BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS

WHAT'S INSIDE

Market Summary 1
Yield Curve
Current Yields

Economic Round-Up............2
Credit Spreads
Economic Indicators

Corporate Credit Ratings......... 3
Risk of Downgrades Has Increased

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.

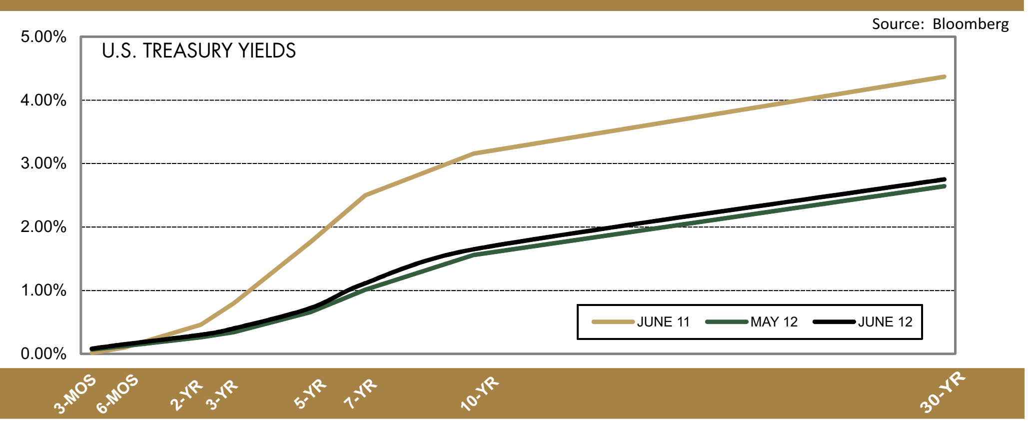
Market Summary

Treasury rates moved slightly higher in June in spite of disappointing economic data, ongoing concerns about Europe's sovereign debt crisis, and the extension of Operation Twist. The markets are trading in a tight range despite market speculation that additional measures to stimulate economic growth from global central banks may be forthcoming. Despite the small back-up in rates between May 31st and June 30th, the overall supply of high quality sovereign debt has continued to decrease as the European financial crisis has escalated, which will continue to support U.S. Treasury market valuations.

The domestic economy has slowed and we believe downside risks remain. Uncertainty regarding an ultimate resolution of the European debt crisis continues to create significant volatility in the financial markets, and concerns about the U.S. reaching a "fiscal cliff" have grown here in the U.S. Domestic economic data continued to be mostly disappointing in June, with the exception of some mildly better than expected housing market data. The past four U.S. non-farm payroll reports have been weaker than expected. In June, the economy added just 80,000 jobs, below the consensus forecast of 90,000. The unemployment rate also remained elevated and unchanged at 8.2%. Consumer confidence has recently declined and retail sales trends have weakened. Manufacturing trends have also slowed, according to the most recent ISM manufacturing index report. While we still expect positive U.S. GDP growth over the next few quarters, we believe growth is likely to be quite sluggish.

Monetary policy in the United States remains very accommodative with assurance from the Federal Reserve that the fed funds rate will remain exceptionally low through late 2014. In June, the Federal Open Market Committee left policy rates unchanged at a range of 0-0.25% and acknowledged that the economy has slowed. The FOMC also announced that it would extend Operation Twist (which was supposed to expire at the end of June) through the end of the year. FOMC participants expect modest improvement in the economy in upcoming quarters, but nonetheless downgraded their economic forecasts at the most recent FOMC meeting as the Fed sees significant downside risks to the outlook. Inflation has declined and the Fed believes longer-term inflation expectations are stable. The Fed cut it's expectations for GDP growth for 2012 to a range of 1.9%-2.4% (from its previous forecast of 2.4%-2.9%), and for 2013 to 2.2%-2.8% (from its previous forecast of 2.7%-3.1%). The Fed is now projecting an unemployment rate of 8.0%-8.2% for 2012, and 7.5%-8.0% in 2013.

TREASURY YIELDS ROSE SLIGHTLY IN JUNE



Treasury rates moved slightly higher in June in spite of disappointing economic data, ongoing concerns about Europe's sovereign debt crisis, and the extension of Operation Twist. The markets are trading in a tight range despite market speculation that additional measures to stimulate economic growth from global central banks may be forthcoming.

TREASURY YIELDS	6/30/12	5/31/12	CHANGE
3 Month	0.08	0.07	0.01
2 Year	0.30	0.26	0.04
3 Year	0.40	0.34	0.06
5 Year	0.72	0.66	0.06
7 Year	1.11	1.01	0.10
10 Year	1.65	1.56	0.09
30 Year	2.75	2.64	0.11

Source: Bloomberg

Consumer Prices

In May, overall CPI inflation softened to 1.7% from 2.3% in April 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 in May, consistent with the trend in March and April. The core rate remains slightly higher than the Fed's inflation target of 2%.

Retail Sales

In May, retail sales rose 5.3% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession though recent activity has slowed down. Elevated unemployment levels and a recent decline in consumer confidence are likely restraining consumer spending.

Labor Markets

The June employment report showed that the economy added just 80,000 jobs. The report was once again disappointing, and below the consensus forecast of 90,000. The net revisions for April and May were down by 1,000 jobs. The unemployment rate remained unchanged at 8.2%. The employment report has been disappointing for the past four months and suggests that the pace of the economic recovery is slowing.

Housing Starts

Single-family housing starts rose 3.2% to 516,000 in May compared to 500,000 in April. The housing market remains under pressure, but some data has surprised to the upside this year.

