CHANDLER ASSET MANAGEMENT

February 2011

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 clients' portfolios.

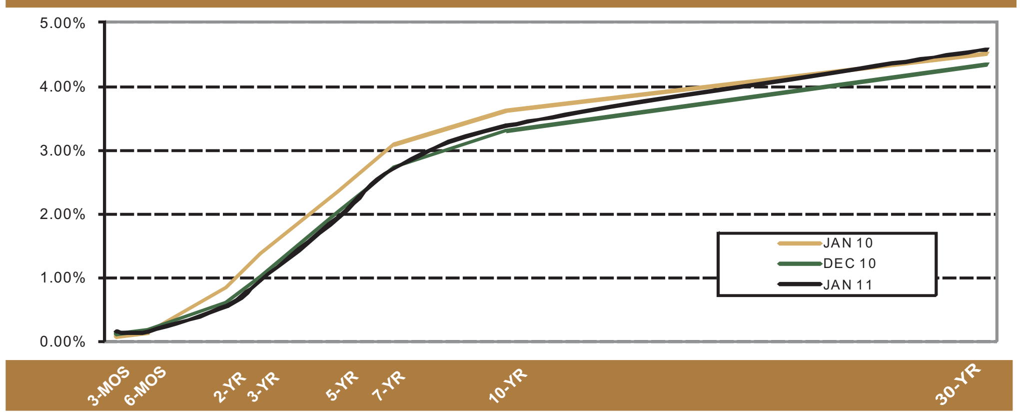
Market Summary

Treasury yields were mixed in January, as better economic data led to higher long-term rates while market participants took advantage of Q4 2010's selloff to purchase some short and intermediate-term Treasuries.

Fears of a return to recession, or a prolonged period of deflation, have virtually disappeared for the moment, and many economists have begun revising their economic forecasts higher. The first reading of Q4 2010 GDP showed that the economy grew at a 3.2% annual pace, the fastest rate of growth since the previous spring. The report also indicated that companies had drawn down inventories in the fourth quarter—a bullish sign for future growth (lower inventories mean that companies will have to increase future production in order to restock the shelves.) However, the jobs report was somewhat disappointing, and the labor market has not yet picked up significantly making it unlikely that the economy is poised to enter a truly robust growth phase.

Although commodity prices have been increasing, inflation readings remain tame, with the Core CPI (ex-food & energy) report indicating a year-over-year increase of only 0.8%. Although fears of deflation have almost disappeared, most economists forecast continued moderate inflation well into 2011. The Federal Reserve maintains its exceptionally easy monetary policy, and continues to purchase longer-dated Treasury securities in an effort to promote economic growth. The next Fed meeting is March 15, and most market participants expect no change in Fed policy at least through mid-2011.

TREASURY YIELDS MIXED IN JANUARY



Treasury yields ended the month mixed as short-term rates declined slightly while long-term rates were moderately higher. The yield curve steepened and the spread between 2-year Treasuries and 10-year Treasuries is near a record high.

YIELDS	1/31/11	12/31/10	CHANGE
3 Month	0.15	0.12	0.03
2 Year	0.56	0.60	(0.04)
3 Year	0.96	1.00	(0.04)
5 Year	1.95	2.02	(0.07)
7 Year	2.71	2.72	(0.01)
10 Year	3.38	3.30	0.08
30 Year	4.57	4.35	0.22

Consumer Prices

In December, the CPI showed that consumer prices increased 1.5% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 0.8% rate. Although some producer prices have begun to increase, prices on consumer goods appear stable at this point. Many economists believe that inflation will remain moderate over the next 12 months, although fears of deflation appear to have subsided somewhat.

Retail Sales

In December, Retail Sales rose 7.9% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been promising; however, activity is still far short of 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 January employment report showed that the economy added just 36,000 jobs, significantly fewer than the market was expecting. The private sector added 50,000 jobs in January, while government jobs fell 14,000. Meanwhile, the unemployment rate unexpectedly dropped to 9.0% (from 9.4%). The consensus estimate was 9.5%. The decrease in the unemployment rate was largely due to a drop in the labor force. Overall, the latest employment report was mixed, but points to a gradually improving labor market. Severe winter weather may have hindered payroll growth in the month.

Housing Starts

Single-family housing declined 9.0% in December, the lowest level since May 2009. This report was below expectations, but could be related to the difficult weather conditions experienced in certain regions of the country.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.11	0.17	(0.06)
2-year AA corporate note	0.35	0.40	(0.05)
5-year AA corporate note	0.55	0.61	(0.06)
5-year Agency note	0.37	0.35	0.02

