CHANDLER ASSET MANAGEMENT

March 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

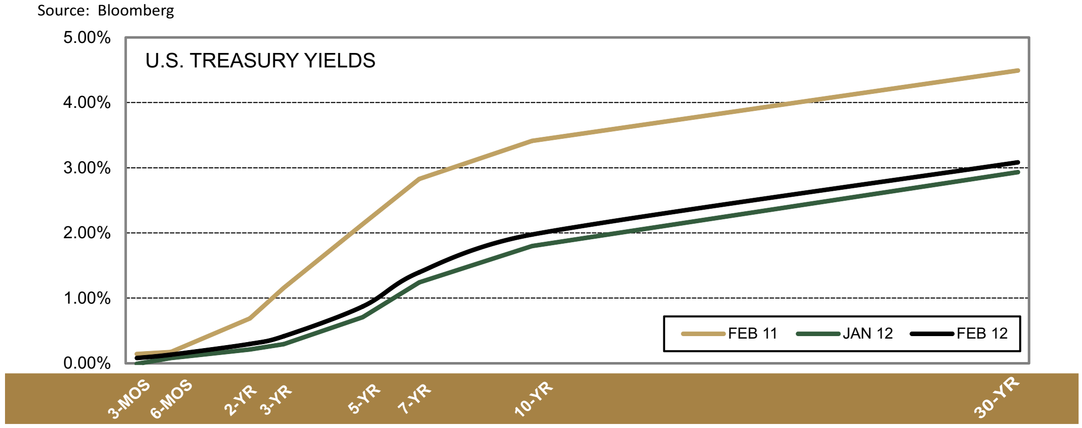
Treasury rates moved higher in February, driven by recent improvement in domestic economic data. However, the move up was modest, as the impacts of Operation Twist as well as ongoing uncertainty about global growth, continue to keep a lid on rates. Looking back over the past three months, the Treasury yield curve experienced a modest twist with shorter maturities rising and longer maturities falling slightly.

Domestic economic news continues to support our view that the U.S. economy is growing at a modest pace. In February, payroll jobs grew by 227,000, better than the 204,000 boost the market was expecting. The unemployment rate remained unchanged at 8.3%. Meanwhile the manufacturing sector continues to expand, and consumer spending was relatively strong in spite of rising gas prices. Several banks reported signs of growing loan demand in their recent quarterly results and consumer credit expanded. In addition, the Federal Reserve indicated it will remain accommodative, which could be a tailwind for further domestic economic growth. However, the European economy remains under stress and market participants continue to be concerned about global growth trends. We believe the European Central Bank is unlikely to be as accommodative as the Fed, since the ECB has a heightened focus on promoting fiscal austerity in Greece and other weak European economies. And, unlike the Fed, which has a dual mandate to promote employment and control inflation, the ECB has only one mandate, price stability. Looking ahead, we anticipate that ongoing turmoil in Europe will continue to create volatility in global financial markets over the near- to intermediate-term.

Last week, the Fed announced it would retain the policy rate range of 0.0-0.25%. The Fed provided a generally upbeat assessment of the economy and held off announcing any new forms of quantitative easing, despite market speculation the Fed might announce a new form of monetary stimulus. There was no change to the Fed's assurance that the fed funds rate will remain exceptionally low through late 2014. Recent increases in gas prices were acknowledged, but the Fed expects the impact on overall inflation will be temporary. The Fed noted that while strains on global financial markets have eased, they continue to pose a significant downside risk to the economic outlook.

TREASURY YIELDS ROSE IN FEBRUARY

Source: Bloomberg



Treasury yields moved higher in February, driven by improvement in domestic economic data.

TREASURY YIELDS	2/29/12	1/31/12	CHANGE
3 Month	0.08	0.05	0.03
2 Year	0.30	0.21	0.09
3 Year	0.42	0.29	0.13
5 Year	0.87	0.71	0.16
7 Year	1.40	1.24	0.16
10 Year	1.98	1.80	0.18
30 Year	3.08	2.93	0.15

Source: Bloomberg

Economic Roundup

Consumer Prices

In January, the CPI showed consumer prices increased 2.9% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.3% rate. Overall, price increases remained subdued. However, concerns have recently developed about rising oil prices and the negative impact higher prices at the pump could potentially have on consumer spending.

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 was moderate; however, high unemployment continues to restrain consumer spending.

