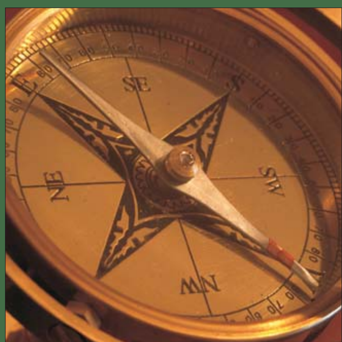
CHANDLER ASSET MANAGEMENT

November 2010

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS



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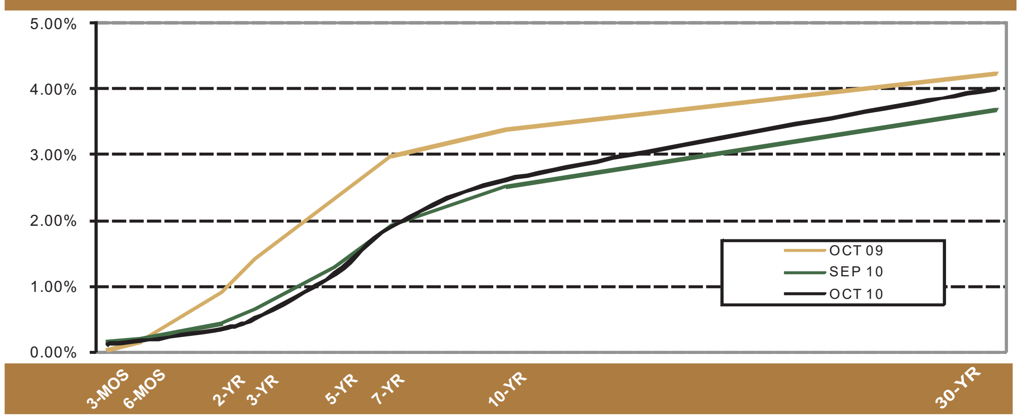
Since 1988, Chandler Asset Management has specialized in the management fixed income portfolios. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our clients' portfolios.

MARKET SUMMARY

Treasury yields were relatively unchanged in October with short-term rates declining slightly and longer-term rates rising slightly. Market participants continue to debate the impact of an extended period of weak economic growth, as well as a second round of Federal Reserve asset purchases. U.S. economic data has picked up slightly in the past month highlighted by the best employment report since last spring. Nevertheless, the overhang from the housing bubble and credit crisis is likely to restrain consumer spending and economic activity for some time to come. As a result, inflation is tame, and the Federal Reserve is actually attempting to promote higher prices.

Now that the mid-term elections have concluded, and the Fed has announced a second round of quantitative easing, market focus will likely turn to upcoming economic releases. Also important will be whether the federal government provides any further fiscal stimulus and whether or not the Bush tax cuts are allowed to expire. While the odds of a return to recession appear to have diminished, it is not clear what the primary driver of economic activity will be in the months ahead. The prospect of a vigorous economic recovery remains questionable.

TREASURY YIELDS MIXED IN OCTOBER



Treasury yields ended the month mixed as market participants anticipated sluggish economic growth and debated the impact of a second round of quantitative easing by the Federal Reserve. Longer-term Treasury yields remain higher than shorter-term yields.

YIELDS	10/31/10	9/30/10	CHANGE
3 Month	0.11	0.15	(0.04)
2 Year	0.34	0.42	(0.08)
3 Year	0.50	0.63	(0.13)
5 Year	1.18	1.28	(0.10)
7 Year	1.90	1.91	(0.01)
10 Year	2.61	2.52	0.09
30 Year	4.00	3.69	0.31

ECONOMIC ROUNDUP

Consumer Prices

In September, 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. Tame inflation readings reduce the pressure on the Fed to aggressively reverse their historically easy monetary policy. Most economists believe that inflation will remain moderate over the next 12 months, as deflation currently appears to be more of a concern than inflation.

Retail Sales

In September, Retail Sales rose 7.3% 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.

Labor Markets

The October employment report showed that the economy added 151,000 jobs, the best reading since May. The more important private payrolls number showed an increase of 159,000, while the previous month's report was revised higher. The unemployment rate remains at 9.6%. Overall, the employment report was positive, although many economists currently believe that it will be some time before the unemployment rate declines in a meaningful way.

