IdahoTrust

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WealthManagement

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Market Insights

A periodic newsletter from Idaho Trust

Domestically, bond yields have increased so far this year. The low interest rate environment continues to shape the returns available in the bond market. European bond yield volatility has declined substantially and European debt markets appeared to have stabilized. The European Central Bank's unlimited bond buying program has calmed markets and restored relative stability.

Domestic Bond Markets

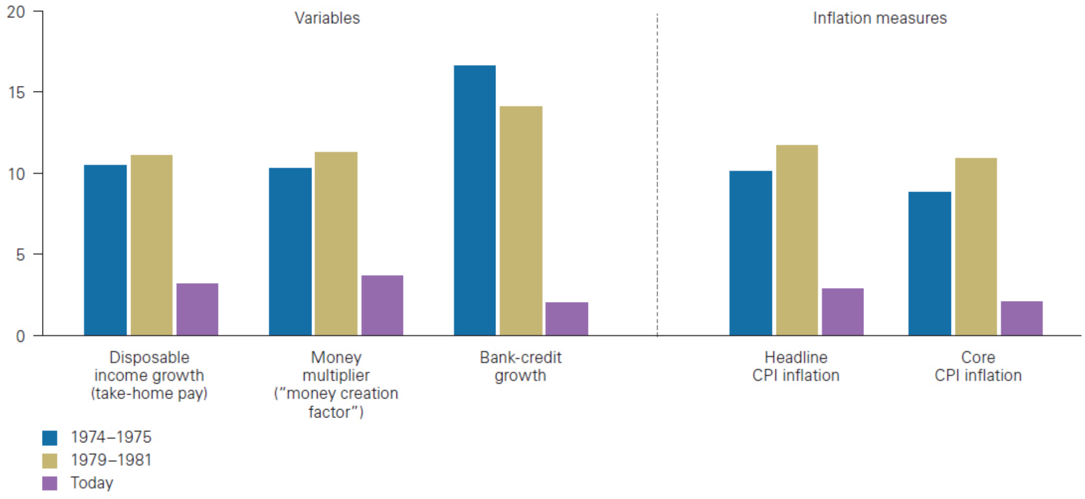
The latest Federal Reserve meeting minutes, released last month, show that there are some internal dissensions about how long to continue current monetary easing strategies. The meeting minutes reveal that some members of the Federal Reserve's Open Market Committee are concerned that current monetary policies are spurring risk taking in bond markets. This is not altogether surprising. The Federal Reserve is currently buying $85 billion in mortgage and treasury securities with newly printed money each month which is over a trillion dollars annually of new money and have kept short-term interest rates near rock bottom for several years.

Many investors fear that this amount of stimulus, plus all of the previous stimulus programs engaged by the Federal Reserve, will fuel inflation, which has yet to materialize. Key drivers of inflation such as labor costs, inflation expectations, economic slack and the velocity of money suggest that inflation is likely to remain within its current range of 1.5% - 3%. The following graphic shows today's economic inputs that contribute to inflation compared to that of other historical periods of high inflation.

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.

Figure 4. Comparing high-inflation environments of 1970s and early 1980s with that of today



Notes: The "money multiplier" is the ratio of the broad money supply (i.e., M2) to the monetary base. Data for "Today" are through January 2, 2013.

Sources: Vanguard calculations, based on data from Moody's DataBuffet.

The Federal Reserve's extended low-rate policy has caused investors to look for higher returns in higher risk assets such as high yield bonds, mortgage securities and corporate bonds. Recent high yield bond issuances highlight the current increased demand for high yield bonds. New high yield issuance is up 55% over last year and double the amount of issuance seen before the Great Recession according to Dealogic, a capital markets consultant. Some corporations are also taking advantage of the low rates and issuing bonds. Netflix has recently issued $400 million in new debt and financial services firm JG Wentworth issued $425 million in bonds to pay a special dividend to shareholders, although the issuance tripled the firm's total debt levels.