Labor Markets

The February employment report showed the economy added 227,000 jobs, with the six-month average slightly higher than 200,000 jobs. The unemployment rate remained unchanged at 8.3%. This report was better than analysts' expectations. Although the unemployment rate remains elevated, current economic data suggests the labor market is improving at a slow but steady pace.

Housing Starts

Single-family housing starts declined 1.0% in January to 508,000, compared to 513,000 in December. 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	0.19	0.26	(0.07)
2-year AA corporate note	0.23	0.32	(0.09)
5-year AA corporate note	0.48	0.57	(0.09)
5-year Agency note	0.28	0.41	(0.13)

Source: Bloomberg

Data as of 2/29/12

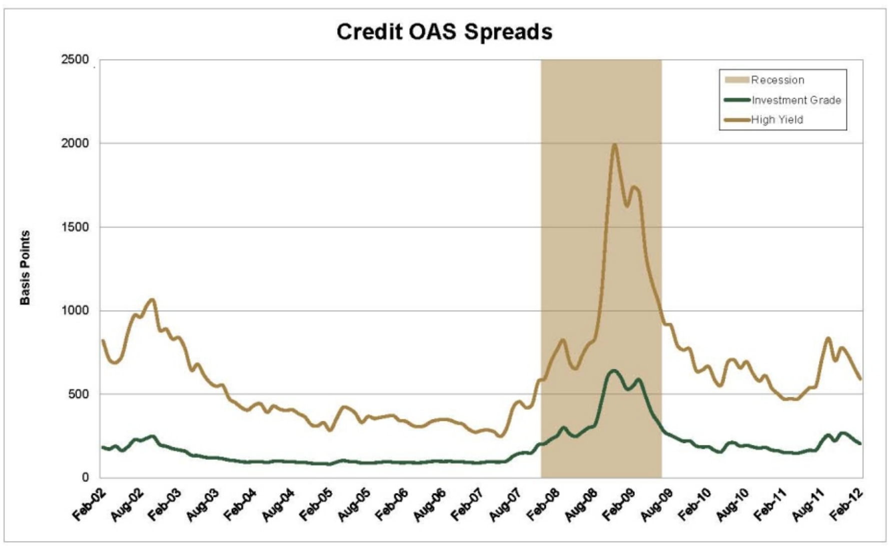
Economic Data Modestly Improving

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(48.8) $Bln DEC 11	(47.1) $Bln NOV 11	(40.5) $Bln DEC 10
GDP	3.0% DEC 11	1.8% SEP 11	2.3% DEC 10
Unemployment Rate	8.3% FEB 12	8.3% JAN 12	9.0% FEB 11
Prime Rate	3.25% FEB 12	3.25% JAN 12	3.25% FEB 11
CRB Index	312.31 JAN 12	305.30 DEC 11	341.42 JAN 11
Oil (West Texas Int.)	$107.07 FEB 12	$98.48 JAN 12	$96.97 FEB 11
Consumer Price Index (y/o/y)	2.9% JAN 12	3.0% DEC 11	1.6% JAN 11
Producer Price Index (y/o/y)	4.1% JAN 12	4.8% DEC 11	3.6% JAN 11
Dollar / EURO	1.33 FEB 12	1.31 JAN 12	1.38 FEB 11

Source: Bloomberg

Corporate Credit Overview

During 2011, investment grade option adjusted credit spreads (OAS) widened approximately 90 basis points on average. During the first two months of this year, investment grade OAS, tightened approximately 50 basis points, to an average OAS of about 200. This level is meaningfully higher than the 10-year median investment grade corporate OAS of approximately 150. Although the 10-year data set includes the financial crisis, when corporate OAS rose to unusually high levels, we believe current corporate bond valuations remain attractive.
We believe the overall credit cycle is favorable, driven by improving domestic economic activity. During 4Q 2011, the U.S. GDP grew by 3.0%. This year, the consensus GDP forecast calls for about 2.2% growth. We are positive on the domestic economy and believe the ongoing recovery in consumer demand will continue to benefit corporate earnings and credit trends. However, we anticipate that ongoing turmoil in Europe will lead to continued volatility in the financial markets.



Source: Bank of America Merrill Lynch

Fourth Quarter Earnings Review
Fourth quarter earnings season was generally better than expected. On average, companies in the S&P 500 reported nearly 5% quarterly earnings growth on a year-over-year basis. Average EPS results were about 3% better than expected, with 320 companies in the S&P 500 posting upside earnings surprises.