Housing Starts

Single-family housing starts increased 4.4% in September to 452,000. The housing recovery seems to have lost some momentum as the expiration of government tax credits for new homebuyers and continued high levels of foreclosures weigh on the market.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.14	0.21	(0.07)
2-year AA corporate note	0.45	0.40	0.05
5-year AA corporate note	0.71	0.66	0.05
5-year Agency note	0.15	0.25	(0.10)

Source: Bloomberg

Data as of 10/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(46.35) $Bln AUG 10	(42.58) $Bln JUL 10	(31.07) $Bln AUG 09
GDP	2.00% SEP 10	1.70% JUN 10	(1.60%) SEP 09
Unemployment Rate	9.60% OCT 10	9.60% SEP 10	10.10% OCT 09
Prime Rate	3.25% OCT 10	3.25% SEP 10	3.25% OCT 09
CRB Index	300.67 OCT 10	286.86 SEP 10	270.38 OCT 09
Oil (West Texas Int.)	$81.43 OCT 10	$79.97 SEP 10	$77.00 OCT 09
Consumer Price Index (y/o/y)	1.10% SEP 10	1.10% AUG 10	(1.30%) SEP 09
Producer Price Index (y/o/y)	4.00% SEP 10	3.10% AUG 10	(4.90%) SEP 09
Dollar / EURO	1.39 OCT 10	1.36 SEP 10	1.47 OCT 09

Source: Bloomberg

Quantitative Easing & Inflation

The Federal Reserve (Fed) recently announced that they will purchase $600 billion worth of long-term U.S. Treasuries (quantitative easing) in an effort to stimulate economic growth and increase inflation expectations. This effort to increase the rate of inflation is somewhat unusual; most people are probably more familiar with efforts on the part of the Fed to decrease the rate of inflation. Proponents of the Fed's new approach argue that the plan will help prevent the U.S. from sinking into a deflationary spiral such as that experienced by Japan.

However, there are also many economists and market participants that argue against what the Fed is doing and are fearful that the Fed's asset purchases will not only stave off deflation but actually prompt too much inflation. With that in mind, the remainder of this article will focus upon inflation and some of the reasons that it can be so damaging to the economy.

In 1923, a student at Freiburg University in Germany ordered a cup of coffee at a cafe. The price on the menu was 5,000 Marks. He had two cups. When the bill came, it was for 14,000 Marks. "If you want to save money," he was told, "and you want two cups of coffee, you should order them both at the same time."* This anecdote comes from a period when prices in Germany were doubling every two days, and the exchange rate of the German Mark to the U.S. Dollar stood at 4 trillion to one. In fact, paper money lost so much of its value that it was cheaper to burn money than wood for fuel.

The point of this historical tidbit is not to suggest that the U.S. is about to succumb to a period of hyperinflation, but rather to demonstrate just how destructive inflation can be if it gets out of control. That is why the mandate of almost every central bank in the world is to promote price stability. Some central banks, such as the U.S. Federal Reserve, have a dual mandate that also includes promoting economic growth. Others, such as the European Central Bank, are tasked solely with keeping inflation contained. If inflation is controlled, the theory goes, economic growth will take care of itself.

Over time, prices for a wide variety of goods and services tend to increase. That is why the Big Mac we purchased for a dollar when we were kids now costs $6, or why we can't go to the movies for $5. This normal, gradual increase in prices represents an acceptable, normal level of inflation and is far preferable to a period of decreasing prices, or deflation, which is usually associated with a severe economic slowdown. While gradual inflation increases the prices, we have to pay to lead our lives, wages generally increase gradually as well to offset this increase. In fact, inflation doesn't really become a problem until consumers begin to expect much higher levels of inflation in the future. These "inflation expectations" lead to changing behavior patterns among consumers with often severe consequences for the overall economy.

When consumers fear that prices will be higher tomorrow than they are today, they rush to the store to buy as much as possible as soon as possible. This rapid demand increase causes supplies to drop and prices to rise, which further increases inflation expectations, which causes more of a rush to buy, and so on and so forth in a vicious cycle. For this reason, the Fed and other central banks keep a sharp eye on inflation expectations and tend to act rapidly to contain inflation.

Inflation can generate a number of negative consequences. Inflation harms those on a fixed income; this is a particular concern in countries with rising populations of retirees, such as the U.S. or Europe.

Another negative effect of inflation is that it increases the price of exports, making a country less competitive in international trade, an important consideration in today's increasingly globalized world.

Inflation can be good news for debtors, who get to repay principal and interest with dollars worth less than those they borrowed. However, the opposite is also true; creditors are negatively impacted by high rates of inflation, thereby reducing their incentive to lend. Inflation also increases the uncertainty surrounding capital investments and other long-term corporate investments. An unwillingness to lend or commit to capital investments can lead to an increase in consumption over investment to the detriment of an economy's long run prosperity.

These negative consequences of high inflation can be extremely difficult to reverse once they get started. Policy makers are aware of this but currently believe that the risks from deflation outweigh those from inflation. Nevertheless, inflation measures will bear careful monitoring in the months and years ahead in order to determine whether the Fed is ultimately too successful in prompting inflation.

-Brian Perry, V.P. Investment Strategist

* The German Hyperinflation, 1923 Excerpt from Paper Money by "Adam Smith," (George J.W. Goodman), pp. 57-62. http://www.pbs.org/wgbh/commandingheights/shared/minitext/ess_germanhyperinflation.html