CHANDLER ASSET MANAGEMENT

June 2010

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

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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.

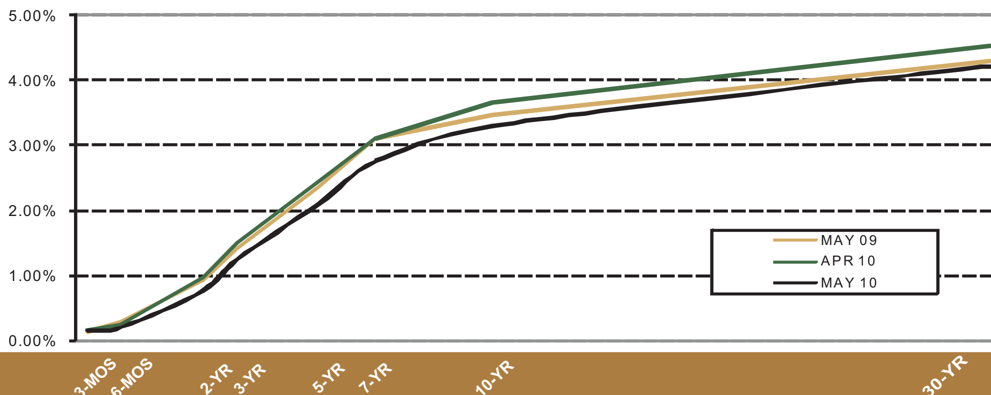
MARKET SUMMARY

Continued concerns over European sovereign debt problems helped push Treasury bond prices higher, and interest rates lower in May. Market participants are worried that sovereign debt problems in Greece, Portugal, Spain and other European countries could spread and derail the global economic recovery. There is also concern that a sovereign debt default or restructuring could prompt losses at banks, leading to a repeat of the turmoil that followed the collapse of Lehman Brothers.

In the US, economic data is still mixed, but the economy does appear to be strengthening—the one notable exception was the employment report that came in weaker than expected. Inflation remains tame, lessening pressure on the Federal Reserve to tighten monetary policy. The FOMC is being extremely careful not to harm the incipient economic upturn; to that end they have reiterated their pledge to keep financial conditions extraordinarily easy for the foreseeable future.

Markets are likely to remain volatile into the summer as traders debate the impact of sovereign debt concerns and improving underlying economic fundamentals. Many market participants are also nervous about financial reform and its ultimate impact on the markets and the economy.

TREASURY YIELDS LOWER IN MAY



Treasury yields ended the month lower as market participants grew concerned that deteriorating conditions in Europe might derail the global economic recovery.

YIELDS	5/31/10	4/30/10	CHANGE
3 Month	0.15	0.15	0.00
2 Year	0.77	0.96	(0.19)
3 Year	1.25	1.48	(0.23)
5 Year	2.10	2.42	(0.32)
7 Year	2.76	3.11	(0.35)
10 Year	3.30	3.66	(0.36)
30 Year	4.22	4.53	(0.31)

The Fed (Part 2)

In April's newsletter article, we discussed the history of the Federal Reserve, its structure, and its mandate to facilitate economic growth and promote price stability. This month we will explore in detail some of the most important measures of short-term interest rates, as well as the tools the Federal Reserve (Fed) uses to implement monetary policy.

By gaining a better understanding of the Federal Reserve's structure and mechanisms for controlling monetary policy, market participants can better monitor future Federal Reserve movements and their impact on economic growth and interest rate movements. This understanding can then translate into more effective fixed income portfolio management.

Key Interest Rates

The Federal Funds Rate (Fed Funds)

The fed funds rate is the rate at which banks and financial institutions lend money amongst themselves on a short-term basis. It is the most important short-term rate the Fed uses in implementing its monetary policy. The Fed targets a fed funds rate through its open market operations (explained later).

The Discount Rate

The discount rate is the rate that the Federal Reserve charges banks to borrow directly from it. This rate is less important than the fed funds rate in implementing monetary policy.

The Prime Rate

The Federal Reserve has no direct impact on the prime rate, which is set individually by various banks and other financial institutions. In practice though, most banks set their prime rate at a level three hundred basis points above the fed funds rate. Therefore, when the Fed raises rates, the prime rate usually increases, and when the Fed cuts rates, the prime rate decreases. The prime rate is used in pricing a wide range of consumer and commercial loans such as credit cards, construction loans, and small business loans. Therefore, when the prime rate fluctuates in response to Fed actions, it serves to further promote or discourage economic growth.

Tools of the Fed

The Fed attempts to manage short-term interest rates and the money supply in order to facilitate economic growth and promote price stability. It has several tools that it employs in order to accomplish its goals. The two most commonly used tools are open market operations and discount window lending.

