CHANDLER ASSET MANAGEMENT

January 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.

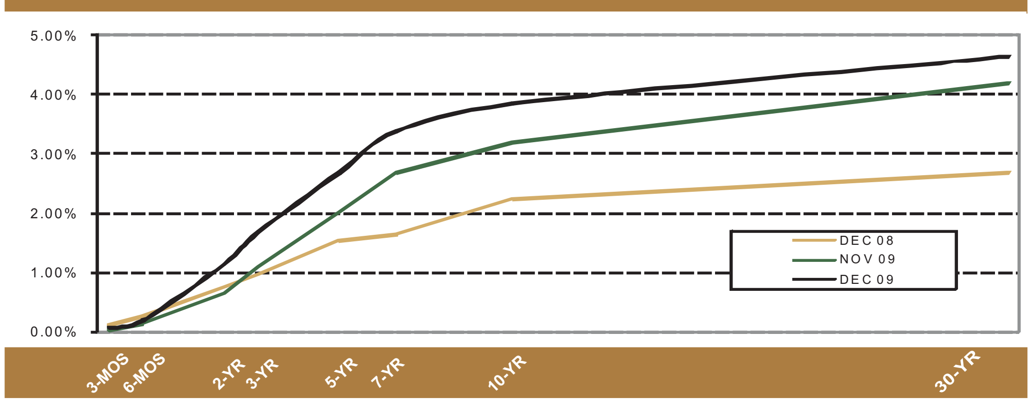
Market Summary

As the year came to an end, market participants continued to debate the strength of the economic recovery. November's positive jobs report, combined with a continued deluge of Treasury issuance, helped lead to a sharp selloff in the Treasury market. For the month of December, two year Treasury yields rose 48 basis points (0.48%) and ten year Treasury yields rose sixty three basis points (0.63%). Despite this increase, yields largely remain in the range they have been in since last summer. Going forward, interest rates are likely to remain volatile as market participants debate the strength of the economic recovery, the withdrawal of central bank liquidity measures, and the continued heavy issuance of Treasury bonds.

The December non-farm payroll report showed that the economy lost 85,000 jobs last month, a somewhat disappointing figure, however, the overall trend in employment remains positive, but at very weak levels. It is important not to read too much into a single month's report, as jobs data tends to be volatile, especially at inflection points. Inflation remained tame, as the overall CPI reading showed a year-over-year increase of 1.8% while the Core reading (ex food & energy) showed a year-over-year increase of 1.7%. Most economists, as well as the Federal Reserve, forecast that inflation will remain muted during the year ahead, and may even decline.

The FOMC remains on hold and most prognosticators forecast no increase in the Fed Funds Rate during 2010. However, the Fed is already removing some of the temporary liquidity measures put in place during the height of the credit crisis. As financial market conditions and the economy improves, look for the Fed to continue removing excess liquidity in the market place. At the same time though, the Fed stands ready to react to any further weakening in the economy and the Federal Government may implement a second stimulus package if they perceive that the economy is not recovering as strongly as they would like.

TREASURY YIELDS MUCH HIGHER IN DECEMBER



Treasury yields rose sharply in December as market participants reacted to positive economic data and the continued heavy issuance of Treasury securities.

YIELDS	12/31/09	11/30/09	Change
3 Month	0.05	0.03	0.02
2 Year	1.14	0.66	0.48
3 Year	1.67	1.10	0.57
5 Year	2.68	2.00	0.68
7 Year	3.38	2.69	0.69
10 Year	3.83	3.20	0.63
30 Year	4.63	4.19	0.44

With the possibility of renewed collapse appearing more unlikely each passing day, policymakers must now move on to their next challenge: withdrawing unprecedented fiscal and monetary stimulus without damaging the still tenuous economic recovery. Additional uncertainties facing the economy include reduced credit availability and the question of whether or not private sector demand will pick up as the American consumer continues to deleverage. Not surprisingly given these uncertainties, the economic and financial market outlook for 2010 is extremely opaque.

Nevertheless, despite the current uncertainty, some economic outcomes seem more likely than others. With that in mind, we will examine three possible economic scenarios for 2010 as well as investor implications for each of these scenarios.

Scenario One: A Gradual Recovery

The first, and perhaps most likely, scenario involves a gradual economic recovery during 2010. In this scenario, the contrasting forces currently influencing the economy could result in a middle-of-the-road result featuring sluggish economic growth and stubbornly high unemployment, a situation some pundits have termed "the new normal."

An analysis of previous recessions and recoveries indicates that recessions that are global in nature or prompted by financial crisis foster weaker recoveries. Furthermore, the bursting of the housing and consumer credit bubbles has left the American consumer more inclined to save than to spend—thereby depriving the economy of its main engine of growth (in recent years, consumer spending has been responsible for upwards of 70% of total economic activity.)

Under the "new normal" scenario, GDP growth in the 1.5% to 3.5% range may be likely. While this headline number may not appear that bad, the economy is unlikely to "feel" good. Unemployment is likely to remain above 9%, and struggling homeowners will continue to face the possibility of foreclosure. Interest rates are likely to remain low in this scenario, with the Federal Reserve on hold throughout the year. Longer-term rates may be more volatile, rising during months which feature strong economic data and declining when a spate of weak economic data surfaces. In this sluggish growth environment, inflation is unlikely to be a problem, despite some concerns about a rising money supply.

Under this scenario investors should take advantage of a gradually improving economic environment by purchasing corporate bonds in order to capture the higher yields they provide. With the yield curve historically steep, investors would also do well to position some of their holdings further out on the yield curve in order to receive higher returns. This is particularly true in an environment where money market securities effectively yield zero.

