CHANDLER ASSET MANAGEMENT

August 2010

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

WHAT'S INSIDE

Since 1988, Chandler Asset Management has specialized in the management fixed income portfolios. 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.

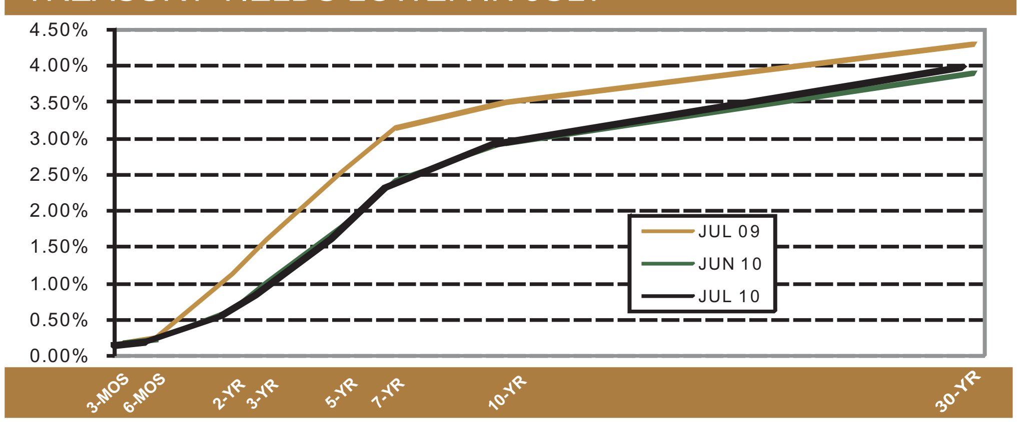
MARKET SUMMARY

Concern over the possibility of a double-dip recession eased somewhat in July as market participants, instead, debated the impact of an extended period of weak economic growth and possible deflation. Fear over European sovereign debt also diminished, helping to fuel a rally in stocks and corporate bonds. Treasury yields continued to move lower as the market pushed back the target date for any FOMC rate increases until well into 2011.

U.S. economic data remains mixed, indicating that an economic recovery that is continuing, albeit at a relatively weak pace. Because unemployment remains high, the economic recovery is unlikely to gain momentum until a meaningful recovery in the jobs market begins. Inflation remains tame, and market participants have turned their focus from higher inflation to the possibility of deflation. The Fed is also on guard against this possibility and, over the next several months, the market will be watching for signs of additional economic stimulus from the Fed. Any additional stimulus would likely come in the form of further quantitative ease.

Going forward, market participants will continue to debate the strength of the economic recovery and the possibility of deflation. Many traders also remain nervous about the impact that financial reform and other government regulation will have on the markets and the economy.

TREASURY YIELDS LOWER IN JULY



Treasury yields ended the month lower as market participants anticipated sluggish economic growth and the possibility of deflation.

YIELDS	7/31/10	6/30/10	CHANGE
3 Month	0.14	0.17	(0.03)
2 Year	0.55	0.62	(0.07)
3 Year	0.82	0.99	(0.17)
5 Year	1.59	1.79	(0.20)
7 Year	2.30	2.43	(0.13)
10 Year	2.91	2.95	(0.04)
30 Year	3.98	3.91	0.07

An Overview of the Causes of Financial Crises

Financial crises have occurred for hundreds of years and involve asset classes ranging from simple tulip bulbs to incredibly complex derivative securities. Regardless of the asset class involved though, in almost every instance a financial crisis has been prompted by a price bubble. Asset price bubbles, in turn, are caused by investors searching for higher returns. As prices steadily rise, greed takes over, and investors bid asset prices to unsustainable levels. Eventually, valuations become excessive and investors decide to take profits. As prices begin to decline, greed is replaced with fear, and investors rush to sell their holdings. If the bubble has been sufficiently large, too many investors may be attempting to sell their holdings. A financial panic will ensue.