Open Market Operations

The Federal Open Market Committee (FOMC) meets eight times a year to discuss economic conditions and set a target for the federal funds rate. The "cheaper" the cost of these funds, the more willing customers are to borrow. Therefore, when the Federal Reserve wishes to tighten credit throughout the financial system, they raise the federal funds rate. When they want to promote economic activity, they lower the rate. Adjusting the fed funds rate is the primary tool that the Federal Reserve uses to combat inflation and promote economic growth.

The federal funds rate is a target rate that the FOMC sets at its meetings. The Fed then attempts to maintain the target overnight rate using open market operations. With open market operations, the Federal Reserve buys and sells US Treasury and Agency securities on a regular basis in order to manage the money supply. If the Fed wants to add more money to the system, it buys securities. If it wants to remove liquidity from the system, it sells securities. All open market operations are conducted by the Federal Reserve's New York branch.

Discount Window Lending

The FOMC sets the discount rate in conjunction with the federal funds rate. In theory, if the discount rate is higher, banks will be less willing to borrow from the Fed, thereby curtailing economic activity. Banks usually prefer to borrow from one another rather than directly from the Fed. This is why the discount rate is less important as a tool of monetary policy than the fed funds rate.

The Fed and the Crisis

The Federal Reserve has been aggressive since the onset of the financial crisis, employing both traditional techniques as well as extraordinary measures designed to maintain financial stability and promote economic growth. In addition to lowering the federal funds rate to less than 0.25%, the Federal Reserve also engaged in quantitative easing. Quantitative easing refers to a process in which the Fed purchases securities in the open marketplace in order to alter the balance of supply and demand, improve liquidity, and lower interest rates. The Fed purchased more than $1 trillion worth of mortgage-backed securities, as well as hundreds of billions of dollars worth of US Treasuries and government agencies.

In order to promote financial stability at the height of the crisis, the Federal Reserve also opened the discount window to all financial institutions (previously it had only been available to banks.) Additionally, the Federal Reserve fast tracked the approval of Goldman Sachs' and Morgan Stanley's conversion to bank holding companies in order to improve market confidence in the stability of those organizations.

Having learned from the aftermath of previous financial crises that prematurely tightening monetary policy can derail an economic recovery, the Federal Reserve is determined not to make that mistake. However, with stability having returned to the financial system, the Fed has begun to differentiate between emergency measures put in place at the height of the crisis and more traditional monetary policy. The removal of these emergency measures should not be seen as an indication of future monetary policy, but rather as recognition that the worst of the crisis has passed. Nevertheless, the Fed stands ready to reinstate emergency measures should a renewal of the financial crisis occur.

Conclusion

This article has examined some of the tools that the Federal Reserve uses in order to promote economic growth and contain inflation. The events of the past several years have also caused the Federal Reserve to use nontraditional means in order to mitigate the worst effects of the financial crisis. Many of these measures are currently being unwound; however, the Fed has pledged to maintain easy monetary conditions for an extended period in the hopes of promoting a sustainable economic recovery.

Brian Perry, Vice President, Investment Strategist

Consumer Prices

In April, the CPI showed that consumer prices increased 2.2% 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 reduced 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 twelve months.

Retail Sales

In April, retail sales rose 8.8% 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 May employment report showed that the economy gained 431,000 jobs, but most of those were due to the census. Permanent hiring came in below expected, prompting concern that the employment picture remains weak. The unemployment rate declined to 9.7%, but the drop was attributed to discouraged job seekers giving up their search. Despite the relatively weak report, market participants continue to hope that the employment situation has turned and that the economy can continue to add jobs in the months ahead.

Housing starts

Single-family housing starts increased 10.2% in April to 593,000. Recent data indicates a housing market that has stabilized, but has yet to display a robust recovery.

Credit Spreads Wider

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.31	0.12	0.19
2-year AA corporate note	0.49	0.39	0.10
5-year AA corporate note	0.77	0.67	0.10
5-year Agency note	0.23	0.21	0.02

Source: Bloomberg

Data as of 5/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.4) $Bln MAR 10	(39.40) $Bln FEB 10	(28.8) $Bln MAR 09
GDP	3.0% MAR 10	5.6% DEC 09	(6.40%) MAR 09
Unemployment Rate	9.70% MAY 10	9.90% APR 10	9.40% MAY 09
Prime Rate	3.25% MAY 10	3.25% APR 10	3.25% MAY 09
CRB Index	254.80 MAY 10	277.71 APR 10	253.05 MAY 09
Oil (West Texas Int.)	$73.97 MAY 10	$86.15 APR 10	$66.31 MAY 09
Consumer Price Index (y/o/y)	2.20% APR 10	2.30% MAR 10	(0.70%) APR 09
Producer Price Index (y/o/y)	5.50 APR 10	6.00% MAR 10	(3.50%) APR 09
Dollar / EURO	1.23 MAY 10	1.33 APR 10	1.42 MAY 09

Source: Bloomberg

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