CHANDLER ASSET MANAGEMENT

August 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

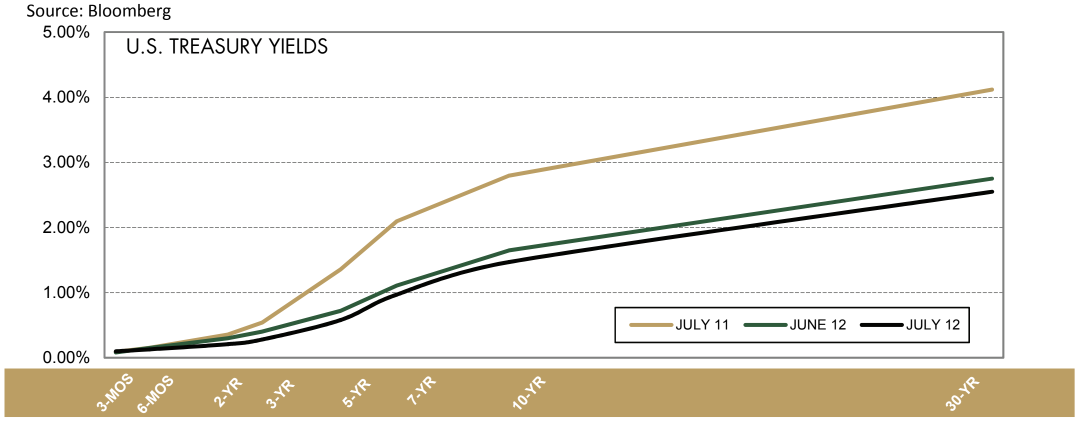
Treasury rates declined moderately in July as domestic economic activity weakened and concerns remained about the European sovereign debt crisis. The Treasury yield curve also flattened as longer term rates fell more than shorter term rates. The financial markets continued to be supported by the expectation of additional measures to stimulate economic growth from global central banks.

The domestic economy has slowed and we believe downside risks remain. Uncertainty regarding the European debt crisis continues to create significant volatility in the financial markets, and concerns about the U.S. reaching a "fiscal cliff" are rising here in the U.S. The July employment report showed that the economy added a better than expected 163,000 jobs. The report reverses four months of disappointing jobs reports and may be more indicative of the underlying trend in the labor markets. While we still expect positive GDP growth over the next few quarters, we believe growth is likely to be quite sluggish.

In August, the Federal Reserve Open Market Committee left policy rates unchanged at a range of 0-0.25% and was more cautious about its outlook for the economy. The Fed said it "will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability." Financial market participants interpreted that the FOMC statement signaled a greater likelihood of further monetary policy stimulus in the future.

TREASURY YIELDS DECLINED IN JULY

Source: Bloomberg



Treasury rates declined in July as domestic economic activity weakened and concerns remained about the European debt crisis. The recent yield curve flattening most likely reflects the continued influence of the Federal Reserve's accommodative monetary policy.

TREASURY YIELDS	7/31/12	6/30/12	CHANGE
3 Month	0.10	0.08	0.02
2 Year	0.21	0.30	(0.09)
3 Year	0.28	0.40	(0.12)
5 Year	0.58	0.72	(0.14)
7 Year	0.97	1.11	(0.14)
10 Year	1.47	1.65	(0.18)
30 Year	2.55	2.75	(0.20)

Source: Bloomberg

Economic Roundup

Consumer Prices
In June, overall CPI inflation held steady at 1.7% on a year-over-year basis. Consumer prices remained soft, reflecting a decline in energy prices. Meanwhile food prices rose 0.2% in June. The year-over-year Core CPI (CPI less food and energy) nudged down to 2.2% in June, from 2.3% in May. The core rate remains slightly higher than the Fed's inflation target of 2%.

Retail Sales
In June, retail sales rose 3.8% on a year-over-year basis. On a month-over-month basis, however, retail sales fell 0.5% in June, well below the consensus forecast of +0.2%. Consumer spending has rebounded from the depths of the recession but recent activity has slowed down. Elevated unemployment levels and a recent decline in consumer confidence are likely restraining consumer spending.

Labor Markets
The July employment report showed that the economy added a better than expected 163,000 jobs. The report reverses four months of disappointing jobs reports and may be more indicative of the underlying trend in the labor markets. The unemployment rate increased slightly to 8.3% from 8.2%, but the change was insignificant and a result of mathematical rounding. The employment report continues to reflect an overall slow pace of growth in the domestic economy.

