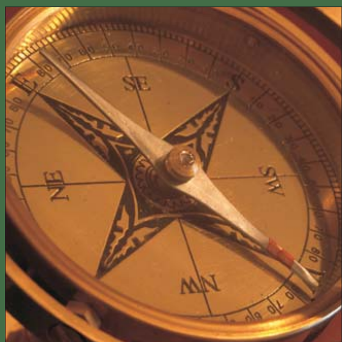
CHANDLER ASSET MANAGEMENT

January 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.

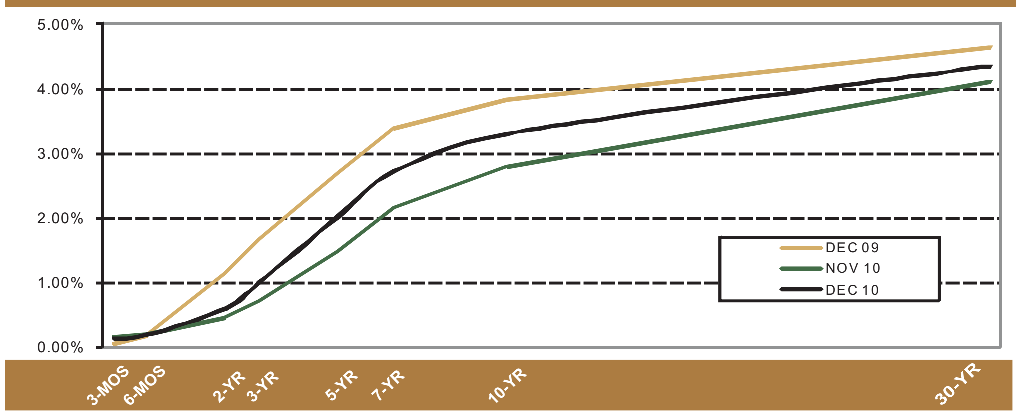
Market Summary

During December, market participants reacted to a series of better than expected economic reports by increasing their forecasts for future economic growth. As a result, Treasury yields moved higher, led by five year Treasuries (+55 basis points) and seven year Treasuries (+57 basis points).

Housing starts, leading economic indicators, and various manufacturing activity indicators all pointed to stronger growth, as did reports from retailers of strong holiday sales. However, the jobs report was somewhat disappointing, and the labor market has not 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 dissipated, 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 January 26, and most market participants expect no change in Fed policy at least through mid-2011.

TREASURY YIELDS HIGHER IN DECEMBER



Treasury yields ended the month higher as market participants reacted to a series of positive economic reports. Longer-term Treasury yields remain higher than shorter-term yields.

YIELDS	12/31/10	11/30/10	CHANGE
3 Month	0.12	0.16	(0.04)
2 Year	0.60	0.45	0.15
3 Year	1.00	0.70	0.30
5 Year	2.02	1.46	0.56
7 Year	2.72	2.15	0.57
10 Year	3.30	2.79	0.51
30 Year	4.35	4.11	0.24

ECONOMIC ROUNDUP

Consumer Prices

In November, 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 0.8% 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, and fears of deflation appear to have somewhat subsided.

Retail Sales

In November, Retail Sales rose 7.7% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession, and recent activity has been promising; however, activity still falls 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 December employment report showed that the economy added 103,000 jobs: fewer than the market was expecting. However, the unemployment rate declined to 9.4% (from 9.8%), and previous payroll figures were revised somewhat higher. Overall, the latest employment report was somewhat disappointing, and the tepid recovery in the labor market is likely to continue restraining economic growth.

Housing Starts

Single-family housing starts rose 6.9% in November. This was a positive report, and market participants will watch closely to see whether it marks the start of a gradual pickup in the housing recovery. The impact of recent increases in mortgage rates will also bear monitoring.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.09	0.08
2-year AA corporate note	0.40	0.44	(0.04)
5-year AA corporate note	0.61	0.70	(0.09)
5-year Agency note	0.35	0.20	0.15

Source: Bloomberg Data as of 12/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.71) $Bln OCT 10	(44.60) $Bln SEP 10	(32.30) $Bln OCT 09
GDP	2.60% SEP 10	1.70% JUN 10	1.60% SEP 09
Unemployment Rate	9.40% DEC 10	9.80% NOV 10	9.90% DEC 09
Prime Rate	3.25% DEC 10	3.25% NOV 10	3.25% DEC 09
CRB Index	332.80 DEC 10	301.41 NOV 10	283.38 DEC 09
Oil (West Texas Int.)	$91.38 DEC 10	$84.11 NOV 10	$79.36 DEC 09
Consumer Price Index (y/o/y)	1.10% NOV 10	1.20% OCT 10	1.80% NOV 09
Producer Price Index (y/o/y)	3.50% NOV 10	4.30% OCT 10	2.20% NOV 09
Dollar / EURO	1.34 DEC 10	1.30 NOV 10	1.43 DEC 09

Source: Bloomberg

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New Year, New Challenges

The financial turmoil of the past few years has left investors in a vastly altered investment landscape. Up for reconsideration are such basic investing concepts as yield structures and sector allocation. Confounding this situation is the need to keep abreast of an ever-expanding body of knowledge that includes changing asset classes and regulatory reform.

