IdahoTrust

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WealthManagement

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Market Insights

A periodic newsletter from Idaho Trust

The European Central Bank (ECB) aggressively expanded its quantitative easing program. The ECB's actions are aimed at easing credit conditions that have remained much tighter than policy officials had hoped. High-yield bonds have struggled over the past year due in part to a sharp decline in commodities prices, especially oil. However, these concerns along with a possible bottom in energy prices may well be reflected in current prices.

European Central Bank

Last month, Mario Draghi, the head of the ECB, announced a significant expansion to its monetary stimulus program. The ECB cut its deposit rate by 10 basis points (0.10%). The ECB's package also included an increase in the pace of quantitative easing - adding an additional 20 billion euro per month. To accommodate the larger monthly bond buying, the ECB added corporate non-bank investment-grade debt to the list of assets it may purchase. Finally, the ECB expanded a number of lending programs aimed at spurring further credit growth in Europe.

By including corporate bonds in the bond purchasing program, the ECB has helped to ease credit conditions in Europe. Since the announcement, there have been some modest improvements in credit conditions.

European economic activity has lagged behind domestic growth as the U.S.

Idaho Trust Bank offers total wealth solutions including its LifeNeeds™ investing process. The LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust's unique TacticLogic™ investment process. All of which are tailored to our clients' unique financial needs.

Central Bank responded much earlier and more aggressively to weak economic growth. Bond yields in Europe are already low, and in some cases, yields are negative. Europe needs more time to regain consumer and investor confidence.

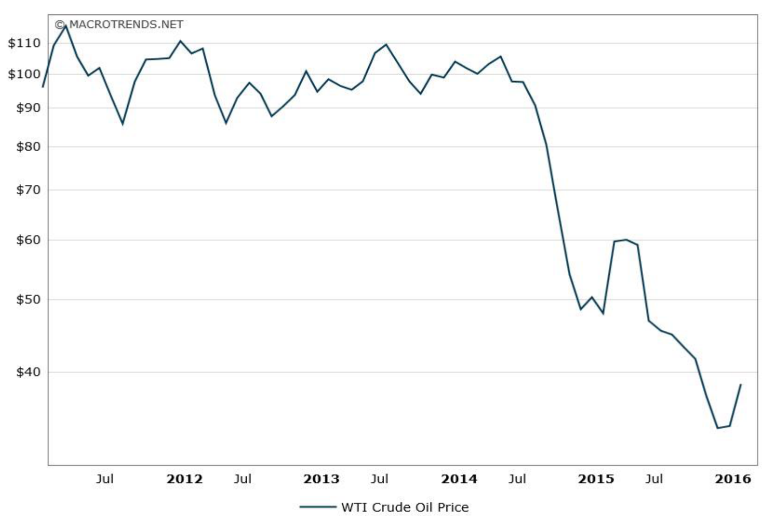
One side effect of the ECB program should be a weaker Euro, which will make European exports more competitive to non-European customers. However, despite the size and extent of the package, the Euro has remained relatively strong. We would expect the Euro to weaken over time. More recent monetary actions by many major central banks appear to be less effective at stimulating their respective economies. Many economists believe that European banks have been hoarding their cash and they just need some incentive to start lending again.

High-Yield Credit and Energy Prices

The sharp decline in commodity prices has hurt energy and metals companies high-yield bonds. Concerns over these price declines have put major pressure on the entire high-yield bond segment. However, the decline in commodities prices may well turn out to be a positive tailwind for other industry groups with this investment category.

Unless there is a sharp increase in commodities prices, which we do not expect, default rates from oil, coal, and other commodity companies will likely increase over the next couple of years. Prices for these commodities have reached multi-year lows due to a sharp increase in supply as well as a decline in demand, primarily from China. Many energy-sector companies borrowed aggressively when oil prices were high and now that prices have fallen (see chart) these companies will struggle to repay these debts.

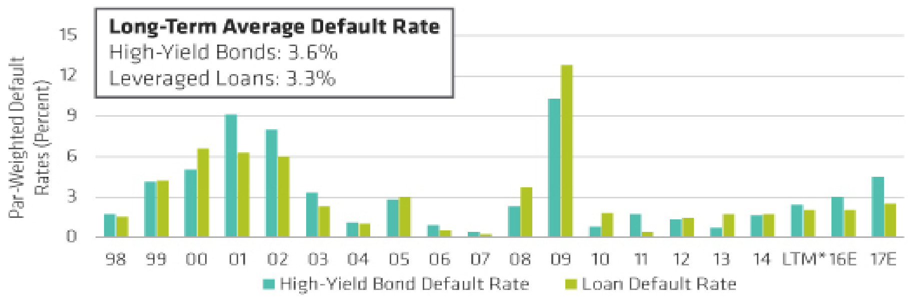
Crude Oil Prices



The majority of the bonds contained in the high-yield index are non-energy companies and they should benefit from lower commodity costs. Moreover, many consumers benefit from these lower costs as well, which should ultimately boost consumer spending and economic activity.

Default rates for high-yield bonds have been at historically low levels for several years (see bar chart). A move back to the long-run average, or slightly higher, over the next couple of years seems likely. The bulk of defaults may come from issuers in the energy sector.

HIGH-YIELD DEFAULTS LIKELY TO RISE SOMEWHAT



As of November 30, 2015
*Last 12 months
Source: J.P. Morgan

Following the strong economic activity experienced in the late 1990s, high-yield bonds experienced a downturn in 2000-2002. During that time, most of the credit problems and a majority of the defaults were in the telecom sector. The broader high-yield market suffered during that period but investors eventually realized that many non-telecom bonds were attractively priced and the high-yield sector rebounded. Defaults hurt the most when they come as a surprise, as they did in 2008. Currently, the prices of most of the lower-quality energy-sector bonds are already anticipating the possibility of default.

Bond yields can be a solid predictor of future long-term returns. “Yield to worst” (YTW) is a metric used to evaluate the lowest possible yield an investor might receive on a bond, provided the issuer does not default. The YTW calculation has been a good indicator of what an investor can expect to earn over the next five years. By the end of last year, YTW had climbed above 8%, which represented a sharp increase from around 5% in mid-2014.

The risk-reward tradeoff for high-yield bonds is more favorable today than it was just 18 months ago. An increase in default rates does not necessarily mean negative sector returns. In fact, in 2009, high-yield defaults hit a record high, yet high-yield bonds experienced strong returns. Assuming economic conditions do not continue to deteriorate, which we do not expect them to do, performance on high yield bonds may be stronger than many expect since prices already reflect a very challenging environment and we think things will turn out to be a bit better than these negative assumptions.

Conclusion

We think that the economic impact from lower commodities prices may be more positive than negative. The credit problems from lower oil prices appear to be more than reflected in high-yield bond prices and we believe that a stronger economy could benefit all the high-yield bonds that are issued by non-energy companies.

S&P 500 Index

3 Month	1.35%
Year-to-Date	1.35%
1 Year	2.17%
3 Year	11.98%
5 Year	11.45%

MSCI EAFE Net Index

3 Month	-3.01%
Year-to-Date	-3.01%
1 Year	-8.40%
3 Year	2.38%
5 Year	2.21%

Barclays Aggregate Bond Index

3 Month	3.03%
Year-to-Date	3.03%
1 Year	1.65%
3 Year	2.47%
5 Year	3.78%

As of 3.31.2016

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