CHANDLER ASSET MANAGEMENT

October 2010

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 client's portfolios.

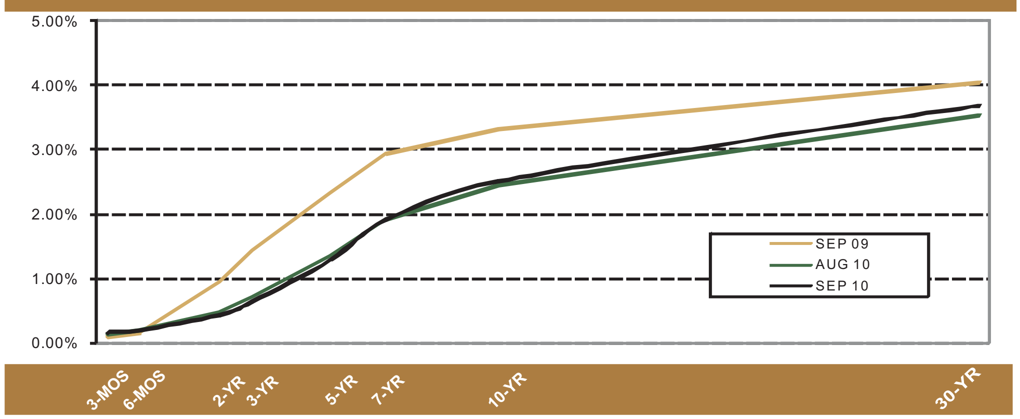
Market Summary

Treasury yields were relatively unchanged in September, but remained at record low levels. Market participants continue to debate the impact of an extended period of weak economic growth as well as the possibility of a second round of Federal Reserve asset purchases. While consensus opinion continues to agree that the economy will remain in a prolonged period of relatively weak economic growth, forecasters continue to assign a significant probability to the possibility of a "double-dip" recession.

U.S. economic data has been relatively disappointing, although activity has picked up significantly from the depths of the recession. Unemployment remains high (9.6%), and the economic recovery is unlikely to gain momentum until a meaningful recovery in the jobs market begins. Inflation is tame, and market participants have turned their focus from higher inflation to the possibility of deflation.

Perhaps the most important thing to watch in the months ahead is whether or not the Federal Reserve undertakes a second-round of quantitative easing. 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. With consumer and business spending constrained, it is not clear what the primary driver of economic activity will be in the months ahead and a vigorous economic recovery remains unlikely.

TREASURY YIELDS MIXED IN SEPTEMBER



Treasury yields ended the month mixed as market participants anticipated sluggish economic growth and debated whether or not the Federal Reserve will implement a second round of quantitative easing. Longer-term Treasury yields remain higher than shorter-term yields, but the yield curve has flattened significantly from record steep levels (longer-term Treasury yields have declined more than shorter-term Treasury yields recently.)

YIELDS	9/30/10	8/31/10	CHANGE
3 Month	0.15	0.13	0.02
2 Year	0.42	0.48	(0.06)
3 Year	0.63	0.70	(0.07)
5 Year	1.28	1.34	(0.06)
7 Year	1.91	1.92	(0.01)
10 Year	2.52	2.48	0.04
30 Year	3.69	3.53	0.16

Consumer Prices

In August, 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 0.9% 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, and deflation currently appears to be more of a concern than inflation.

Retail Sales

In August, Retail Sales rose 3.6% 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 September employment report showed that the economy lost 95,000 jobs, a figure that continues to be influenced by the government census conducted last spring. The more important private payrolls number showed a slightly worse than expected gain of 64,000, while the previous month's report was revised higher. The unemployment rate remains at 9.6%. Most 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 4.3% in August to 438,000. The housing recovery seems to have lost some momentum, as the expiration of government tax credits for new home buyers 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	0.21	0.17	0.04
2-year AA corporate note	0.40	0.40	0.00
5-year AA corporate note	0.66	0.67	(0.01)
5-year Agency note	0.25	0.24	0.01

Source: Bloomberg

Data as of 9/30/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.78) $Bln JUL 10	(49.76) $Bln JUN 10	(33.09) $Bln JUL 09
GDP	1.70% JUN 10	3.70% MAR 10	(0.70%) JUN 09
Unemployment Rate	9.60% SEP 10	9.60% AUG 10	9.80% SEP 09
Prime Rate	3.25% SEP 10	3.25% AUG 10	3.25% SEP 09
CRB Index	286.86 SEP 10	264.19 AUG 10	259.39 SEP 09
Oil (West Texas Int.)	$79.97 SEP 10	$71.92 AUG 10	$70.61 SEP 09
Consumer Price Index (y/o/y)	1.10% AUG 10	1.20% JUL 10	(1.50%) AUG 09
Producer Price Index (y/o/y)	3.10% AUG 10	4.20% JUL 10	(4.90%) AUG 09
Dollar / EURO	1.36 SEP 10	1.27 AUG 10	1.46 SEP 09

Source: Bloomberg

Five Questions for Investors

This article will briefly examine five developing situations that are likely to be important for fixed income investors during the next twelve months. While the ultimate outcome of each of these situations is extremely uncertain, investors that closely monitor developments will be better positioned to react to market developments and adjust their portfolios accordingly.

