CHANDLER ASSET MANAGEMENT

July 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.

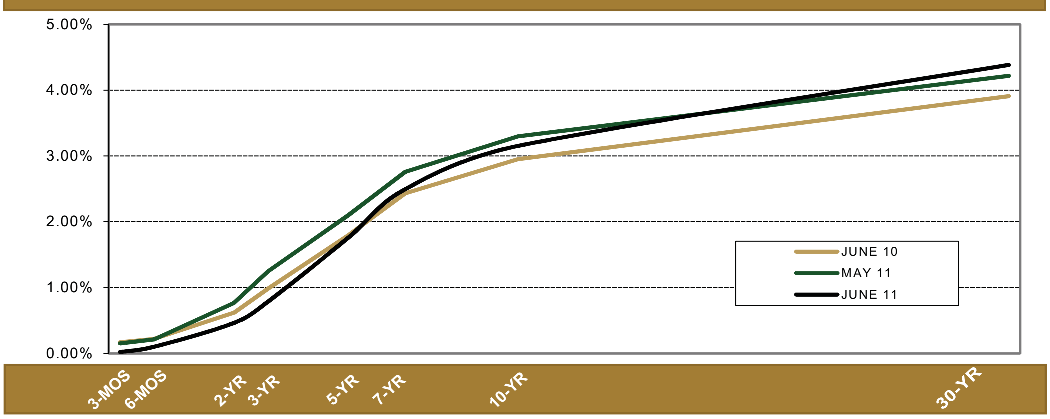
Market Summary

Treasury yields were modestly higher in June as market participants debated whether weaker economic data is only temporary, or if it is a sign of another economic slowdown. The market is also paying close attention to the European sovereign debt crisis, a situation which is likely to drag on for quite a while.

Economic data continues to reflect a sluggish and uneven economic recovery. The June non-farm payrolls report was very disappointing, showing an increase of only 18,000 jobs and an increase in the unemployment rate to 9.2%. The housing market remains very weak, and higher gas prices continue to affect consumer spending (although there is some hope that this effect may begin to moderate). On the positive side, manufacturing activity rebounded slightly in June, with the ISM manufacturing index rebounding to 55.3 (versus 53.5 the previous month). Although inflation has risen, the Federal Reserve continues to believe that this is a temporary development reflecting higher food and energy prices.

Although they have concluded their second round of large-scale asset purchases (QE2), the Federal Reserve maintains its exceptionally easy monetary policy. The Fed Funds rate remains near 0% and the Fed will continue to reinvest principal and interest payments from its securities portfolio. The next scheduled Fed meeting is August 9.

TREASURY YIELDS HIGHER IN JUNE



Treasury yields ended the month modestly higher, with yields on longer securities rising more than those on shorter securities.

YIELDS	6/30/11	5/31/11	CHANGE
3 Month	0.02	0.05	(0.03)
2 Year	0.46	0.46	0.00
3 Year	0.79	0.76	0.02
5 Year	1.75	1.69	0.06
7 Year	2.49	2.38	0.11
10 Year	3.15	3.05	0.10
30 Year	4.38	4.22	0.16

Economic Roundup

Consumer Prices

In May, the CPI showed that consumer prices increased 3.6% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.5% rate. Although some producer prices have begun to rise, prices on consumer goods are not expected to increase 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 May, Retail Sales rose 7.7% 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 June employment report showed that the economy added only 18,000 jobs and the previous two months' totals were revised lower. The unemployment rate rose to 9.2%, and the average weekly hours worked figure also declined. Taken as a whole, this was a very weak report and cast doubt on the strength and durability of the economic recovery. 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 increased 3.7% in May to 419,000, compared to 404,000 in April. On a year-over-year basis, single-family housing starts were down 8.9% compared to May 2010. This report indicates that the housing market remains relatively weak and continues to struggle to gain momentum.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.18	(0.01)
2-year AA corporate note	0.37	0.39	(0.02)
5-year AA corporate note	0.58	0.57	0.01
5-year Agency note	0.36	0.34	0.02