In addition to greed and fear, the historical record demonstrates that several other factors have been present at the beginning of many financial crises. These factors include: an asset/liability mismatch, excessive leverage, excessive risk, and currency mismatches. Furthermore, crises can be difficult to anticipate because, while seemingly obvious in retrospect, these factors are not always readily apparent prior to the onset of a crisis. Here we will examine some of the causes of financial crises in the hopes that readers will have a better understanding of those conditions likely to be present prior to the onset of future crises.

Asset/Liability Mismatch

Financial institutions often have a wide differential between the duration of their assets and their liabilities. When this occurs, the institution has an asset/liability mismatch. Asset/liability mismatches can cause problems when interest rates are volatile or if the financial institution finds itself unable to roll over short-term financing at an attractive level. If this occurs, a financial institution may find it necessary to reduce their mismatch by selling assets into a declining marketplace. This can prompt large losses for the financial institution and, in some cases, even threaten its solvency.

Excessive leverage

If financial institutions could simply avoid having an asset/liability mismatch, the problem would be academic. However, facilitating the transformation of short-term deposits into long-term loans is one of the main purposes of financial intermediaries. This makes an asset liability mismatch an inherent part of a financial institution's business model. In the normal course of business, this mismatch is manageable. However, when financial markets become exceptionally volatile and the institution utilizes excessive leverage, an asset/liability mismatch can become fatal. Excessive leverage exacerbated the asset/liability mismatch at Bear Stearns and Lehman Brothers and was also the primary cause of the Long-Term Capital Management (LTCM) collapse during the Asia/Russia financial crisis of 1997-1998.

Excessive Risk

The search for higher returns and correspondingly higher risk tolerance is the defining feature of a financial bubble. As more and more financial market participants take on excessive risk, the bubble grows thereby setting the stage for an ensuing financial crisis. Excessive risk-taking usually occurs when financial institutions make a conscious decision to increase their risk tolerance. However, there have been occasions when financial institution risk exposure increased unintentionally. For instance, many of the investment banks and other financial institutions that purchased mortgage-backed securities prior to the current financial crisis did so because they believed that these "AAA" rated securities were quite safe. This turned out to be a false assumption with the result that financial institutions actually had far greater risk exposure than they had intended.

A similar problem can occur when a financial institution believes that their holdings are uncorrelated, only to discover that in a market panic all of their positions move in the same direction. This occurred in 1998 when LTCM found that all their trades began to move in the same direction, prompting massive losses and fears of a systemic financial collapse.

Currency Mismatch

A common feature of many emerging market financial crises is a currency mismatch. This can occur when governments or corporations borrow in foreign currency. If financial markets begin to decline, the government or corporation may find itself unable to roll over its existing debt. Even worse, the host currency may be declining in value thereby increasing the "real" amount owed. Currency mismatches were present in the Latin debt crisis of the 1980s, the Asian financial crisis of 1997, and the Argentina debt default of 2002.

A currency mismatch rarely causes a financial crisis in and of itself. However, currencies usually decline when asset prices are falling. This means that a currency mismatch generally harms the borrower at precisely the worst time namely when the values of its other assets are also declining. Therefore, currency mismatches have the capacity to turn a market decline into a financial crisis.

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Identifying Crises Before and After They Occur

These four factors are generally most likely to occur following a protracted period of low interest rates, easy money, declining inflation and rising asset prices. This benign, external environment often results in increasing investor confidence. As investors grow more confident, they tend to become less risk averse. Less risk aversion can in turn lead investors to employ more leverage and can also increase the willingness of financial institutions to extend the duration of their assets - thereby increasing their inherent asset/liability mismatch.

When confidence reverses, investors quickly become more risk-averse, which causes them to reduce leverage and risk. Financial institutions also might seek to lower their risk exposure by reducing their asset/liability mismatch – usually by selling risky assets. These factors can be further exacerbated when a currency mismatch is present because currency declines often accompany a reversal in investor confidence these currency declines tend to amplify downward movements in asset prices.

Because a common set of conditions is often present at the onset of a financial crisis, identifying crises before they occur is a seemingly simple exercise. However, while the presence of a potential crisis is often obvious in retrospect, financial market participants tend not to recognize crises before they occur. In part, this is because pre-crisis conditions usually occur when the external investment environment is strong and confidence is high. Often investors will argue that although prices seem inflated, "this time things are different." Other times, investors may realize that a financial bubble is underway and a crisis will at some point ensue. In these instances though, investors may believe that they will be able to time the crisis properly, thereby making money during the bubble and selling prior to the onset of trouble.