In the consumer sector, higher-end retailers continued to outperform mid- and lower-tier retailers during the holiday season. In the food and grocery sectors, price increases helped drive revenue growth in the fourth quarter, though earnings continued to be pressured by high input costs. High energy and commodities prices were also a headwind to some industrial companies. Meanwhile, several oil and gas companies reported strong revenue growth, driven by increased volume and higher pricing, though the higher prices were a hindrance to refining margins. Earnings in the technology sector were mixed with results for hardware companies significantly outpacing results from semiconductor, software, and services companies, on average.

During the fourth quarter, the financial sector faced a challenging environment of low interest rates, slow economic growth, and new regulations. Banks with exposure to investment banking and trading revenues were negatively impacted in the quarter by client risk reduction and lower trading volumes. Meanwhile, banks with less international exposure and larger commercial lending activity performed better. Some banks did see positive growth in the quarter, and credit quality trends continued to show modest improvement. Overall, earnings results in the financial sector were mixed. Expectations were generally low prior to the earnings season, helping some banks post better than expected results. Looking ahead, several banks plan to reduce expenses through layoffs. Increased regulation is another obstacle for bank earnings. Yet, stricter capital requirements and increased oversight has generally been beneficial to credit quality. In summary, the financial sector continues to look attractively priced relative to the overall corporate bond market.

Earnings Outlook
Few companies raised their earnings guidance for the year during fourth quarter earnings season. We expect first quarter earnings to show year-over-year

growth on average, and to be in-line or better than analysts' consensus views. Earnings results in the banking sector may be more favorable, as trading volumes seem to have improved during the first quarter vs. 4Q11. Some companies may have also benefitted in the latest quarter from recent easing in non-energy commodities prices. Notably, over the past few quarters, the magnitude of overall upside earnings surprises declined, and we expect this trend will continue in the first quarter. We anticipate companies with significant international exposure to remain cautious, in light of uncertainties about global growth (Europe and China in particular). While companies with significant business will benefit from ongoing improvement in the U.S. economy. We also expect in many cases, strategic deployment of capital (via share repurchases and acquisitions) will help drive earnings growth, as several companies have recently used cash to buy back shares.

Looking further ahead, global event risk, employment trends, and oil prices are likely to have an important impact on corporate credit throughout the remainder of the year. These are just a few of the key data points we will be watching closely.

Global Event Risk. The European economy remains under stress and market participants continue to be concerned about global growth trends. We anticipate ongoing turmoil in Europe will continue to create volatility in the global financial markets over the near- to intermediate-term. Furthermore, exogenous shocks to the U.S. economy, such as an unexpected escalation of the fiscal crisis in Europe or heightened Iranian tensions, could have a meaningful impact on the financial markets and credit spreads.

Employment. U.S. unemployment also continues to be one of the most closely watched economic data points. The unemployment rate is currently 8.3%, which remains high but is down from the recent recession peak of 10.1% during the third quarter of 2009. According to Bloomberg data, market participants expect a slow decline in the unemployment rate over the next year and are calling for a rate of 7.8% by the second quarter of 2013. We expect an improving labor market will help drive slow and steady demand and corporate earnings growth, which will continue to support corporate credit quality.

Oil Prices. Rising oil prices could be a hindrance to corporate earnings over the next year. According to the Energy Information Administration's Short-Term Energy Outlook as of March 6th, the price of regular-grade motor gasoline is expected to average $3.79 per gallon in 2012, compared with $3.53 cents per gallon last year. The EIA recently raised its forecasted price of West Texas Intermediate (WTI) crude oil by $5 per barrel to an average of about $106 per barrel in 2012, $11 per barrel higher than the average price last year. Supply disruptions in the Middle East and Africa contributed to a significant increase in world crude oil prices during February. Although we are not forecasting a significant increase in the price of crude oil, we believe a rise in prices to the $130-$150 per barrel range would begin to put pressure on consumer spending levels and the overall domestic economy.

Conclusion

Overall, we believe the outlook for corporate credit remains favorable this year. Given our expectation for volatility in the financial markets, we believe the investment grade corporate bond sector provides an attractive risk/reward profile. Though the pace of earnings growth and corporate credit rating upgrades has slowed, in light of ongoing economic uncertainty and market volatility, we remain constructive on corporate earnings and expect the overall economy will continue to grow.

- Shelly Henbest
VP, Credit Analyst