CHANDLER ASSET MANAGEMENT

February 2012

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.

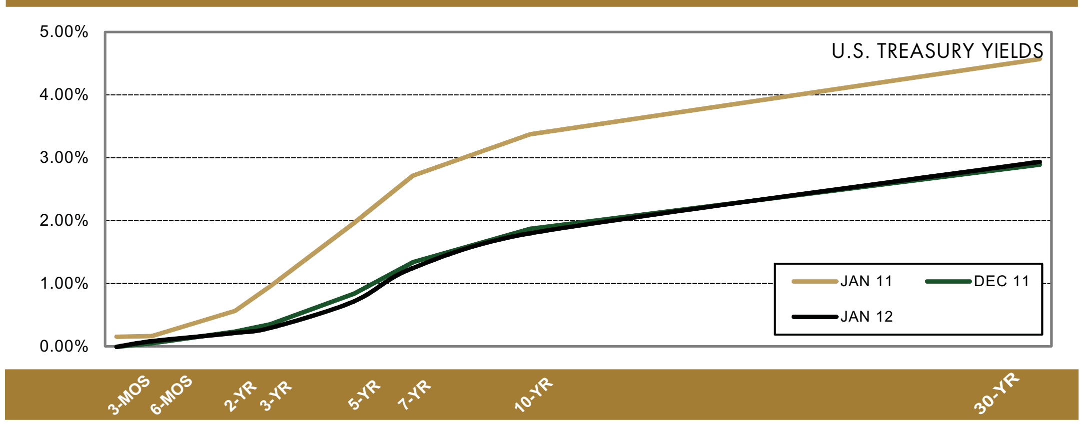
Market Summary

Treasury rates in the belly of the yield curve moved lower in January, while shorter rates and the long end moved modestly higher. Domestic economic indicators continued to improve during the month, but not enough to push interest rates significantly higher. Uncertainty about global growth continues to affect the financial markets keeping demand for dollar based assets firm. Operation Twist, which doesn't expire until June, is also keeping a lid on rates.

U.S. economic data over the last several weeks has been indicative of a slow-to-modest growth environment. The manufacturing sector continues to show strength and the labor market is improving. In January, payroll jobs grew by 243,000, much better than the 135,000 boost that the market was expecting. The unemployment rate dropped to 8.3% in January from 8.5% in December. After the employment report, comments from Federal Reserve Chairman Bernanke remained dovish; foreshadowing the Federal Reserve does not intend to alter its accommodative stance. Though recent economic indicators have improved, we remain cautious about the global economy, particularly in light of the ongoing turmoil in Europe and concerns about decelerating growth in China. A severe contraction in the European economy caused by its debt crisis could impair the U.S. economic recovery. Furthermore, though the overall domestic economy seems to be strengthening, the housing sector remains sluggish and consumer spending continues to be uneven.

In January, the Fed announced that it would retain the policy rate range of 0.0-0.25%. Notably, the Fed stated that it now expects the fed funds rate to remain exceptionally low through late 2014, versus its previous statement that rates would remain exceptionally low through mid-2013; otherwise, the statement was virtually unchanged from December. The Fed continues to believe that the economy is expanding moderately despite a slowing in global growth.

TREASURY YIELDS MOSTLY LOWER IN JANUARY



Treasury yields moved modestly lower in January, with the exception of the long end of the curve which moved slightly higher.

TREASURY YIELDS	1/31/12	12/31/11	CHANGE
3 Month	(0.01)	(0.01)	(0.01)
2 Year	0.21	0.24	(0.03)
3 Year	0.29	0.35	(0.06)
5 Year	0.71	0.83	(0.12)
7 Year	1.24	1.34	(0.10)
10 Year	1.80	1.87	(0.07)
30 Year	2.93	2.89	0.04

Economic Roundup

Consumer Prices
In December, the CPI showed that consumer prices increased 3.0% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.2% rate. Overall, price increases remained subdued, and the Federal Reserve has recently noted that some cost pressures have eased.

Retail Sales
In December, Retail Sales rose 6.5% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been moderate; however, high unemployment continues to restrain consumer spending.

Labor Markets
The January employment report showed that the economy added 243,000 jobs with the six-month average at 167,000 jobs. The unemployment rate fell from 8.5% to 8.3%. This report was better than analysts' expectations with many markets participants forecasting continued positive labor market momentum into early 2012. Although the unemployment rate remains elevated, current economic data suggests the labor markets maybe entering a period of slow sustained growth.

Housing Starts
Single-family housing starts rose 4.4% in December to 470,000, compared to 450,000 in November. The housing market remains under pressure, but seems to have stabilized following several years of sharp declines, and some housing data has recently surprised to the upside.

Credit Spreads Tighter

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.26	0.46	(0.20)
2-year AA corporate note	0.32	0.49	(0.17)
5-year AA corporate note	0.57	0.69	(0.12)
5-year Agency note	0.41	0.48	(0.07)

Source: Bloomberg

Data as of 1/31/2012

Economic Data Modestly Improving

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(47.8) $Bln NOV 11	(43.3) $Bln OCT 11	(38.8) $Bln NOV 10
GDP	2.8% DEC 11	1.8% SEP 11	2.3% DEC 10
Unemployment Rate	8.3% JAN 12	8.5% DEC 11	9.1% JAN 11
Prime Rate	3.25% JAN 12	3.25% DEC 11	3.25% JAN 11
CRB Index	312.31 JAN 12	305.30 DEC 11	341.42 JAN 11
Oil (West Texas Int.)	$98.48 JAN 12	$98.83 DEC 11	$92.19 JAN 11
Consumer Price Index (y/o/y)	3.0% DEC 11	3.4% NOV 11	1.5% DEC 10
Producer Price Index (y/o/y)	4.8% DEC 11	5.7% NOV 11	3.8% DEC 10
Dollar / EURO	1.31 JAN 12	1.30 DEC 11	1.37 JAN 11

Source: Bloomberg

January FOMC Meeting Introduces New Communication Strategy and Communicates Subtle Shift

At the January 24-25 meeting, the Federal Reserve put into practice a new approach to communicate with the public. The new strategy features meaningful changes in the way the FOMC publicizes its opinions about the future state of the economy and its intentions about policy actions.

