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IdahoTrust

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Market Insights

A periodic newsletter from Idaho Trust

This year started with a market rally fueled by a string of good economic indicators that now appears to have tapered off. The European Debt crisis has started to make headlines again. Despite investors developing more of a risk appetite in 2012, U.S. treasury yields remain at historic lows.

U.S. Bond Markets

At its latest reading, inflation was measured at 2.1%, in line with its 20-year average and slightly above the Federal Reserve's target rate of 2%. Although inflation is currently above the Federal Reserve's target level it is only slightly above its mandated target. The market is not pricing in inflation any time soon either. The 10-year break-even rate on inflation protected bonds, a measure of the market's inflation expectations, is only at 2.28%.

Conversely, the U.S. Treasury recently sold $16 billion of 5-year inflation protection securities at auction in April. Treasury Inflation Protection Securities (TIPS) are typically used by investors to protect their purchasing power from the eroding effects of inflation. The results of this latest auction are particularly telling. Participants in the auction paid a price that would cause them to realize a negative return over the life of the security. Basically, investors are willing to pay a steep premium to the government to protect against the threat of rising prices. The outlook for inflation remains mild, however, the recent results of this TIPS auction infer that investors are taking measures to hedge against the risk of future inflation.

Both the results of the recent TIPS auction and current Treasury yields tell us that

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investors could be positioning themselves more defensively, seeking safety and protection. There has been some weaker-than-expected data released that may have some investors investing more cautiously. Sales of previously owned homes in the U.S. fell for the third time in four months, home construction starts have slowed to a five-month low and news coming from Europe continues to worry markets.

The historically low yields on treasuries and other bonds continue to represent challenges for investors who depend on income from their portfolios. This trend is not likely to reverse either. By the Federal Reserve's latest estimates, interest rates will stay at low levels in order to continue to stimulate the economy with the earliest foreseeable rise occurring in 2014. Investors that depend on the income provided by bonds have been struggling to find alternative investments to supplement the lower amounts of income that these securities are now generating. We have seen a rise in popularity of dividend paying stock funds, international bonds and high-yield bonds largely from investors trying to increase their investment income.

European Debt Markets

Indebted European Sovereign Governments are making their way back into the headlines again. Although, the European debt crisis has been comparatively quite recently, global investors have been keeping a close watch on Europe. The European Central Bank's (ECB) two refinance programs, termed long-term financing operations (LTROs), are running out. During the duration of these programs participating commercial banks borrowed 1 trillion euros at the ECB's main interest rate of 1%, a scheme to keep the areas banks afloat. Now these supportive programs are winding down, national politics are threatening progress and the optimism to reach targeted budget deficits is fading.

10-Year Sovereign Debt Yields Over Time

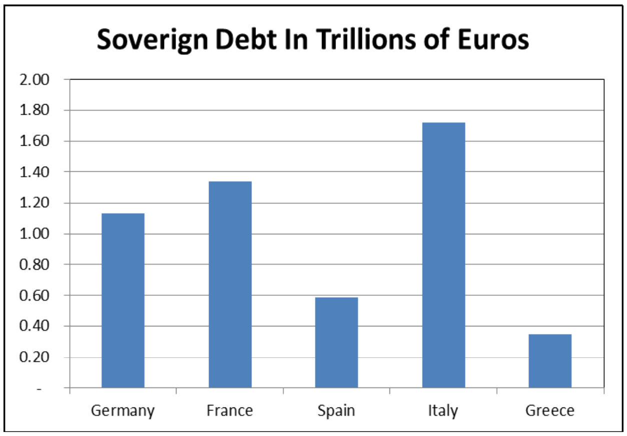
Country	*12.31.2010*	*6.30.2011*	*12.31.2011*	*Current*
U.S.	3.29%	3.16%	1.87%	1.95%
Germany	2.95%	3.02%	1.82%	1.67%
France	3.36%	3.40%	3.13%	2.95%
Spain	5.44%	5.43%	4.99%	5.73%
Italy	4.80%	4.87%	6.95%	5.47%
Greece	12.44%	15.61%	28.39%	19.66%

Source: Bloomberg

Spain's Government has had a bumpy ride recently as a series of political mishaps has sent the market's focus onto Spain, exposing their mistakes. The Spanish Government delayed its critical 2012 budget because of the schedule of Spanish elections, cast doubt on the accuracy of their statistics, mishandled negotiations with the European Union concerning a revised deficit target and muddled a bond auction all before Easter.

The Government's handling of Spain's 2012 budget certainly didn't help reaffirm to the market their commitment to reforms. In the end, the Spanish government announced its targeted deficit as 5.8% of GDP, higher than the 4.4% agreed upon with European leaders. Because of this, the market has seen Spanish debt yields creep back up which continues to increase the cost of financing Spain's debt load and continues to put pressure on their efforts of deficit reduction.

Italian yields have been rising as well. Last year, amidst the pressure of the European debt crisis Silvio Berlusconi, Italy's former Prime Minister, pushed through a package of reforms and resigned. Mario Monti, an economist, replaced him. In 2011, the Italian 10-year bond yields reached well over 7% and the country was running at 120% debt-to-GDP ratio. Today Italy remains a major concern for the area although 10-year debt yields have since declined to 5.50%.



Source: OECD as of 2010

The latest polling information from France, whose presidential election is ongoing, indicates that challenger Francois Hollande will beat incumbent President Nicolas Sarkozy. The French election could have a profound effect on the resolution of the European debt crisis because of France's coordinated effort with Germany to resolve the European debt crisis. French credit risk is currently at a three month high on concerns that anti-business policies will be adopted after the presidential elections.

France, along with Italy and Spain have economies too big to be supported by the resources currently in the euro zone, unlike Greece which has been supported by the euro zone's programs. Greece eventually defaulted on its bonds by writing off some of its debt through negotiated write-offs with Greece's bond holders.

Greece's Prime Minister, Lucas Papademos, recently called for elections after Greece concluded a sovereign debt exchange and secured a 130 billion euro bailout for the ailing country. The debt exchange called for debt holders to accept a 53.5% cut in face value of their holdings which eliminated about 100 billion euros of Greek debt. These measures have helped keep Greece's economy from collapsing. Greece's interim government was put into place following the resignation of former Prime Minister George Papandreou last November.

The markets are taking a decidedly more defensive stance than they were earlier this year. This appears to be due to the recent developments coming out of Europe which continue to support the low yield levels prevalent in the market.

S&P 500

3 Month	7.07%
Year-to-Date	11.87%
1 Year	4.73%
3 Year	19.43%
5 Year	3.24%

Barclays Aggregate Bond Index

3 Month	0.53%
Year-to-Date	1.41%
1 Year	7.54%
3 Year	7.05%
5 Year	6.52%

Barclays Global Aggregate bond Index

3 Month	0.38%
Year-to-Date	2.06%
1 Year	3.30%
3 Year	7.62%
5 Year	6.53%

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Contact Us

Boise
888 W. Broad Street
Boise, Idaho
208.373.6500

Coeur d'Alene
1450 Northwest Blvd.
Suite 101
Coeur d'Alene, ID
208.664.6448

Info@IdahoTrust.com
www.IdahoTrust.com

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