This article will consider areas of uncertainty that are challenging investors now. Persistent low interest rates are compelling investors to reassess their portfolios' maturity structures. Less surprising are the uncertainties presented by evolving asset classes and regulation. What newly developed or still evolving securities or asset classes will be appropriate for conservative investors? What form will regulation take?

Low Rates/ Flatter Yield Curve

The current market environment is characterized by persistently low short-term interest rates. As well, the yield curve has flattened. In this environment, there is an unbalanced or skewed risk/return trade-off. That is, with current short-term rates near zero, there is not much room for rates to move lower. Alternatively, rates are likely to rise at some point in the future; when they do, higher rates will tend to devalue bond portfolios. Because rates are low across the yield curve, extending maturities does not offer as much of a cushion of coupon income as might be the case in normal interest rate environments. Yet even at these levels, longer maturity investments offer significantly more return than short securities, the yield of which approaches zero.

Expanding Knowledge Base

The current post-crisis investment environment, with its great scope and pace of change has naturally led to significant uncertainty and great challenge. Let us look at what has happened in the agency sector.

Traditional Assets

Growth in the federal housing agency market (e.g., FNMA and FHLMC), during the early 1990s and ending in 2008, resulted from their issuance of increasingly greater amounts of debt to finance increased home ownership. With the perceived safety of implied federal backing, conservative bond investors gladly enjoyed the yield and safety in this market sector.

With the bursting of the housing bubble, FNMA and FHLMC are in a state of change. As Congress and regulators weigh the benefit of their traditional purpose—to foster increased home ownership—both agencies have been mandated to shrink their balance sheets. Although the federal government continues to stand in support of the housing agencies and their senior debt, their long-term existence remains in question.

Other Options

This change in a popular asset class has led conservative bond investors to consider alternative investment options beyond the traditional asset classes of treasuries and agencies.

Municipal Bonds

Build America Bonds (BABs), created by Congress under The American Recovery and Reinvestment Act of 2009, had but a brief period of issuance until the Act expired at the end of 2010. BABs are municipals with a twist: the interest on BABs is taxable rather than tax-free. This makes BABs attractive to non-traditional buyers—those who may not pay income tax or who seek diversification or other benefits—instead of traditional muni investments. Like all non-government guaranteed investments, BABs expose the investor to credit risk, and those considering BABs must have the expertise to fully analyze that risk. Finally, while the end of the BABs program will likely decrease the liquidity of these bonds in the secondary market, there has been some talk in Washington of introducing a similar program at some future point.

Corporate Bonds

Investment grade corporate debt can be an attractive alternative to government securities. Like all non-government guaranteed bonds, investment in corporate notes requires analytic expertise. Not all investors have the risk tolerance and, in some cases, the authorization to buy corporate credit.

Regulation

Regulation is another area undergoing drastic change. Given the breadth of the changes, staying informed of all the nuances is challenging. In direct response to the financial crisis, and in examining the events that led to the market breakdown, one of the areas examined by the federal government has been regulation. The hope is that regulatory reform will help restore transparency and, with any luck, stability and trust in the market. The means of achieving these goals effectively is not without disagreement. Proposed regulatory changes are extremely broad ranging, and a detailed analysis is outside the scope of this article. However, to give a sense of the range of regulatory reform under consideration, take a look at this list: regulation of the housing agencies, FNMA and FHLMC, and their future role; how the government will support, monitor and regulate financial institutions and banks; how fiduciary standards are applied; the roles and responsibilities of the rating agencies to investors and other stakeholders; the role of the MSRB in protecting governmental entities as debt issuers; the structure of financial regulation and the creation of a regulator or regulatory entities to identify emerging risks and coordinate multi-agency cooperation; regulation of nonfinancial institutions failure of which could have profound systemic risks on the economy in general; registration of previously unregistered financial entities; the oversight of payments, clearing and settlement; and the authority and accountability for emergency responses.

Conclusions

The impact of the financial crisis of 2008-2009 was so broad and deep that it is far too soon for the government to have developed the necessary safeguards and solutions. Instead, investors must navigate the markets with crystal balls even more foggy than usual.

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