Moral Hazard

The final factor that prevents investor behavior from changing prior to the onset of a financial crisis is moral hazard. Moral hazard occurs when incentives exist for an investor to take a position from which they can benefit if things go well and shift the losses on to others if things go poorly. For instance, many financial industry pay practices encourage moral hazard by paying traders and portfolio managers when they make profits but not penalizing them if they lose money. System wide moral hazard exists as long as financial market participants believe that in a worst-case scenario the government will step in to bail them out. Here government actions intended to benefit the many and reinforce negative behavior in the few.

Prior to the onset of the U.S. financial crisis some observers did believe a crisis was coming and adjusted their positions accordingly. However, the majority believed that markets would suffer at worst a mild correction. Even those participants that successfully anticipated the crisis would have had difficulty in predicting both the timing of the crisis and the magnitude of its effects. With this absence, simply forecasting an eventual financial crisis often does not result in profitable investment returns. In these instances, it is sometimes easier simply to join in the herd mentality and ride the wave for as long as it continues.

Conclusion

We've briefly examined some of the conditions that often exist prior to the onset of a financial crisis. Having a basic understanding of these conditions can perhaps help an investor properly position their portfolio before the onset of future financial crises. Nevertheless, it is important to remember that although financial crises have occurred for hundreds of years, history rarely repeats itself exactly. For that reason, the next financial crisis is unlikely to look exactly like the one we just experienced. Investors overly focused upon finding the next financial crisis are likely to miss out on the investment gains to be had during more normal market conditions. In the market, as in life, optimists usually win out over pessimists.

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

Consumer Prices

In June, the CPI showed that consumer prices increased 1.1% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 0.9% rate. Tame inflation readings reduce the pressure on the Fed to aggressively reverse their historically easy monetary policy. 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 June, Retail Sales rose 4.8% on a year-over-year basis. Consumer spending appears to have rebounded from the depths of the recession, but has not yet reached the heights of the previous economic expansion. Consumers remain somewhat cautious due to job losses, home price declines and a general tightening of credit standards.

Labor Markets

The July employment report showed that the economy lost 131,000 jobs due to census worker layoffs. The decline was in line with expectations. Private hiring was positive but came in below expectations, fueling concern that the employment picture remains weak. The unemployment rate remained at 9.5% as more discouraged job seekers gave up their search. Most economists currently believe that it will be some time before the unemployment rate declines in a meaningful way.

Housing Starts

Single-family housing starts decreased 0.6% in June to 454,000. The housing recovery seems to have lost some momentum, however, the housing market remains stronger than during the depths of the downturn.

Credit Spreads Tighter

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.43	(0.26)
2-year AA corporate note	0.42	0.53	(0.11)
5-year AA corporate note	0.69	0.80	(0.11)
5-year Agency note	0.21	0.23	(0.02)

Source: Bloomberg Data as of 7/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.27) $Bln MAY 10	(40.32) $Bln APR 10	(24.86) $Bln MAY 09
GDP	2.40% JUN 10	3.70% MAR 10	(0.70%) JUN 09
Unemployment Rate	9.50% JUL 10	9.50% JUN 10	9.40% JUL 09
Prime Rate	3.25% JUL 10	3.25% JUN 10	3.25% JUL 09
CRB Index	274.35 JUL 10	258.52 JUN 10	257.45 JUL 09
Oil (West Texas Int.)	$78.95 JUL 10	$75.63 JUN 10	$69.45 JUL 09
Consumer Price Index (y/o/y)	1.10% JUN 10	2.00% MAY 10	(1.40%) JUN 09
Producer Price Index (y/o/y)	2.80% JUN 10	5.30% MAY 10	(4.40%) JUN 09
Dollar / EURO	1.30 JUL 10	1.22 JUN 10	1.43 JUL 09

Source: Bloomberg

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