Source: Bloomberg Data as of 1/31/2011

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.3) $Bln NOV 10	(38.4) $Bln OCT 10	(35.2) $Bln NOV 09
GDP	3.20% DEC 10	2.60% SEP 10	5.00% DEC 09
Unemployment Rate	9.00% JAN 11	9.40% DEC 10	9.70% JAN 10
Prime Rate	3.25% JAN 11	3.25% DEC 10	3.25% JAN 10
CRB Index	341.42 JAN 11	332.80 DEC 10	265.58 JAN 10
Oil (West Texas Int.)	$92.19 JAN 11	$91.38 DEC 10	$72.89 JAN 10
Consumer Price Index (y/o/y)	1.5% DEC 10	1.1% NOV 10	2.7% DEC 09
Producer Price Index (y/o/y)	4.0% DEC 10	3.5% NOV 10	4.3% DEC 09
Dollar / EURO	1.37 JAN 11	1.34 DEC 10	1.39 JAN 10

Source: Bloomberg

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On Raising the Debt Ceiling

The debt ceiling currently stands at $14.3 trillion; it is projected to be reached in early 2011. As this event nears, the question of whether to raise the federal debt ceiling or not will likely garner more interest and debate. This discussion should include consideration of the broader issues of deficits and the overall level of debt.

The debt ceiling statutorily restricts the total amount of debt the federal government can incur. Unique to the American political process is that Congress authorizes spending (including deficit spending) separately from issuing debt. Under this two part arrangement, Congress can spend more than it collects while, at the same time, denying the authority to borrow to make up the difference. Therefore, in theory, there could be a situation where the federal government spends but is hamstrung from borrowing by the debt ceiling. This could lead to the curtailment of some government activities, the halting of certain federal benefits or to default.

Depending on which side of the fence one sits, catastrophe looms with not raising the ceiling and calamity from raising the ceiling and continuing to issue debt. Raising the debt ceiling at this point would merely allow the Treasury to meet obligations that have already been authorized; it does not change or increase the debt outstanding.

One side of the debate argues that not raising the debt ceiling would have disastrous consequences for the U.S. economy and global financial markets. It would erode confidence in U.S. debt, the U.S. dollar, and the economy. Historically, U.S. debt has had zero default risk, and thus, has served as a safe haven for investors worldwide. Even the subtlest suggestion of risk introduces a risk premium and increases the interest rate investors would demand to hold U.S. Treasury securities. Global financial markets, already on edge from the European sovereign debt crises, would be in turmoil.

Furthermore, this side contends the budgetary consequences would be dire, especially in light of the economy's fragility. A drop in spending would cause a decrease in economic growth and employment as the economy is starting to recover. In a worst-case scenario, the United States would have to turn to the International Monetary Fund for assistance.

The opposing argument suggests that a choice between more debt and default is no choice at all. Raising the debt ceiling merely prolongs hard decisions on entitlements and spending, structural imbalances and necessary reforms. Instead of raising the ceiling to avoid default, it recommends significant spending cuts and sequencing debt payments. This side argues that any increase in the ceiling must be accompanied by a spending cut.

In the long run, more debt is likely to prove damaging to the economy. Interest rates would probably increase, and the value of the dollar would fall. The government might even allow this to happen so that debt repayment would be in cheaper dollars, and consequently, less expensive. Investors might then be less willing to buy U.S. debt, forcing interest rates even higher.

Historical Antecedent

The original debt ceiling crisis occurred in 1995, when partisan gridlock obstructed raising the debt ceiling for about six months. This roiled financial markets and forced two government shutdowns. In the past five years, the ceiling has been raised five times. The most recent increase, in February 2010, raised the ceiling by over 15%, or $1.9 trillion, from its previous level established in 2009.

Because the limit has been increased so often, it is perceived as having no real consequence on government finance. Even if Congress balanced the budget, the debt limit would eventually be reached by the very nature of growth.

Refocusing the Debate

Neither option is attractive. Refocusing this debate away from the ceiling question to a broader consideration of federal spending and entitlements, and the debt resulting from deficit spending, might prove more useful.

Government debt is the accumulation of budget deficits. The U.S. debt is the largest in the world. Tax cuts, two wars, high growth government spending, and structural imbalances have all contributed to the debt. The financial crisis exacerbated the situation. Unemployment benefits, bailout bills and the stimulus package added to the deficit. Further, the tax base and government revenues shrunk as unemployment skyrocketed. Each year, interest on the debt is added to the debt. Social Security and Medicare are mandatory costs that are spiraling. As Baby Boomers start retiring, more and more government spending will be devoted to this expense. Historically, the federal government benefited from more workers paying payroll taxes than retirees collecting benefits. Understanding, let alone controlling healthcare costs, has been elusive. Currently, debt levels are above historical averages by many measures. More worrisome, trends suggest more debt to come.

Realizing the unsustainability of the status quo, the Obama Administration created a bipartisan National Commission on Fiscal Responsibility and Reform with a mandate to propose ways of reducing the deficit. The Commission presented its findings and set forth bold proposals to slash the deficit by cutting expenses and reforming entitlements. It presented a restructuring of the tax code that both raises taxes and eliminates deductions and write-offs. Support for the proposals has been tepid. Proposed alternatives have not been meaningful enough to dent the problem.

Addressing the federal deficit requires difficult decisions, many unpopular, and changes to long held practices (ear marking and entitlements). With political will lacking, this is likely the explanation why nothing has been done about the deficit and debt problem to date. There is no winning answer to the question of whether to raise the debt ceiling.

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