Source: Bloomberg Data as of 6/30/2011

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(50.2) $Bln MAY 11	(43.6) $Bln APR 11	(42.2) $Bln MAY 10
GDP	1.9% MAR 11	3.1% DEC 10	3.7% MAR 10
Unemployment Rate	9.2% JUN 11	9.1% MAY 11	9.5% JUN 10
Prime Rate	3.25% JUN 11	3.25% MAY 11	3.25% JUN 10
CRB Index	338.05 JUN 11	350.06 MAY 11	258.52 JUN 10
Oil (West Texas Int.)	$95.42 JUN 11	$102.70 MAY 11	$75.63 JUN 10
Consumer Price Index (y/o/y)	3.6% MAY 11	3.2% APR 11	2.0% MAY 10
Producer Price Index (y/o/y)	7.3% MAY 11	6.8% APR 11	5.1% MAY 10
Dollar / EURO	1.45 JUN 11	1.44 MAY 11	1.22 JUN 10

Source: Bloomberg

Corporate Credit: 2Q Earnings Preview and Second Half 2011 Outlook

Corporate Credit – Current Trends and Outlook

Corporate credit fundamentals have improved significantly since the financial crisis and economic recession. Many corporate credit issuers have seen a dramatic improvement in their key credit ratios over the past two years (including interest coverage, free cash flow to debt, return on equity, total debt to capital, etc.), leading to a number of credit rating upgrades over that time frame and a significant contraction in overall credit spreads. Since the spring of 2009, investment grade option adjusted credit spreads (OAS)[1] have tightened approximately 350 basis points on average. The average OAS for investment grade corporate debt, according to data based on the Bank of America Merrill Lynch US Corporate Index, now stands at about 155, which is just moderately higher than the 10-year median investment grade corporate OAS. Considering that this data set includes the financial crisis, when corporate OAS rose to unusually high levels, we believe current corporate bond valuation remains compelling.

We also believe the overall credit cycle remains favorable. However, we see less upside in credit fundamentals in the current environment and expect credit trends to be more stable over the near- to intermediate-term. We remain constructive on the economy and believe that ongoing demand recovery will continue to benefit corporate earnings and credit trends. We anticipate that the pace of earnings growth and corporate credit rating upgrades may slow, in light of an uncertain economic environment, rising cost pressures, increased capital deployment, and heightened event risk. Year-over-year revenue, margin, and earnings comparisons are also becoming more challenging as the economy is now entering the third year of expansion since the official end of the recession in June 2009.

Second Quarter Earnings Preview

We are expecting second quarter earnings to show solid year-over-year growth on average and to be relatively in-line or better than analysts' consensus views. However, we expect that the magnitude of upside earnings surprises will be less significant in 2Q11 than the past few quarters. We also anticipate that some companies may have a more cautious outlook on the second half of the year, particularly in light of recent weakness in economic data and intensifying margin pressures.

In spite of mixed economic data during the second quarter, many corporate management teams remained optimistic about corporate earnings and business trends. Several management teams hosted their annual analyst and investor conferences during the second quarter, and a number of them provided a bullish forecast of longer-term growth opportunities, driven in large part by international expansion, capital investments, and an ongoing recovery in demand. However, few companies raised their near-term earnings guidance during the quarter. Many of them either affirmed their forecasts or did not update their earnings outlook.

While we believe that an ongoing recovery in demand has, and will continue to, fuel earnings growth for many companies, there were some factors which pressured second quarter earnings and may limit the magnitude of upside surprises. In the consumer sector, we expect that higher-end retailers outperformed mid- and lower-tier retailers, which likely had a more difficult time of passing along price increases to their customers whose wallets have been stretched by high food and gas prices. In the food and grocery sectors, we expect that price increases helped to drive revenue growth in the second quarter but anticipate that margins continue to be pressured by high commodity costs. In the insurance industry, we expect second quarter earnings were hampered by unusually high catastrophe losses, as most of the large domestic insurance companies have already issued intra-quarter guidance about these charges. Meanwhile, we expect earnings in the banking sector were hindered by legal charges and sluggish loan activity, which was likely somewhat offset by improving credit trends and the continued reversal of loss provisions. For those with a manufacturing or supply chain and/or a significant customer base in Japan (such as the automotive and technology sectors), we expect that ongoing disruption related to the earthquake had a negative impact on earnings in the quarter.

