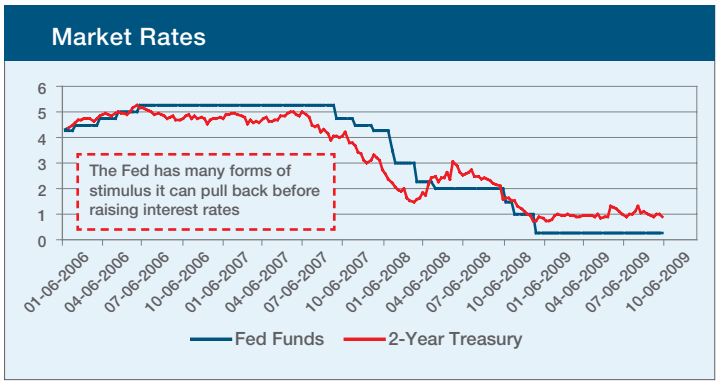
Consumers are uncertain of their wealth due to a volatile housing market.



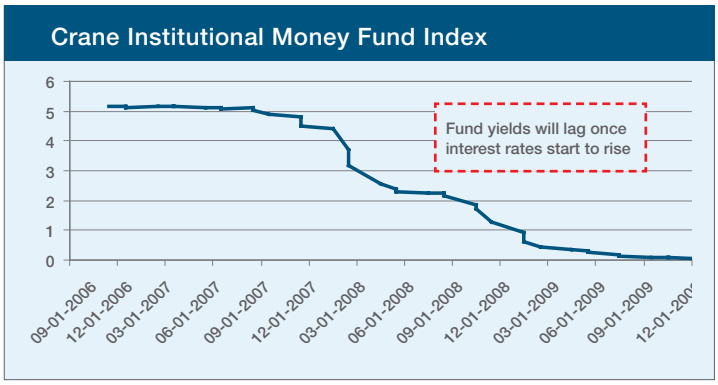
In addition, consumers are worried about the stability of their income.



Volatile wealth and risky job prospects will keep the consumer to the sidelines.



Lacking consumer demand, U.S. market interest rates will remain low for the foreseeable future.



Money fund yields will continue flirting with zero, driving investors to seek return in longer-term investments.

Source: Bloomberg, SVB Asset Management

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