CHANDLER ASSET MANAGEMENT

*June 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

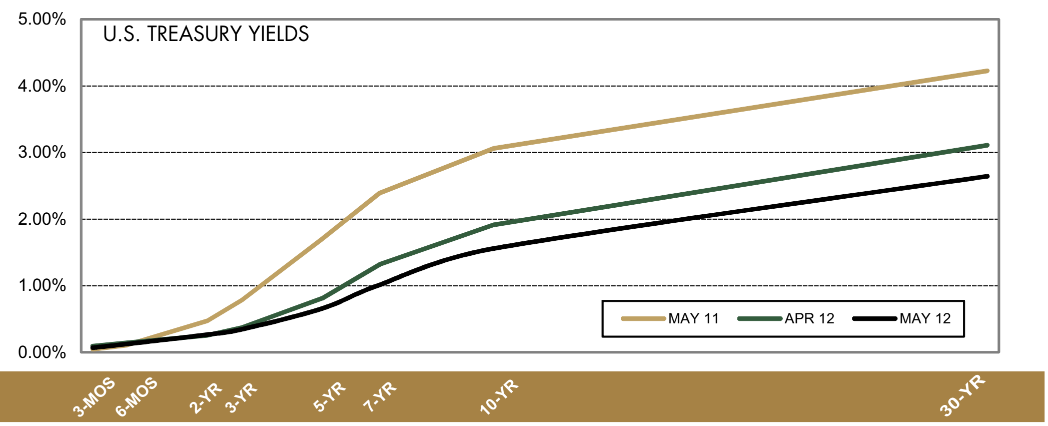
Treasury rates in the long end of the yield curve moved lower in May, reflecting some disappointing domestic economic data and growing uncertainty about the global economic outlook. Inflation concerns also eased further as oil prices continued to decline in the month. In addition, Operation Twist (which expires at the end of this month) continues to put downward pressure on longer-term interest rates.

The domestic economy appears to be stumbling on its path to recovery. We believe a confluence of factors have contributed to the slowdown. Tensions in Europe have recently flared up again, just as concerns about reaching a "fiscal cliff" are rising here in the U.S. Meanwhile, we believe the recent trading loss reported by JP Morgan and the Facebook IPO fiasco have had a negative effect on sentiment in the financial markets. The past three U.S. non-farm payroll reports have been weaker than expected. In May, the economy added just 69,000 jobs, well below the consensus forecast of 150,000. The unemployment rate also rose to 8.2% from 8.1%. Fortunately, manufacturing and consumer trends appear to remain healthy, but we have become more cautious about the economic outlook. While we still expect positive GDP growth over the next few quarters, we believe growth is likely to be at the low end of prior expectations.

The Federal Reserve's next official policy statement is due later this month on June 20th. Operation Twist, the latest iteration of monetary policy to help stimulate maximum employment and price stability, expires on June 30th. Given the aforementioned slowing economy and a more benign inflation outlook, there is increasing speculation that the Federal Reserve will announce additional measures to support economic growth in the coming months. If the Federal Reserve chooses to utilize the balance sheet again, an important element for investors to consider is whether the anticipated additional measures expand the Fed's balance sheet or simply change the composition of the holdings. An outright increase in the size of the balance sheet is consistent with increasing the risk of inflation and hence will likely lead to higher U.S. sovereign yields if implemented.

### TREASURY YIELDS FELL IN MAY

Source: Bloomberg

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| TREASURY YIELDS | 5/31/12 | 4/30/12 | CHANGE |
|---|---|---|---|
| 3 Month | 0.07 | 0.09 | (0.02) |
| 2 Year | 0.26 | 0.26 | 0.00 |
| 3 Year | 0.34 | 0.37 | (0.03) |
| 5 Year | 0.66 | 0.81 | (0.15) |
| 7 Year | 1.01 | 1.32 | (0.31) |
| 10 Year | 1.56 | 1.91 | (0.36) |
| 30 Year | 2.64 | 3.11 | (0.47) |

Source: Bloomberg

### Consumer Prices
In April, overall CPI inflation softened to 2.3% from 2.7% in March on a year-over-year basis, driven primarily by a decline in energy prices. The year-over-year Core CPI (CPI less food and energy) increased at a 2.3% rate. The core rate remains slightly higher than the Fed's inflation target of 2%.

### Retail Sales
In April, retail sales rose 6.4% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been healthy. Nevertheless, elevated unemployment levels continue to restrain consumer spending to some degree.

### Labor Markets
The May employment report showed the economy added just 69,000 jobs. The report was disappointing, and well below the consensus forecast of 150,000. Payroll jobs were also revised down for March and April by a combined total of 49,000. The unemployment rate rose to 8.2% in May from 8.1%. The overall employment report has been disappointing for the past three months and suggests the pace of the economic recovery is slowing down.