Credit Spreads Were Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.13	0.04
2-year AA corporate note	0.26	0.30	(0.04)
5-year AA corporate note	0.68	0.75	(0.07)
5-year Agency note	0.34	0.34	0.00

Source: Bloomberg Data as of 6/30/12

Economic Data Remained Weak

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(50.1) $Bln APR 12	(52.6) $Bln MAR 12	(43.6) $Bln APR 11
GDP	1.9% MAR 12	3.0% DEC 11	0.4% MAR 11
Unemployment Rate	8.2% JUN 12	8.2% MAY 12	9.1% JUN 11
Prime Rate	3.25% JUN 12	3.25% MAY 12	3.25% JUN 11
CRB Index	284.19 JUN 12	272.97 MAY 12	338.05 JUN 11
Oil (West Texas Int.)	$84.96 JUN 12	$86.53 MAY 12	$95.42 JUN 11
Consumer Price Index (y/o/y)	1.7% MAY 12	2.3% APR 12	3.6% MAY 11
Producer Price Index (y/o/y)	0.7% MAY 12	1.9% APR 12	7.1% MAY 11
Dollar / EURO	1.27 JUN 12	1.24 MAY 12	1.45 JUN 11

Source: Bloomberg

Corporate Credit Ratings - Risk of Downgrades Has Increased

Although corporate credit fundamentals of many high grade bond issuers have improved significantly since the financial crisis and recession, we believe the risk of an increase in the number of corporate credit rating downgrades has recently become more elevated. In some cases, the weakening of corporate credit is directly tied to the rising debt levels of sovereign issuers. For this reason, we believe the outcome of the European debt crisis and the U.S. presidential election later this year (which should provide insight into the fiscal budget outlook for the U.S. and potentially impact the U.S. credit rating), will have a meaningful influence on corporate credit ratings.

As the credit ratings of many sovereign debt issuers have declined due to soaring government debt levels and poor fiscal management, the credit-worthiness of their homeland banks and financial institutions has also weakened.

Pressure on some corporate credit issuer's fundamentals (from industrials to consumer-related corporations) is rising because of the European sovereign debt crisis, which has strained the overall European economy, and has begun to hinder revenues and earnings of many global corporations. For example, Proctor & Gamble, Ford, and Dover are among some of the companies that have recently lowered their earnings guidance, in part because of lowered demand in Europe. Should the European Union fail to find a resolution to their fiscal crisis, we expect that the corporate credit fundamentals of companies with significant exposure to Europe in particular will come under more pressure.

However, credit ratings of banks and financial institutions are most directly tied to sovereign debt ratings, and likely face the most immediate pressure. Although the intrinsic credit-worthiness of many domestic banks and financial institutions has improved over the past few years, due to increased oversight, higher capital levels, and stronger balance sheets, the implied support from the government has declined. As the credit ratings of many sovereign debt issuers have declined due to soaring government debt levels and poor fiscal management, the credit-worthiness of their homeland banks and financial institutions has also weakened. This is because most banks and financial institutions receive credit rating boosts from implied government support (i.e. in the event of a financial crisis or liquidity event, it is assumed that the government would step in and provide a backstop). Over the past year, we have seen several sovereign credit rating downgrades, which have negatively impacted the credit ratings of many banks.

In the month of June, Moody's downgraded fifteen global banks, including high quality issuers such as JP Morgan, Credit Suisse, and HSBC. The downgrades were anticipated by Chandler's portfolio management team, and were driven in part by the perception of diminished government support, and in some cases by the banks' exposure to Europe. S&P has recently taken similar action on financial institutions in Spain due to a decline in implied support from the Spanish government. Recall that S&P downgraded the U.S. sovereign credit rating in August last year, and subsequently lowered the credit ratings of some financial issuers whose ratings reflected government support.

S&P, Moody's, and Fitch each maintain a Negative Outlook on the sovereign credit rating of the U.S. Any potential further downgrade of the U.S. sovereign debt rating would most likely put additional downward pressure on the credit ratings of domestic banks. Moody's has indicated that they plan to update their view on the U.S. after the presidential election. Outside of the U.S., we believe the potential for further sovereign credit rating downgrades in Europe remains high, putting foreign banks at risk for further downgrades as well.

During the second quarter of 2012, the number of credit rating upgrades by Standard & Poor's outnumbered downgrades (S&P upgraded thirteen companies and downgraded five). However, in a report released earlier this month, S&P said that it expects downgrades may outnumber upgrades in the near to intermediate term, since current rating outlooks are somewhat negatively biased. According to S&P, the telecommunications services and financials sectors have the highest downgrade potential over the near to intermediate term. In a separate report, S&P also noted that their rating outlooks remain negative for the majority of large complex banks and trust banks. For most banks, they said that their outlooks reflect the negative outlook on the sovereign rating on the U.S. and the likely impact that a potential downgrade of the U.S. would have on the support factored into bank ratings. Overall, S&P has indicated that the number of potential corporate credit rating downgrades is currently at its highest level since August 2010.

Looking ahead, we believe developments in Europe, and secondarily the outcome of the U.S. presidential election, will have a significant influence on the global and domestic economy, as well as sovereign and corporate credit ratings. Because we think the downward pressure on credit ratings may be rising, the team at Chandler has taken a more conservative stance in selecting securities for our client portfolios in recent months, and we believe a more defensive posturing is prudent over the near- to intermediate-term.

- Shelly Henbest
VP, Credit Analyst

S&P Downward Ratings Migration
Recent Downgrades of Sovereign and Bank Credit Ratings by S&P