Scenario Two: A V-Shaped Recovery

The second economic scenario to consider features a stronger than expected recovery. Historically, severe recessions have resulted in very strong economic rebounds. Furthermore, the developing world, led by China, is growing rapidly—boosting the prospects for American exports. With continued monetary and fiscal stimulus, it is possible the economy can gain enough momentum to sustain above-average growth even as officials begin to remove some of their extraordinary stimulus measures.

In this environment, GDP growth would likely be above trend, perhaps 4% or higher. Unemployment would remain higher than it has been over most of the previous decade, but would likely decline below 9% by the end of the year. Inflation readings should remain moderate, but may begin to increase as they reflect rising commodity and energy prices. Importantly for investors, each strong economic report would increase speculation about the eventual timing of Federal Reserve interest rate increases.

In the V-shaped recovery scenario, interest rates are likely to move higher throughout the course of 2010. What then should fixed income investors do if they expect such a strong recovery? One tool would be to slightly shorten the average duration of the portfolio in order to gain some protection from rising interest rates. Investors in such a scenario would also do well to own corporate bonds that would likely outperform Treasuries if interest rates rise. In the V-shaped scenario, investors may even want to slightly lower their credit criteria for corporate bonds (for instance, owning "A" rated bonds instead of "AA" rated bonds.)

Scenario Three: The Double Dip Recession

Given the extreme measures taken by global policymakers in order to stimulate economies, the least likely outcome at this point may be a double dip recession. Nevertheless, as policymakers remove stimulus, it is possible economic growth will slow again, particularly if businesses do not begin hiring and consumer spending remains weak. One important indicator to watch if one is concerned about a double dip recession is Chinese economic growth. China is broadly credited with spurring the global economic recovery and if the Chinese economy slows meaningfully in the next year, it could have dire implications for the United States and the world.

In this third scenario, the Federal Reserve would remain on hold throughout 2010 and probably throughout 2011 as well. Unemployment would remain high and GDP would either stagnate at extremely low levels (+1.0%) or turn negative. Inflation would not be a concern; in fact deflation would be more of a concern among policymakers and market participants. If this scenario comes to pass, expect to hear a lot of talk about the Japanese economic stagnation following the 1989 bursting of that country's stock and property bubbles.

If the economy falls back into recession, interest rates in the short end of the yield curve would remain near zero and longer rates would probably decline. Investors would do well to increase the duration of their portfolio in order to take advantage of these declining long-term interest rates. Corporate bond performance would likely bifurcate with higher-quality names doing better; this would make credit research increasingly important to select the best performing bonds.

Outliers

While the three scenarios presented above are the most likely outcomes for the year ahead, they are certainly not the only possibilities. In particular, some investors fear either a repeat of the global financial crisis or hyperinflation prompted by large government bond issuance. Fortunately, the return of financial collapse is unlikely given the amount of additional stimulus global policymakers have injected into the economy. At the same time, hyperinflation is unlikely as long as central banks remain vigilant against inflation, unemployment remains high, and spare capacity in the manufacturing sector remains at record levels.

For investors, it is important to be aware of upside and downside economic risks, but portfolios should be focused upon the more likely outcomes. Proper portfolio positioning, combined with the

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willingness and ability to react quickly if unexpected events occur, will likely result in optimal portfolio performance over time.

Conclusion

These scenarios are not intended to be forecasts, but rather to provide a broad analysis of likely possibilities in the year ahead for investors to consider. Having considered these possibilities, it is up to each investor to decide which outcome seems most likely to them, and how best to position their portfolio so that they may profit if their chosen scenario comes to pass, while at the same time minimizing downside risk if the unexpected occurs.

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

Consumer Prices

In November, the CPI showed that consumer prices increased 1.8% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.7% y-o-y rate. Despite hopes for an economic recovery and an increased money supply, many economists believe that inflation will remain moderate over the next 12 months.

Retail Sales

In November, Retail Sales rose 1.9% on a year-over-year basis, a significant improvement over the previous several months' readings. Consumers have increased their savings rate and slowed their spending in reaction to a general tightening of credit standards, job losses, and the housing market contraction.

Labor Markets

The December non-farm payroll employment report showed a worse than expected loss of 85,000 jobs while the unemployment rate remained at 10.0%. This employment report was weaker than expected and reflected a job market that is struggling to recover. While the job market is expected to slowly recover, it appears unlikely that the unemployment rate will meaningfully decline in the near future. 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 rose 2.1% in November to 482,000. 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	0.24	0.21	0.03
2-year AA corporate note	0.49	0.67	(0.18)
5-year AA corporate note	0.79	0.87	(0.08)
5-year Agency note	0.29	0.35	(0.06)

Source: Bloomberg

Data as of 12/31/09

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(32.94) $Bln OCT 09	(35.65) $Bln SEP 09	(59.39) $Bln OCT 08
GDP	(2.20%) SEP 09	(0.70%) JUN 09	(2.70%) SEP 08
Unemployment Rate	10.00% DEC 09	10.00% NOV 09	7.40% DEC 08
Prime Rate	3.25% DEC 09	3.25% NOV 09	3.25% DEC 08
CRB Index	283.38 DEC 09	277.40 NOV 09	229.54 DEC 08
Oil (West Texas Int.)	$79.36 DEC 09	$77.28 NOV 09	$44.60 DEC 08
Consumer Price Index (y/o/y)	1.80% NOV 09	(0.20%) OCT 09	1.10% NOV 08
Producer Price Index (y/o/y)	2.40% NOV 09	(1.90%) OCT 09	0.40% NOV 08
Dollar / EURO	1.43 DEC 09	1.50 NOV 09	1.40 DEC 08

Source: Bloomberg

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