CHANDLER ASSET MANAGEMENT

October 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.

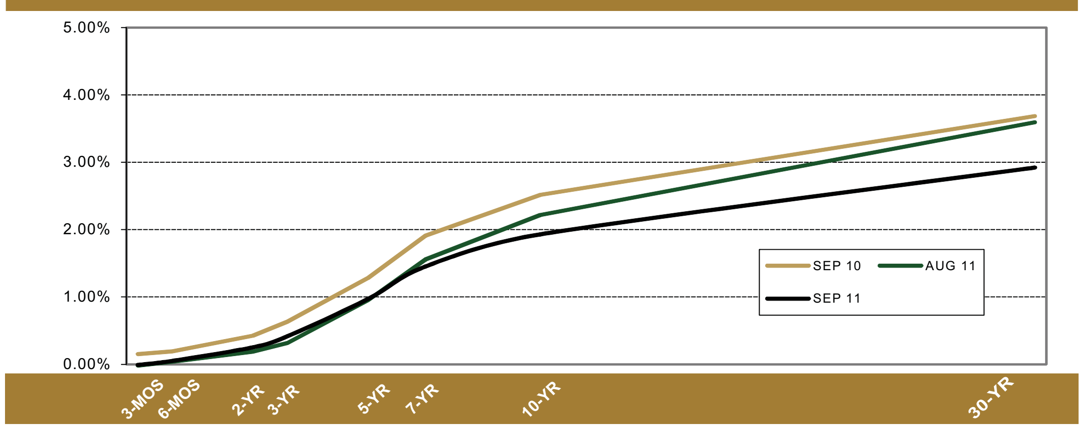
Market Summary

Treasury yields in the long end of the curve moved lower in September driven by "Operation Twist," as well as concerns about a slowing global economy, equity market turmoil, and sovereign debt issues in the euro zone. Events in Europe have been the primary market mover over the past month, and the outcome of the sovereign debt crisis remains uncertain. Market participants are watching closely for a resolution.

Concerns about the domestic and global economy have been rising. Many investors have "fled to quality," cutting back on higher-risk securities in exchange for securities that are perceived as safer or more liquid, driven largely by fears of a pronounced slowdown in domestic and global economic growth. However, there have been some better than expected economic data points in recent weeks providing encouragement that the U.S. may not be headed for a recession. The September employment report was better than expected, as the economy added 103,000 jobs, and the previous two-month's totals were revised higher. The ISM manufacturing index and ISM non-manufacturing indices for September were also better than expected. Though components of these reports were mixed, the overall composite indices suggest that the economy continues to expand.

In September, the Fed announced that it would engage in a form of "Operation Twist" by extending the average maturity of its securities purchases. The FOMC intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program is intended to put downward pressure on longer-term interest rates in an effort to stimulate the economy. The Fed kept its target rate unchanged at 0%-0.25%, and affirmed that it expects to keep the fed funds rate exceptionally low through mid-2013. The Fed's message on the economy was more downbeat than the prior FOMC statement, as they noted, "there are significant downside risks" to the current economic environment. The next regularly scheduled FOMC meeting is November 1.

A TWIST IN THE YIELD CURVE



YIELDS	9/30/11	8/31/11	CHANGE
3 Month	(0.01)	(0.02)	0.01
2 Year	0.25	0.19	0.06
3 Year	0.42	0.31	0.11
5 Year	0.97	0.95	0.02
7 Year	1.45	1.55	(0.10)
10 Year	1.93	2.22	(0.29)
30 Year	2.92	3.59	(0.67)

Economic Roundup

Consumer Prices

In August, the CPI showed that consumer prices increased 3.8% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.0% rate. Although some producer prices have begun to increase, prices on consumer goods are not expected to rise sharply in the months ahead. The Federal Reserve has noted that it is monitoring commodity price increases, but does not believe that they will flow through to sharply higher consumer prices.

Retail Sales

In August, Retail Sales rose 7.2% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been moderate; however, activity is still far short of the heights of the previous economic expansion as a weak job market and high energy prices restrain consumer spending.

Labor Markets

The September employment report showed that the economy added 103,000 jobs and the previous two month's totals were revised higher by 99,000. The unemployment rate remained at 9.1%. This report was an improvement; nevertheless, the employment situation in the country remains poor. Even though the economic recovery is two years old, the pace of recovery in the labor market is extremely weak by historical standards, and is one of the primary reasons why the recovery has been tepid.

Housing Starts

Single-family housing starts declined 1.4% in August to 417,000, compared to 423,000 in July. The housing market remains weak but seems to have stabilized following several years of sharp declines.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.38	0.32	0.06
2-year AA corporate note	0.55	0.58	(0.03)
5-year AA corporate note	0.69	0.82	(0.13)
5-year Agency note	0.42	0.45	(0.03)

Source: Bloomberg

Data as of 9/30/2011

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(44.8) $Bln JUL 11	(51.6) $Bln JUN 11	(41.6) $Bln JUL 10
GDP	1.3% JUN 11	0.4% MAR 11	3.8% JUN 10
Unemployment Rate	9.1% SEP 11	9.1% AUG 11	9.6% SEP 10
Prime Rate	3.25% SEP 11	3.25% AUG 11	3.25% SEP10
CRB Index	298.15 SEP 11	342.57 AUG 11	286.86 SEP 10
Oil (West Texas Int.)	$79.20 SEP 11	$88.81 AUG 11	$79.97 SEP 10
Consumer Price Index (y/o/y)	3.8% AUG 11	3.6% JUL 11	1.1% AUG 10
Producer Price Index (y/o/y)	6.5% AUG 11	7.2% JUL 11	3.3% AUG 10
Dollar / EURO	1.34 SEP 11	1.44 AUG 11	1.36 SEP 10

Source: Bloomberg

Is the United States Headed for Another Recession?