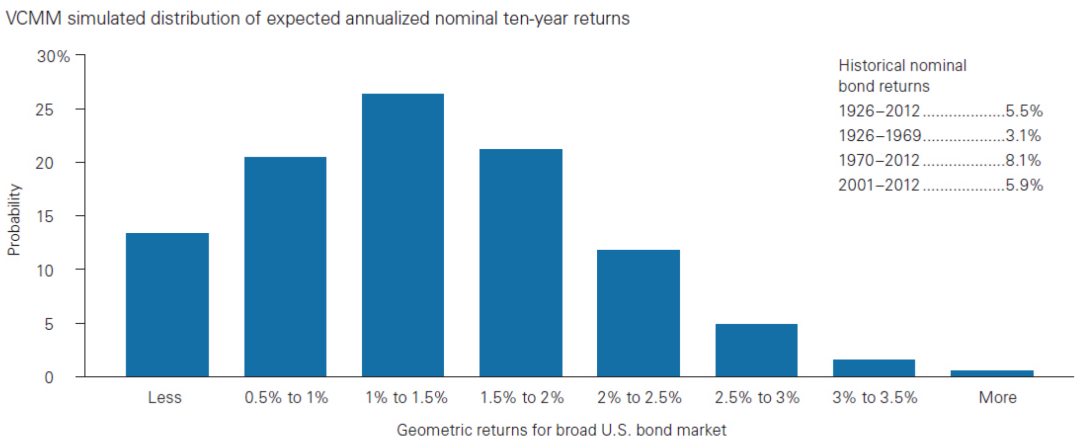
Last month, it was announced that the U.S. is planning to issue adjustable-rate notes. These adjustable-rate notes would be the first new security issued by the Treasury Department in more than 15 years. The adjustable-rate notes will differ from the other notes offered by the Treasury Department in that the interest that the notes will pay will depend on the level of interest rates and not a pre-determined amount. This change may expand the Treasury's investor base and possibly help the Treasury extend the maturity of the debt issued by the Treasury. However, the Treasury Department has not yet chosen an interest rate benchmark for these new bonds.

Bond Forecasts

Many investors are wondering what bond returns will look like in the future given the length of the extraordinarily low-rate environment that has dominated bond markets in recent years. Forecasted expected returns for bonds in the next ten years are expected to be subdued. Vanguard has forecasted that the expected return for the broad taxable bond market over the next ten years to be modest as the graphic depicts (see following). Vanguard's forecast for bond returns is much lower than what bonds have returned in previous decades. In the last five years, bond returns were driven higher as investors moved their assets from riskier asset classes during the volatile Great Recession. As a result of this risk-adverse behavior, the Barclay's Aggregate bond index has returned 5.42% annualized for the last five years.

Despite the tepid outlook for future bond returns, it is important to remember that bonds will continue to provide vital diversification benefits and current income to investment portfolios. Future bond correlations are forecast to be low with stock markets fulfilling an important part of a diversified portfolio and will continue to offer better downside protection than stocks.

Figure 6. Projected total U.S. bond market returns



Source: Vanguard, as of November 30, 2012.

European Bond Markets

After three years of volatile yield changes, European bond markets appear to have stabilized. This welcome development was largely driven by the European Central Bank's unlimited pledge to buy as many European country bonds as it would take to support the euro-area's governments. Today, 10-year government yield levels in the euro-area are much lower than they have been in the recent past and much more stable. Although the area's bond yields have stabilized, the euro-area's economies are still struggling to foster growth and champion reform. As a whole, the euro-area had negative growth in 2012 and is not forecast to return to growth until 2014.

Spain's economic suffering is particularly severe, with an unemployment rate at 26% and an even higher rate for Spanish youth. Growth prospects for the Spanish economy are dismal with a forecasted -1.6% GDP for 2013 and only 0.8% for 2014. Meanwhile, the country's leadership is engulfed in widespread corruption charges including evidence linked to current Prime Minister Mariano Rajoy.

Conclusion

Both bond and stock markets have benefitted from the stabilization of the European bond markets and their lower volatility. Bond yields have risen a bit domestically, economic fundamentals appear sound and inflation is forecasted to remain benign.

S&P 500 Index

3 Month	7.58%
Year-to-Date	6.61%
1 Year	13.44%
3 Year	13.45%
5 Year	4.94%

Barclays Municipal Bond Index

3 Month	-0.52%
Year-to-Date	0.72%
1 Year	5.01%
3 Year	6.28%
5 Year	6.79%

Barclays Aggregate Bond Index

3 Month	-0.34%
Year-to-Date	-0.20%
1 Year	3.12%
3 Year	5.44%
5 Year	5.52%

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