Will the United States experience another recession?
Most forecasters predict that the U.S. economy will experience a protracted period of somewhat weak economic growth. However, forecasters also believe it is possible the country will slide into another recession. While it is unlikely that another recession would equal the severity of the previous one, it would still be a painful event. If the U.S. enters another recession, unemployment will likely rise again, consumer sentiment fall, and corporate profits weaken. Furthermore, a recessionary environment is unlikely to provide the necessary backdrop for the housing market to finally recover. In summary, the damage done by the financial crisis will take time to heal; if the United States falls into a second recession, this period of time will lengthen, further prolonging the hardship many people are suffering.

Another round of quantitative easing in the United States?
Another important topic in the financial markets is whether or not the Federal Reserve will embark on another round of quantitative easing. Quantitative easing, or QE, refers to extraordinary Federal Reserve purchases of securities in the open market in order to further lower longer-term interest rates in an environment where the federal funds rate is already set at zero. Many economists predict that another round of quantitative easing is likely, especially if the economy does not meaningfully pick up during the remainder of 2010. Further Federal Reserve asset purchases would help keep interest rates low, hopefully stimulating economic growth while also providing a supportive environment for corporate and consumer credit.

Will U.S. interest rates stay low?
Interest rates in the United States are currently at record low levels, and the most prevalent question in the financial markets is whether or not this can continue. The answer depends on a variety of factors, including the future course of U.S. economic growth, the actions taken by the Federal Reserve, and the willingness of investors to continue purchasing fixed-income securities at very low yield levels. Since the future course of interest rates is the primary determinant of fixed-income portfolio returns, investors should closely monitor those factors most likely to determine the path of interest rates. At present, perhaps the most important factor that bears monitoring is the unemployment rate; as long as the unemployment rate remains high, consumer spending is unlikely to increase meaningfully, and the Federal Reserve is unlikely to significantly tighten monetary policy. In such an environment, interest rates may increase, but they are unlikely to move dramatically higher.

What will China do?
China has arguably become the world's most important economy and the engine of global growth. For nearly three decades now, China has grown at an average annual pace of approximately 10%. At the start of 2010, it appeared economic growth in China was overheating, prompting the government to take steps to restrain economic activity. These measures prompted fear among some market participants that Chinese growth would slow too much, sending the country into a period of below trend growth or even a recession.

The course of Chinese growth will have several important impacts upon the financial markets. First of all, the Chinese are among the largest purchasers of US Treasury bonds; if their economy were to slow meaningfully it is likely the Chinese would purchase less U.S. Treasuries, possibly leading to higher U.S. interest rates. Secondly, many multinational corporations depend on China for a growing percentage of their revenue; a Chinese slowdown would lead to lower revenues and profits for these companies. Finally, China is the world's largest purchaser of most commodities—a significant slowdown in economic growth in China would likely lead to much lower commodity prices, harming the economies of many nations that are reliant upon high prices for raw materials.

How risky is sovereign debt?
One of the big debates in the financial markets over the past year has regarded the riskiness of sovereign debt (debt issued by countries.) The primary source of this concern has been from some European countries such as Ireland, Portugal, and Greece, which have been suffering from weak economic growth, large budget deficits, and high debt to GDP ratios. Discussion has swirled around whether or not any of these countries will default on their debt or whether they will be bailed out by the European Union or the International Monetary Fund. While most of these countries are relatively small, their problems are not unique. Markets are also concerned that some very large countries such as the United Kingdom, Japan, and most importantly the United States, share some of the same problems. In the near term, it is extraordinarily unlikely that a large nation will default on their debt, but it will be important to monitor the steps that countries are taking in order to place their finances on a more sustainable path. If countries fail to take these steps, than at some point in the future concern over the safety of the sovereign debt of large nations may be justified.

Conclusion
This article has briefly summarized several important issues currently under debate in the financial markets. Each of these issues is extremely complex and it is beyond the scope of this article to go into detail on the intricacies of these debates or their likely outcomes. However, even a topical understanding of these important issues will allow investors to develop a prism through which to view financial market developments in the months to come and should help investors prepare for some of the changes likely to occur in the financial markets in the future.

-Brian Perry, V.P. Investment Strategist