CHANDLER ASSET MANAGEMENT

April 2010

# Bond Market Review

A MONTHLY REVIEW OF FIXED INCOME MARKETS

## What's Inside



Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

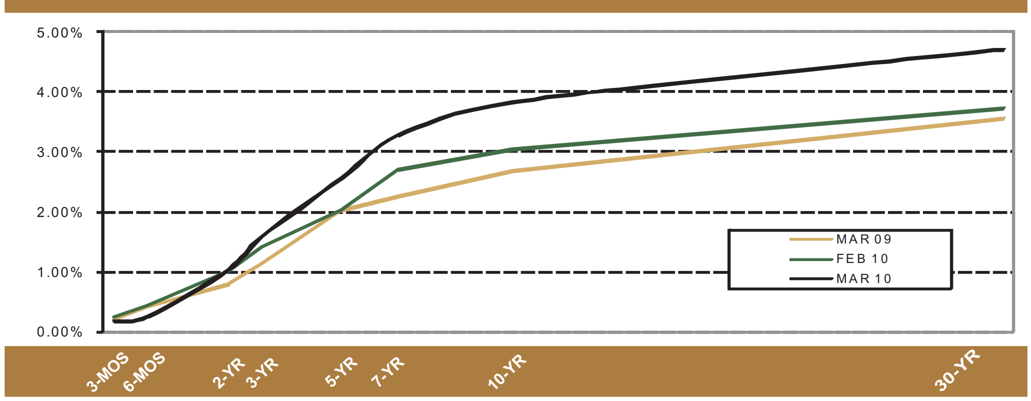
## Market Summary

Interest rates rose in March as market participants speculated that the economic recovery may be strengthening and that the Federal Open Market Committee may begin raising rates by mid-year. Nevertheless, the FOMC continues to state that they will keep financial conditions extraordinarily easy for the foreseeable future. Treasury market participants currently fall into two camps: those that believe a weak economic recovery will keep rates low and those who believe heavy issuance of Treasuries and a strengthening economy will lead to rapidly rising interest rates. For the upcoming months, interest rates are likely to fluctuate depending upon which camp's view is in ascendancy at any given moment.

The March employment report showed a labor market that may be recovering as the economy gained 162,000 jobs and the unemployment rate remained at 9.7% for the third consecutive month. Although overall employment remains weak, it does appear that the labor market is stabilizing. The most recent reading for Core CPI (ex food & energy) increased 1.3% on a year-over-year basis indicating that inflation remains under control. Other economic indicators have been mixed although they generally indicate a gradual economic recovery.

The Fed has begun differentiating between monetary policy and emergency liquidity measures put in place during the height of the financial crisis. Many of these extraordinary measures are in the process of being unwound; recently, the Federal Reserve raised the discount rate. The removal of these uncommon measures should be seen as a sign that the Fed believes the financial crisis has ended, rather than a comment on the strength of the economic recovery or the future path of monetary policy. Market speculation has now turned to the timing of eventual increases in the Fed Funds rate.

TREASURY YIELDS HIGHER IN MARCH




Treasury yields ended the month higher as market participants gained confidence in the economic recovery and the Treasury continued its record government bond issuance.

| YIELDS | 3/31/10 | 2/28/10 | Change |
|---|---|---|---|
| 3 Month | 0.15 | 0.11 | 0.04 |
| 2 Year | 1.02 | 0.80 | 0.22 |
| 3 Year | 1.58 | 1.32 | 0.26 |
| 5 Year | 2.56 | 2.28 | 0.28 |
| 7 Year | 3.28 | 3.03 | 0.25 |
| 10 Year | 3.83 | 3.59 | 0.24 |
| 30 Year | 4.71 | 4.53 | 0.18 |

# The Federal Reserve (Part One)

The Federal Open Market Committee (FOMC) of the Federal Reserve meets approximately every six weeks in order to determine monetary policy. At the end of these meetings, the FOMC releases a statement containing its target level for short-term interest rates and a brief assessment of economic conditions. Investors carefully scrutinize this statement for clues to the future direction of interest rates and bond prices.

But what exactly is the Federal Reserve and what does it do? How does the FOMC operate? In this article, we will examine the mission of the Federal Reserve (the Fed), its history, and its structure. Next month, we will talk about the tools the Fed has at its disposal, as well as how it has chosen to use them over the past several years. At the end of this series, you will have a clearer understanding of how the Federal Reserve operates, allowing you to better understand its impact on the economy and the financial markets.

The Mission of the Federal Reserve

The mandate of the Federal Reserve is to manage short-term interest rates and the money supply in order to promote economic growth and maximum employment while maintaining an environment of moderate inflation and reasonable long-term interest rates. In practice, various Federal Reserve officials have stated that their goal is to keep inflation in the range of 1%-2% annually with GDP growth of 3%-3.5% annually. While managing monetary policy is the Fed's primary and most visible role it also has various other responsibilities. These include: providing financial services to banks and other financial institutions, supervising the banking system, and responding to the needs of the market in times of economic crisis.

History of the Federal Reserve

The Federal Reserve was created in 1913 by an act of Congress. Over the years, the Fed has had various successes and failures. In the late 1970's, Fed Chairman Paul Volker tightened short-term interest rates dramatically in order to curb extremely high inflation levels. Although this pushed the economy into recession, inflation was curtailed, and has remained under control for most of the past thirty years. One of the Fed's most notable mistakes came at the start of the Great Depression in 1929 when it chose to tighten credit. Many scholars, including current Fed Chairman Ben Bernanke, blame this Fed tightening for turning an economic setback into something far worse.

