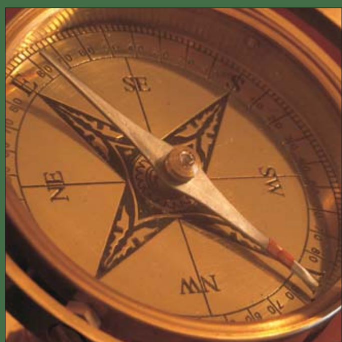
CHANDLER ASSET MANAGEMENT

March 2011

Bond Market Review

A monthly review of fixed income markets



What's Inside

Since 1988, Chandler Asset Management has specialized in the management of 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.

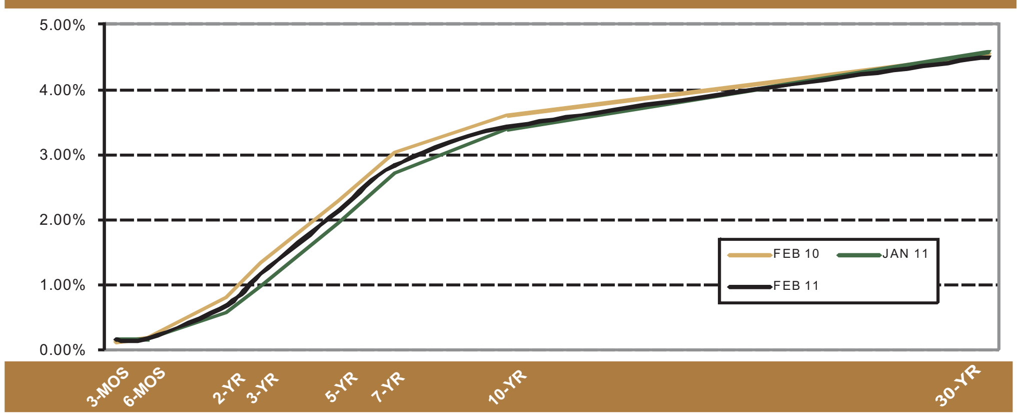
Market Summary

Treasury yields were mostly higher in February as better economic data led to a bond sell-off and higher rates mid-month. However, unrest in North Africa and the Middle East, and sharply higher oil prices, resulted in a Treasury rally during the second half of the month with yields settling moderately higher across most of the yield curve.

Economic growth remains moderate, and many economists have begun revising their economic forecasts higher. The unemployment rate declined to 8.9% in February, and many other economic indicators reflected positive, though not robust, economic activity. There is some concern that the recent spike in oil prices, if it were to continue, could derail the economic recovery. While inflation remains moderate, there is also debate on what impact higher energy prices, as well as higher food prices, will ultimately have. While the future course of inflation is still uncertain, it does appear that the consumer price index has bottomed out for this cycle, and readings are likely to head at least marginally higher over the intermediate term.

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 MOSTLY HIGHER IN FEBRUARY



Treasury yields ended the month mainly higher as 3 & 5-year Treasury yields rose the most, while long-term rates were moderately lower. The yield curve remained steep, and the spread between 2-year Treasuries and 10-year Treasuries is near a record high.

YIELDS	2/28/11	1/31/11	CHANGE
3 Month	0.14	0.15	(0.01)
2 Year	0.69	0.56	0.13
3 Year	1.16	0.96	0.20
5 Year	2.14	1.95	0.19
7 Year	2.83	2.71	0.12
10 Year	3.41	3.38	0.03
30 Year	4.49	4.57	(0.08)

Consumer Prices

In January, the CPI showed that consumer prices increased 1.6% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.0% rate. Although some producer prices have begun to increase, prices on consumer goods are not expected to rise sharply in the months ahead. Many economists believe that inflation will remain moderate over the next 12 months, although inflation levels may pick up somewhat from here.

Retail Sales

In January, Retail Sales rose 7.8% 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.

Labor Markets

The February employment report showed that the economy added 192,000 jobs, which was in line with expectations. Meanwhile, the unemployment rate dropped to 8.9%. Changes in the average work week and average hourly earnings were slightly weaker than expected. Overall, this was a good, but not great, employment report which demonstrates that the labor market is improving but not as rapidly as anyone had hoped.

Housing Starts

Single-family housing declined 1.0% in January to 413,000, the lowest level since May 2009. This report indicates that the housing market remains relatively weak.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.11	0.01
2-year AA corporate note	0.31	0.35	(0.04)
5-year AA corporate note	0.52	0.55	(0.03)
5-year Agency note	0.32	0.37	(0.05)

Source: Bloomberg Data as of 2/28/2011

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.6) $Bln DEC 10	(38.3) $Bln NOV 10	(37.1) $Bln DEC 09
GDP	2.8% DEC 10	2.6% SEP 10	5.0% DEC 09
Unemployment Rate	8.9% FEB 11	9.0% JAN 11	9.7% FEB 10
Prime Rate	3.25% FEB 11	3.25% JAN 11	3.25% FEB 10
CRB Index	352.58 FEB 11	341.42 JAN 11	274.78 FEB 10
Oil (West Texas Int.)	$96.97 FEB 11	$92.19 JAN 11	$79.66 FEB 10
Consumer Price Index (y/o/y)	1.6% JAN 11	1.5% DEC 10	2.6% JAN 10
Producer Price Index (y/o/y)	3.6% JAN 11	4.0% DEC 10	4.5% JAN109
Dollar / EURO	1.38 FEB 11	1.37 JAN 11	1.36 FEB 10

Source: Bloomberg

Housing Finance Reform and GSE Debt Update

Since Fannie Mae and Freddie Mac were placed in conservatorship in 2008, their future has remained largely undetermined. As part of the takeover, they were ordered to shrink their balance sheets while their ultimate fate was considered. Throughout this period, they have continued to benefit from the support of the federal government.