Although managements' tones may be somewhat more cautious, we still expect second quarter earnings will show solid year-over-year growth on average. According to a senior earnings analyst at FactSet Research Systems, Wall Street analysts are projecting 14% year-over-year growth in S&P 500 earnings in the quarter. Energy and

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[1] OAS, calculated at the spread over the Treasury yield curve that equates the present value of a bond's cash flows to its market price, is a measure of a bond's additional return over the return of a comparable Treasury bond, net of the cost of any embedded options. A higher relative OAS may signal that a security is undervalued, while a lower relative OAS may signal that a security is overvalued.

materials companies, in particular, may be poised to report strong earnings and potentially raise guidance because of high energy and commodity prices during the quarter. Meanwhile, companies with significant international exposure may have a more optimistic tone about future earnings, as growth in developing countries is likely to continue outpacing domestic operating trends. We also expect that in some cases, strategic deployment of capital (via share repurchases and acquisitions) will help to drive future earnings growth and prompt some companies to raise their forward-looking guidance.

Second Half 2011 Outlook

Looking ahead, we believe there are a few key factors that are likely to have an important impact on corporate credit in the second half of the year; employment trends, rising cost pressures, and event risk.

Employment. Employment is likely to remain one of the most closely watched economic data points in the second half of 2011. The unemployment rate as of June 2011, was 9.2%, 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 but steady decline in the unemployment rate throughout the remainder of this year and are calling for a rate of 8.5% by the first quarter of 2012. We expect that an improving labor market will help to drive slow and steady demand and corporate earnings growth and will continue to support corporate credit quality.

Margin Pressure. While the Fed continues to downplay the threat of inflation, rising input prices have begun to pressure corporate earnings. Rising commodity, energy, healthcare, wage (especially for those who have operations in China), and regulatory costs are likely to stifle earnings to some degree in the back half of this year. This presents a particular hardship to companies that are unable or unwilling to pass along price increases to their customers in the face of a still sluggish economic recovery. Some companies are forecasting double-digit percentage increases in their costs over the next year. While some companies have had success in offsetting cost pressures and/or passing along initial price increases to their customers, cost pressure is expected to be more significant in the second half of the year.

Event Risk. Event risk is currently one of the most significant risks to corporate credit. While several companies hoarded cash during the credit crisis and continued to conserve cash in the early stages of the recovery, many companies are now deploying cash towards share repurchases, higher dividend payments, and acquisitions. These events are generally unfavorable from a fundamental credit perspective. Share repurchases and dividends, in particular, have little benefit to bondholders. Meanwhile, acquisitions, especially if financed with cash or new debt, can negatively impact a company's credit ratios. Even if a merger or acquisition is beneficial to longer-term earnings growth or cash flow, there is often some execution risk or increased debt load in the early stages of the deal. We believe the industries with the greatest level of this type of event risk include the food, technology, financials, and energy industries, where there has already been meaningful consolidation over the past year. According to a report by PricewaterhouseCoopers (PwC), the value of U.S. merger and acquisition deals in the first five months of 2011 was up 39% from a year earlier, and PwC expects activity to continue to pick up throughout the rest of the year.

Conclusion

Overall, we believe the second half 2011 outlook for corporate credit remains favorable. Though we anticipate that the pace of earnings growth and corporate credit rating upgrades may slow in the latter half of the year, in light of ongoing economic uncertainty, market volatility, and increased headwinds to corporate earnings, we still expect earnings growth to remain healthy and the overall economy to continue growing at a slow but steady pace.

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