Over the past few weeks, concerns about the domestic and global economy have been rising. Many investors have “fled to quality”, cutting back on higher-risk securities in exchange for securities that are perceived as safer or more liquid, driven largely by fears of a pronounced slowdown in domestic and global economic growth. This has caused corporate bond spreads (in aggregate) to widen and has put downward pressure on the equity markets. According to the Bank of America Merrill Lynch U.S. Corporate Index, high-grade corporate bond option-adjusted spreads on average have widened roughly 100 basis points over the past three months, while the S&P 500 index has declined approximately 15% from its April 2011 peak. In the wake of volatile market activity, many investors are left wondering—is the U.S. headed for another recession?

In the U.S., the National Bureau of Economic Research (NBER) is seen as the authority for identifying recessions. The NBER defines an economic recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." Recessions are also often loosely defined by two successive quarters of negative GDP growth.

Though fears of a potential recession have been rising, current forecasts are not indicative of an impending recession. Market participants currently expect GDP growth of 1.8% and 2.2%, in the third and fourth quarters of 2011 respectively. In addition, GDP growth is expected to accelerate to 2.2% in 2012, up from an annualized estimated growth rate of 1.6% in 2011. Market participants are also currently forecasting a drop in the U.S. unemployment rate to 8.7% by the end of 2012 from an estimated rate of 9.1% in 2011. These estimates point to a modest re-acceleration in economic growth in 2012. However, there has been growing skepticism that the U.S. will meet these targets. Recently, several economists, including the Federal Open Market Committee, have lowered their GDP forecasts.

While financial markets may be sending ominous signals of a recession, we believe there are other key factors to examine when attempting to forecast the U.S. economic outlook. In the current environment, these are some of the economic data points we are watching with particular interest: employment, Europe's Sovereign Debt Crisis, U.S. Fiscal and Monetary Policy, the Index of Leading Economic Indicators, and manufacturing. In our view, trends in these data are likely to steer the direction of the U.S. economy.

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Employment

Employment is one of the most critical factors affecting economic growth. The unemployment rate as of October 2011 was 9.1%, which remains high but marks a significant improvement from the third quarter of 2009 when the unemployment rate reached 10.1%. According to Bloomberg data, market participants expect a slow decline in the unemployment rate and are calling for a rate of 8.7% by the end of 2012. We expect that an improving labor market will help to drive slow and steady economic growth. However, an increase in the unemployment rate or lack of new job creation could substantially hinder economic activity.

Europe's Sovereign Debt Crisis

An exogenous shock to the U.S. economy, such as an unexpected European sovereign default or a failure in the European banking system, would have serious negative repercussions on our domestic economy. A sudden escalation of the crisis in Europe could lead to increased volatility in credit markets, which would inhibit companies' and individuals' ability to borrow funds. At this point, we expect that the sovereign debt crisis in Europe will be contained, and that much of the risk has already been priced into the markets, but we are monitoring the developments in Europe closely.

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Is the United States Headed for Another Recession? (continued)

U.S. Fiscal & Monetary Policy

Given the already fragile state of the U.S. economy, any major changes to fiscal or monetary policy could have a meaningful impact on economic growth. The Fed has pledged to pursue an easy monetary policy through 2013, and continues to evaluate additional tools for stimulating economic activity. Federal Reserve Chairman Bernanke has also urged President Obama and Congress to take steps towards fostering economic growth and promoting job creation. Stalled by political gridlock, however, Congress continues to work toward developing a deficit reduction plan that would (hopefully) not derail the economy. A severe tightening in fiscal policy at this point would be detrimental to economic growth.

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Leading Economic Indicators

The Conference Board Leading Economic Index (LEI) is one of the most useful economic data points, in our view. The index is a composite of ten economic indicators that are believed to lead overall economic activity. Recently, the growth trend in the LEI has moderated, though it remained positive in the latest report (August) on both a monthly and year-over-year basis, suggesting that the economy remains in an expansionary phase. According to an economist at the Conference Board, the August LEI indicated that "there is growing risk that sustained weak confidence could put downward pressure on demand and business activity, causing the economy to potentially dip into recession. While the chance of that happening remains below 50-50, the odds have certainly increased in recent months." The LEI for September will be reported on October 20. The consensus forecast calls for a 0.3% gain.

Manufacturing

U.S. manufacturing had an impressive rebound over the past two years and was one of the strongest sectors of the economy during the recovery. The Institute for Supply Management's (ISM) manufacturing index provides a useful snapshot of the manufacturing sector. The index is constructed such that any level at 50 or above signifies growth in the manufacturing sector; a level in the range of approximately 43-50 indicates that the U.S. economy is growing even though the manufacturing sector is contracting; and any level below 43 indicates that the economy is in recession. The ISM index has remained above 50 since August 2009. Though the index has recently moderated to 51.6, it continues to suggest that the manufacturing sector of the economy is in an expansionary phase. A substantial decline in the ISM index would increase the probability of a U.S. recession.

-Shelly Henbest
Credit Analyst