Fannie Mae and Freddie Mac were originally established in 1938 and 1970, respectively, to promote the federal government's policies and lending programs for affordable housing. The companies packaged, issued debt and insured bond buyers against losses with the implicit support of the federal government. Their debt obligations have been extremely popular among public sector investors because of the perceived safety of the implied federal backing. The structure for Fannie Mae and Freddie Mac that ultimately emerges from the current debate, and more importantly, the structure and support of their existing and future debt issuances, remain of critical concern to the public sector and other investors of SLY funds.

The Administration's Report for Reform

On February 11, the Obama administration presented a report to Congress "Reforming America's Housing Finance Market." This report presents three approaches for a future housing finance system, one that is weaned from its dependence on the government. It calls for the government to shrink its role and "ultimately wind down" Fannie Mae and Freddie Mac. Significantly, it commits the government to ensuring that "Fannie Mae and Freddie Mac have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations." Investors can take comfort in this unambiguous commitment of support by the federal government.

The report serves as an opening bell for a political and policy debate that will likely not be short. With the mortgage market massive, the economy's recovery is nascent, and a housing recovery that has not yet taken firm hold, suggest the debate and, ultimately the transition process will be lengthy. Treasury Secretary Timothy Geithner stated to reporters that the transition to a new system would likely take five to seven years. A divided Congress underlies the difficulty and causes a slow political solution and major reforms.

The Three Options

The three options presented suggest varying degrees of reduced government involvement. The reform plan for housing finance that the Administration presents seeks to accomplish several goals. The first objective is to prepare for a private mortgage market by paring government support for housing finance and winding down Fannie Mae and Freddie Mac; to address market flaws to protect borrowers, promote transparency for investors, and increase private capital; and, to target government's support for affordable housing more effectively and transparently.

1. *Privatized system of housing finance with the government insurance role limited to FHA, USDA and Department of Veterans' Affairs' assistance for narrowly targeted groups of borrowers.*

This option is the most dramatic reduction in government's involvement in housing finance. It limits the role of government to FHA and certain other programs targeting low and moderate-income borrowers, leaving the majority of the mortgage market to the private sector. For the most part, taxpayer risk exposure would be limited to loans guaranteed by the FHA.

The repercussions of this option would include decreased access to mortgage credit, increased mortgage rates, heightened competition for smaller lenders outside the Federal Housing Administration (FHA) segment, and potentially a limited ability by the government to respond during a crisis.

2. *Privatized system of housing finance with assistance from FHA, USDA and Department of Veterans' Affairs for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis.*

Like in the first option, the FHA and other programs would provide credit to low and moderate income borrowers. However, in this option, the government would develop a backstop mechanism to ensure access to credit during a crisis. The backstop would have a minimal presence in the market during normal times. The report includes several alternatives to providing this backstop from pricing the guarantee where it would only make sense in the absence of private capital or limiting the amount of insurance sold to the market in normal times.

3. *Privatized system of housing finance with FHA, USDA and Department of Veterans' Affairs assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital.*

This third option most resembles the current government involvement in housing finance. As in the other two options, under this scenario, the mortgage market outside the FHA and the other guarantee programs would be driven by the private sector. However, to increase the liquidity of the mortgage market and access to mortgage credit, as well as the ability of the government to respond to future crises, the government would offer reinsurance for the securities of certain mortgages. Instead of insuring the mortgages or the securities, the government would reinsure the mortgage insurers. Under one alternative, a group of insurers would provide insurance to securities backed by certain mortgages with the government providing reinsurance to these entities at a premium, used to cover future claims and protect taxpayers.

Benefits of this option likely include providing the lowest cost access to mortgage credit. Also, the government reinsurance would attract a larger pool of investors, enhancing liquidity, in turn, lowering the cost of mortgages. As well, it would level the playing field for smaller financial institutions. The government's presence would enhance its ability to deal with crises in the future.

Political Decisions

The reform report lays out these three options as a starting point for housing finance reform. The final course might be very different from all of the options. Given the complexity of the issue and the entrenchment of the status quo, deciding on a course of action for reform would be lengthy under ideal circumstances. The current divided government, the partisanship in the country, the apparent lack of consensus may lead in political posturing further drawing out the debate.

Some suggest, as time goes by, strengthening housing market conditions and improving financial performance of the GSEs might dampen enthusiasm for major reform with ultimate GSE reform involving modest changes in ownership or corporate structure, or limiting business activities.

Fannie Mae and Freddie Mac Debt

Each option presented in the Administration's reform report envisions an end to Fannie Mae and Freddie Mac in their current form. Regardless of which option the political process selects, the reform of housing finance and the fate of government-sponsored enterprises Fannie Mae and Freddie Mac will take years to implement. In the report, the Administration reiterates its support for current and future debt and obligations of these entities. Accordingly, it appears unlikely to pose risk to bondholders of their debt or the senior debt ratings of the securities.

As the debate continues, Chandler Asset Management will continue to keep you informed of the latest developments. We continue to remain confident that any future changes to Fannie Mae and Freddie Mac will not impact the status of the senior debt they have already issued or will issue in the near future.

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