Having learned from the Fed's mistake in 1929, Chairman Alan Greenspan flooded the banking system with liquidity following the 1987 stock market crash. This proved a wise move and the economy continued to prosper despite the stock market turbulence. Greenspan went on to serve as Chairman for nearly 20 years, earning a great deal of respect for the Federal Reserve by overseeing one of the best economic periods in U.S. history. Alan Greenspan retired at the end of his term in early 2006, and was replaced by Ben Bernanke.

The recent financial crisis has marked a watershed in the Fed's history. Alan Greenspan and the Federal Reserve have received much of the blame for causing the conditions that led to the crisis, prompting calls for greater Congressional oversight of the Fed. During the crisis, the Fed was extremely active in employing all of the tools at its disposal in order to support the financial system. Overall, these measures have been successful and while Congress may wind up imposing slightly tighter controls on the Fed's activities in the future, it appears that the core mission of the Federal Reserve will remain unchanged and may even be expanded.

Structure of the Federal Reserve System

The Federal Reserve System consists of four main participants: the Board of Governors, the regional Federal Reserve Banks, the Federal Open Market Committee, and private sector member banks. These participants work together to maintain a strong national banking system and a robust economy.

The Board of Governors has seven members, each of whom is appointed by the president to serve a 14-year term. The length of these terms is designed to insure that no president can control the entire board, thereby keeping the body independent and apolitical. Due to their position at the center of the Reserve system, the Board of Governors is ideally situated to monitor national economic developments.

While members of the board of Governors focus on the national economy, the regional Federal Reserve Banks are more closely attuned to local conditions. The regional Reserve Banks also interact with, and are owned by, private member banks such as Citigroup and Wells Fargo. This structure provides for both Federal Reserve oversight of the banking system as well as private sector input in formulating economic policy. In effect, these regional Banks serve as a "bank for banks," by providing many of the same services to private financial institutions that commercial banks do to individuals or corporations.

The Board of Governors and the regional Reserve Banks come together to form the FOMC. The seven Federal Reserve Board Governors and the presidents of the twelve regional Reserve Banks attend all FOMC meetings. However, not all attendees vote. There are only twelve voting members at each FOMC meeting: the seven Governors plus five of the regional presidents. These five are chosen on a rotating basis from among the regional Bank presidents, although by tradition the president of the New York Fed is always chosen to vote. The decisions that these twelve voters reach are perhaps the most important factor in determining the performance of fixed income portfolios.

Conclusion

Recent events have reiterated the importance of the Fed to the well-being and prosperity of America. As the nation emerges from this recession it is likely that the Fed will continue to play a key role in promoting economic growth and maintaining an environment of price stability.

In next month's article, we will take a closer look at the tools of the Federal Reserve, how they have been employed recently, and how they may be used in future.

Brian Perry, Vice President, Investment Strategist

## Consumer Prices

In February, the CPI showed that consumer prices increased 2.1% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.3% rate. Despite a strengthening economy and an increased money supply, many economists believe that inflation will remain moderate over the next 12 months.

## Retail Sales

In February, Retail Sales rose 3.9% on a year-over-year basis. Consumer spending appears to have rebounded somewhat from the depths of the recession, but consumers remain cautious due to job losses, the housing market contraction, and a general tightening of credit standards.

## Labor Markets

The March employment report showed that the economy gained 162,000 jobs and the previous two months' reports were revised upwards. Taken together, the first quarter of 2010 showed the first quarterly increase in employment since Q4 2007. The unemployment rate remained at 9.7% for the third consecutive month. Although overall employment remains weak, it does appear that the labor market is gradually stabilizing. The trend in the unemployment rate is likely to be the key to the strength and durability of the economic recovery.

## Housing starts

Single-family housing starts declined 0.6% in February to 499,000. Recent data indicates a housing market that has stabilized, but remains weak.

## Credit Spreads Wider

| CREDIT SPREADS | Spread to Treasuries (%) | One Month Ago (%) | Change |
|---|---|---|---|
| 3-month top-rated commercial paper | 0.09 | 0.12 | (0.03) |
| 2-year AA corporate note | 0.38 | 0.43 | (0.05) |
| 5-year AA corporate note | 0.65 | 0.65 | 0.00 |
| 5-year Agency note | 0.17 | 0.23 | (0.06) |

Source: Bloomberg

Data as of 3/31/2010

## Mixed Economic Data

| ECONOMIC INDICATOR | Current Release | Prior Release | One Year Ago |
|---|---|---|---|
| Trade Balance | (37.29) $Bln JAN 10 | (39.90) $Bln DEC 09 | (36.90) $Bln JAN 09 |
| GDP | 5.60% DEC 09 | 2.20% SEP 09 | (5.40%) DEC 08 |
| Unemployment Rate | 9.70% MAR 10 | 9.70% FEB 10 | 8.60% MAR 09 |
| Prime Rate | 3.25% MAR 10 | 3.25% FEB 10 | 3.25% MAR 09 |
| CRB Index | 273.34 MAR 10 | 274.77 FEB 10 | 220.40 MAR 09 |
| Oil (West Texas Int.) | $83.76 MAR 10 | $79.66 FEB 10 | $49.66 MAR 09 |
| Consumer Price Index (y/o/y) | 2.10% FEB 10 | 2.60% JAN 10 | 0.20% FEB 09 |
| Producer Price Index (y/o/y) | 4.40 FEB 10 | 4.60% JAN 10 | (1.40%) FEB 09 |
| Dollar / EURO | 1.35 MAR 10 | 1.36 FEB 10 | 1.33 MAR 09 |

Source: Bloomberg





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