### Housing Starts
Single-family housing starts rebounded in April, rising 2.3% to 492,000 compared to 481,000 in March. The housing market remains under pressure, but some data has surprised to the upside this year.

## Credit Spreads Widened

| CREDIT SPREADS | Spread to Treasuries (%) | One Month Ago (%) | Change |
|---|---|---|---|
| 3-month top-rated commercial paper | 0.13 | 0.08 | 0.05 |
| 2-year AA corporate note | 0.30 | 0.31 | (0.01) |
| 5-year AA corporate note | 0.75 | 0.59 | 0.16 |
| 5-year Agency note | 0.34 | 0.27 | 0.07 |

Source: Bloomberg Data as of 5/31/12

## Economic Data Somewhat Weaker

| ECONOMIC INDICATOR | Current Release | Prior Release | One Year Ago |
|---|---|---|---|
| Trade Balance | (51.8) $Bln MAR 12 | (45.4) $Bln FEB 12 | (46.0) $Bln MAR 11 |
| GDP | 1.9% MAR 12 | 3.0% DEC 11 | 0.4% MAR 11 |
| Unemployment Rate | 8.2% MAY 12 | 8.1% APR 12 | 9.0% MAY 11 |
| Prime Rate | 3.25% MAY 12 | 3.25% APR 12 | 3.25% MAY 11 |
| CRB Index | 272.97 MAY 12 | 305.95 APR 12 | 350.06 MAY 11 |
| Oil (West Texas Int.) | $86.53 MAY 12 | $104.87 APR 12 | $102.70 MAY 11 |
| Consumer Price Index (y/o/y) | 2.3% APR 12 | 2.7% MAR 12 | 3.2% APR 11 |
| Producer Price Index (y/o/y) | 1.9% APR 12 | 2.8% MAR 12 | 6.6% APR 11 |
| Dollar / EURO | 1.24 MAY 12 | 1.32 APR 12 | 1.44 MAY 11 |

Source: Bloomberg





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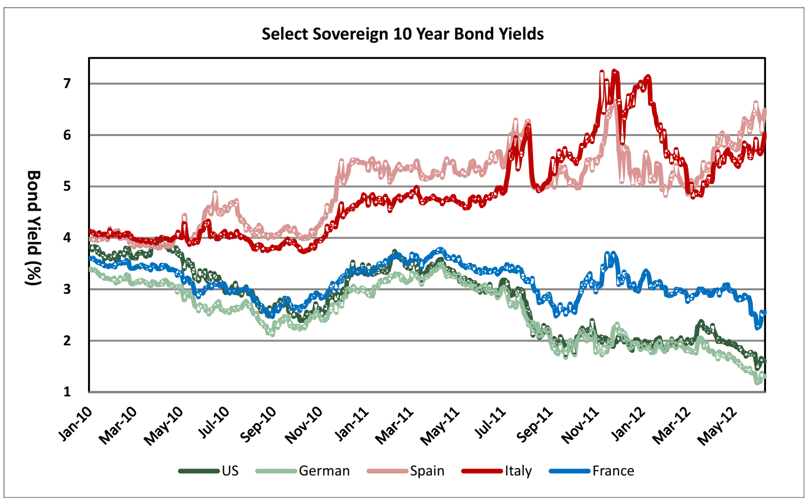
# Are Sovereign Yields Sustainable?

Since the end of the first quarter, risk assets, including equity, commodity, and credit based fixed income markets, have underperformed. Yields in safe haven sovereign governments, in particular the United States and Germany, have contracted to aggressive valuations over the short two month time frame while yields in Spain and Italy have widened materially. The U.S. Dollar has also strengthened, putting potential pressure on global competitiveness within the U.S. The improvement in the U.S. dollar is despite softening domestic economic data, most notably the downward trend in non-farm payrolls. It is our view that the primary catalyst for risk asset weakness and the commensurate flight to quality drop in domestic Treasury yields is being dominated by news and events out of Europe.

At Chandler, we have long remained cautious regarding the market's interpretation of efforts by European leaders and regulators to correct the imbalances accentuated by the financial crisis of 2008. The Euro currency was introduced over a decade ago primarily to promote political harmony within the region. The economic benefits, although at the time thought of as substantial, were not the primary motivator. After the introduction of the Euro, sovereign yields within the region began to converge despite the fragmented economic growth rates of each of the respective nations. In hindsight, it is easy to conclude that the convergence of yields within the EU was irrational considering the varying growth rates, global competeviness, and creditworthiness of each of the respective sovereign nations.