The FOMC has a dual mandate: fostering maximum employment and ensuring price stability. The way the FOMC communicates its policy goals and actions plays an important role in enhancing monetary policy and reduces economic and financial uncertainty. The January changes are the most recent in the FOMC's evolution to greater transparency in the interest of making financial markets less volatile and more reflective of relevant information for monetary policy.

The January changes are the most recent in the FOMC's evolution to greater transparency in the interest of making financial markets less volatile and more reflective of relevant information for monetary policy.

Specifically, the new approach will provide information in three areas:

- FOMC members' projections of the appropriate level of the target federal funds rate in the fourth quarter of 2012, the next few calendar years, and over the "longer run."

It is worth noting, the FOMC does not forecast the Federal Funds rate since it actually sets the Fed Funds target. The forecasts for inflation, GDP and unemployment are dependent upon the interest rate it sets. Each committee participant is instructed to assume the path consistent with the committee's longer-run objectives and then provide forecasts of GDP, inflation, and unemployment.

.

- FOMC members' projections of the timing of the first increase in the target rate.
- A narrative describing factors underlying the assessments and qualitative information about participants' expectations for the Fed's balance sheet

The forecasts do not identify participants individually.

While there are benefits to greater transparency and accountability that the enhanced communication fosters, arguments may be made that providing such information might increase market volatility especially during times when forecasting is more challenging than today.

What the Fed Actually Said

Market expectations have been that the Federal Reserve would maintain its target Federal Funds (Fed Funds)[1] rate at current low levels through mid 2013. Significantly, the Fed pushed back the date for any likely increase in this interest rate by at least a year and a half, until late 2014. The Fed stated that rates at such levels continue to be needed to help boost an improving but still sluggish economy.

Beyond the adjusted outlook for interest rates, Wednesday's statement closely tracked the Fed's previous comments about economic conditions. The Federal Reserve reduced its outlook for economic growth for 2012 but expressed a slightly more optimistic view about the unemployment rate. It expects the economy to grow between 2.2 percent and 2.7 percent this year, a decrease from the November forecast of between 2.5 percent and 2.9 percent. It expects unemployment to fall as low as 8.2 percent this year, an improvement over the earlier forecast of 8.5 percent.

---

[1] The Federal Funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually on an overnight basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances. The federal funds target rate is an administered rate, determined by a meeting of the members of the Federal Open Market Committee.

In implementing the new communication strategy, the Fed provided a rate forecast and a forecast of the timing, along with the expectations of the 17 individual Fed policymakers.[2] The distribution charts clarify the consensus and range of forecasts amongst the participants. Some Fed participants forecast record-low interest rates beyond late 2014 while others see increases sooner. While the consensus is to hold rates low and the Fed stated there will be "exceptionally low rates through at least 2014" reviewing dispersion of the forecasts in the charts suggests that this does not necessarily mean 0.00-0.25%. The Fed could raise rates slightly before the end of 2014 and the rate would still be "exceptionally low." Individual forecasts of the movement of the Federal Funds rate were revealed, with six participants anticipating interest rate hikes in 2012 or 2013, in contrast to the broader expectation for low rates through 2014.

Market Reaction

Market reaction to the new communication approach was subdued, with some concern about policy error, increased risk of inflation and its consequent effects on fixed income securities. In the future, the dispersion of the participants' Fed Funds rate and timing forecasts may heighten market volatility.

Continuing Operation Twist

The Fed sees the economy growing at a modest pace. It held off on any further bond-buying programs to try to increase growth at this point. During 2011, the Fed implemented a program of buying government bonds and mortgage-backed securities with the goal of driving down long-term rates and easing borrowing costs. In driving down interest rates, the Fed seeks to encourage people and businesses to borrow and spend, bringing down unemployment. While not announcing further bond buying, the Fed did hold out the possibility of doing so later. It said it was prepared to adjust its "holdings as appropriate to promote a stronger economic recovery in the context of price stability."

Concluding Thoughts

The recent action to detail the interest rate projections of each of the 17 members who participate in policy meetings, without identifying them by name, advances the Federal Reserve towards more open communication. While market response to the inaugural implementation of this approach was muted, it will be interesting to gauge the market's response in the future.

Market reaction to the new communication approach was subdued, with some concern about policy error, increased risk of inflation and its consequent effects on fixed income securities.

- Sofia Anastopoulos
VP, Client Service

[2] Currently there are 17 participants: Five are Federal Reserve Board Governors and twelve are Federal Reserve Bank Presidents. There are two Federal Reserve Board Governor positions that are unfilled. Only five of the 12 regional Federal Reserve Bank Presidents get to vote at meetings, on a rotating basis, meaning seven people get express their views but not decide.