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M WEALTH PERSPECTIVE

June 2013

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June 2013: The Driving Forces of Bonds

Some investors have expressed angst over the recent bond market downturn. It's true, year to date (through May) Barclays U.S. Government Long Treasury Index returned -4.81%; in May alone, it returned -6.9%. So, let's review how bonds work and some of the driving forces behind current bond yields and bond returns.

What's in a Bond?

We all know the value of a bond is essentially equal to its stream of future cash payments. Those cash payments are made in the form of periodic interest payments and return of principal when the bond matures. In the absence of credit risk (the risk of default), the value of that stream of future cash payments is simply a function of an investor's required return based on current interest rates and his or her inflation expectations. For the purposes of this article we will limit our focus to U.S. Treasury Bonds, thereby eliminating credit risk from the discussion.

So, if the price of a bond is the sum of the present value of future payments using some discount factor, then this discount factor is its "yield." Therefore, when a bond's yield rises, its price falls, and when a bond's yield falls, its price increases. Of course, the maturity of a bond affects its yield as well. In most interest rate environments, the longer the term to maturity, the higher the yield will be.

Interest Rates, Inflation Expectations and…the Feds

Inflation expectations determine an investors yield requirements. Inflation is a bond's worst enemy because inflation erodes the purchasing power of a bond's future cash flows. In an inflationary environment investors will demand a higher yield to compensate for inflation risk.

Inflation—and expectations of future inflation—are a function of the dynamics between short-term and long-term interest rates. Worldwide, short-term interest rates are administered by nations' central banks. In the U.S., the Federal Reserve Board set the federal funds rate. It is the Fed's job to promote economic growth while maintaining price stability. It is not an easy job and investors watch the actions of Federal Reserve Board's Open Market Committee (FOMC), in particular, its Chairman Ben S. Bernanke.

Central banks do not control long-term interest rates. Market forces (supply and demand) determine equilibrium pricing for long-term bonds, which set long-term interest rates. If the bond market believes that the FOMC has set the fed funds rate too low, expectations of future inflation increase, which means long-term interest rates increase relative to short-term interest rates - the yield curve steepens. If the market believes that the FOMC has set the fed funds rate too high, the opposite happens and long-term interest rates decrease relative to short-term interest rates - the yield curve flattens.

When central banks have already lowered short-term interest rates to near 0% levels without creating an economic stimulus, they tend to use quantitative easing. The desired effect is to increase the money supply by buying government securities from the market. The intent is to flood financial institutions with capital in an effort to promote increased lending and liquidity. The major risk of quantitative easing is that, although more money is floating around, there is still a fixed amount of goods for sale, which will eventually lead to higher prices or inflation.

So, Here We Are

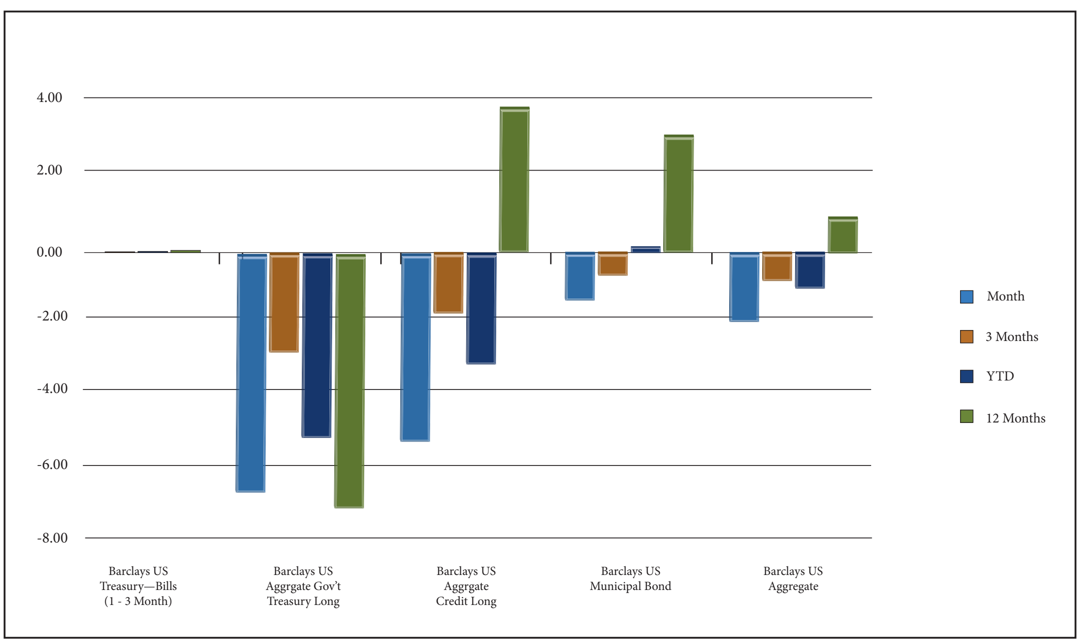
More recently, investors have reacted to Mr. Bernanke's comments that "tapering" the Fed's monthly $85 billion bond purchases would not be the end to record long quantitative easing. U.S. Treasury yields have climbed this month as investors weighed whether the economy is strengthening enough for the FOMC to consider reducing bond purchases that have been used to keep borrowing rates low. Bernanke told Congress on May 22 the central bank's policy-setting board could start scaling back its bond purchases in its "next few meetings" if the U.S. employment outlook shows sustainable improvement.

In Wednesday's Treasury Auction, prices fell on the prospect of less bond-buying support from the Federal Reserve. Ten-year Treasury note prices fell the most to yield 2.2%, the highest level in more than a year. At the same time, the yield on the U.S. 30-year bond was the highest level since April 2012.

The Federal Reserve will meet June 18-19, when it will discuss its bond-buying program. Until then, investors will anxiously await the post-meeting news conference when Mr. Bernanke may try to clarify the Fed's thinking.

The Chart below summarizes recent returns for fixed income indices.

Selected Indices—Total Return (%)
5/31/2013



Source of statistics not otherwise specifically cited within this newsletter: Strategic Capital Investment Advisors

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For More Information

For more information on the services offered by M Wealth, please contact:

Dennis L. Eslick, ChFC, CLU
deslick@eslickfinancial.com
319.833.5555

Kevin M. Eslick
keslick@eslickfinancial.com
319.833.5555

Scott B. Wirtz, CLTC
sbwirtz@eslickfinancial.com
319.833.5555

or visit the M Wealth website at:

www.mfinwealth.com

Eslick Financial Group, Inc.
999 Home Plaza, Suite 201
Waterloo, IA 50701
319.833.5555
www.eslickfinancial.com