Despite the aforementioned differences with each of the countries within the euro zone, the European Central Bank (ECB) sets monetary policy for the region as a whole. Herein lies one of the most fundamental issues with the Euro common currency. European monetary policy is too easy for the Northern section of the Euro, most notably Germany, and too tight for the Southern European nations, most notably Spain and Italy (we are purposely excluding commenting on Greece in this article). Historically, a country's exchange rate was an effective mechanism to stimulate global competitiveness via depreciating the home currency. The construction of the single currency Euro prohibits Spain or Italy (and other governments within the EU as well) from depreciating their currency at the expense of the other countries within the Euro to increase global competitiveness on a long-term basis. So the real question becomes if countries within the Euro zone are going to have a single monetary policy then should all of the countries also have the ability to access the capital markets at the same rate? The interest rate at which the European Union as a whole could access the markets would undoubtedly be higher than what Germany currently pays but lower than the current rates in Spain and Italy.



Source: Bloomberg

At Chandler, we believe Ten Year sovereign yields are at unsustainable levels over an intermediate time horizon in both the U.S. and Europe. On a long-run basis, the Federal Reserve strives to maintain core inflation of around 2.0%. Purchasing Ten Year Treasury notes at the current yield of 1.56% almost assuredly locks an investor into a negative real return, if the investment is held to maturity as the rate of inflation exceeds the yield of the Treasury note. The Federal Reserve has a dual mandate of full employment and stable prices. The unemployment rate remains too high and the pace of new job creation is insufficient to bring the level down.

As we have highlighted in the past, Federal Reserve Chairman Bernanke is an expert on the depression of the 1930s and thus will continue to utilize unorthodox policies to fulfill the Fed's dual mandate. The recent deterioration in higher risk assets, in particular equity markets and commodity prices (see chart below), is putting downward pressure on inflation jeopardizing the 2nd tenet of the Fed's dual mandate of stable prices. If the Federal Reserve chooses to utilize the balance sheet again, an important element for investors to consider is whether the anticipated additional measures expand the Fed's balance sheet (Quantitative Easing) or simply change the composition of the underlying holdings (Operation Twist). An outright increase in the size of the Fed's balance sheet is consistent with increasing the risk of inflation and hence will likely lead to higher U.S. yields, if implemented. Additionally, measures taken in Europe to bring down the yields of Spain and Italy will lessen the demand for safe haven assets and thus exert pressure on both U.S. and German sovereign yields.

We are looking for more concrete actions from the ECB and European governments to drive the direction of risk assets in the 2nd half of 2012. Recent actions taken by the ECB, in particular the Long Term Refinancing Operations (LTROs) in December 2011 and February 2012, have been inadequate. Unlike the Federal Reserve, which took credit risk onto its balance sheet, the ECB continues to act as a financing conduit thus leaving the credit risk of owning European sovereign debt with the purchasing institutions. As the European debt crisis has metastasized, engaging in outright quantitative easing is likely no longer enough. On a long-term basis, we believe one of the only viable options for the European Union is a Euro bond mechanism that pools the financial resources of the region as a whole. It is our expectation this “long-term” solution will take a substantial amount of time to implement. Although the Federal Reserve remains poised to take additional steps to assist the US economic recovery, actions by the ECB will drive the price of risk assets in coming months.

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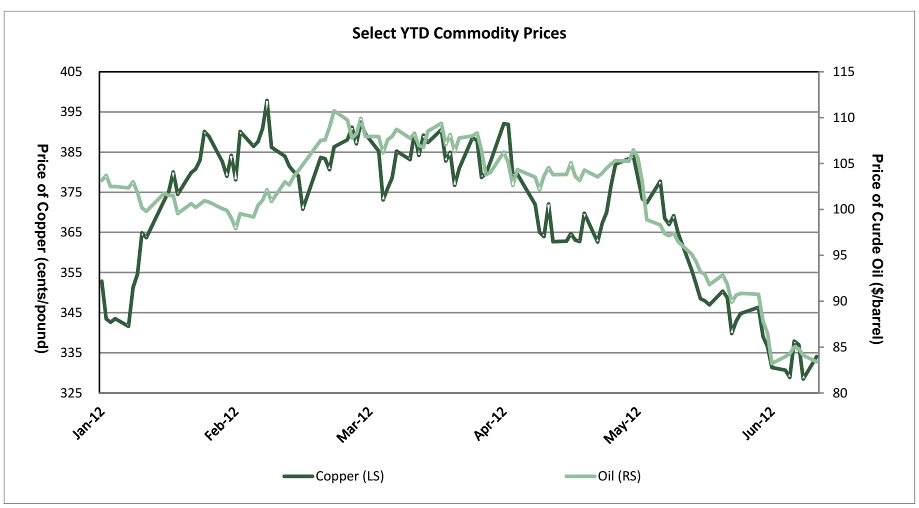


Source: Bloomberg

RISKS AND OTHER IMPORTANT CONSIDERATIONS
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