Housing Starts
Single-family housing starts rose 4.7% to 539,000 in June compared to 515,000 in May. 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	0.09	0.17	(0.08)
2-year AA corporate note	0.35	0.26	0.09
5-year AA corporate note	0.82	0.68	0.14
5-year Agency note	0.31	0.34	(0.03)

Source: Bloomberg Data as of 7/31/12

Economic Data Remains Weak

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(48.7) $Bln MAY 12	(50.6) $Bln APR 12	(47.7) $Bln MAY 11
GDP	1.5% JUN 12	2.0% MAR 11	2.5% JUN 11
Unemployment Rate	8.3% JUL 12	8.2% JUN 12	9.1% JUL 11
Prime Rate	3.25% JUL 12	3.25% JUN 12	3.25% JUL 11
CRB Index	299.51 JUL 12	284.19 JUN 12	342.08 JUL 12
Oil (West Texas Int.)	$88.06 JUL 12	$84.96 JUN 12	$95.70 JUL 11
Consumer Price Index (y/o/y)	1.7% JUN 12	1.7% MAY 12	3.6% JUN 11
Producer Price Index (y/o/y)	0.7% JUL 12	0.7% JUN 12	6.9% JUL 11
Dollar/EURO	1.23 JUL 12	1.27 JUN 12	1.44 JUL 11

Source: Bloomberg

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What the LIBOR Scandal Means for Investors

Commonly known as LIBOR, the London Interbank Offered Rate is considered one of the most important interest rates in finance. It serves as a reference rate for trillions of dollars of derivatives and financial contracts, and also as a benchmark for debt that most people are familiar with: adjustable rate mortgages, student loans, small business and corporate loans.

How LIBOR is determined

LIBOR is the interest rate at which top-tier banks in London offer to lend unsecured funds among themselves on a short term basis. LIBOR rates are set each business day through a process overseen by the British Bankers' Association. Between seven and 18 large banks are asked what interest rate they would have to pay to borrow money for fifteen different time periods, ranging from one day to one year. The responses are collected by the firm Thomson Reuters which makes some adjustments for outliers, calculates the averages, and creates the LIBOR quotes.

When markets are transparent, the movement in prices provides a signaling mechanism for investors; the LIBOR scandal broke this mechanism for investors.

Historically, the banks in the LIBOR market have been among the strongest credits in the world. This type of lending has been viewed as extremely low risk, and, as a result, LIBOR has been among the lowest interest rates available in the market.

LIBOR is unique in that it is not determined by supply and demand. Neither is it set by any government. Instead, it is based on an honor system whereby banks are assumed to report accurately the interest rates they would have to pay to borrow.

The scandal

When the accuracy of the data the banks report is questioned, the integrity of the markets is threatened. In the recent LIBOR scandal, two general types of manipulation came to light.

In the first place, certain banks moved LIBOR levels (up or down) to lower their cost of borrowing, and, more significantly, to benefit their investment positions. Lower LIBOR rates resulted in higher valuations of the banks' fixed income investments.

The second scheme occurred during the financial crisis. Certain banks underreported LIBOR to appear more creditworthy. Like consumers and investors, banks were reluctant to lend to each other during the crisis as markets seized. By posting lower LIBOR reports, some banks gave the appearance of being financially stronger. Given that there was not much direct lending or "funding" being done during this time, undermined the validity of the published LIBOR rates. Taking this line of reasoning a step further, systemic underreporting of LIBOR during the crisis served to ease the sense of panic. Some critics are questioning whether there was some complicity on the part of the regulators.

Barclays Capital and others

In July of this year, Barclays Capital reached a settlement with U.K. and U.S. regulators and paid approximately $450 million, admitting that it lied in its LIBOR submissions about its cost of borrowings.

According to the settlement, between 2005 and 2008, Barclays' traders repeatedly plotted with bankers charged with its LIBOR reporting, to tailor the bank's reports to benefit their trading positions. Even more damaging, Barclays staffers also conspired with counterparts from other banks to manipulate rates.

Demonstrating the second form of LIBOR fraud, during the height of the financial crisis, between late 2007 and early 2009, Barclays made artificially low LIBOR submissions, fearful that reports of high borrowing costs would be punished by the market as investors questioned its financial health.

Deutsche Bank, the Royal Bank of Scotland, Credit Suisse, Citigroup, and JPMorgan Chase have acknowledged they are being investigated by regulators in the LIBOR scandal.

Why it matters

Some argue that any damage to consumers has not been meaningful. After all, lower LIBOR rates mean smaller payments for mortgages, car and student loans, and other forms of debt. Lower rates continue to bolster the debt of the United States and Germany, underpinning global economies.

However, the fraudulent LIBOR submissions made by banks undermine the foundation of the markets. When markets are transparent, the movement in prices provides a signaling mechanism for investors; the LIBOR scandal broke this mechanism for investors. For all the gains made by banks on their financial contracts or derivatives, there were counterparties on the other side - whether factories, farmers, or governments using derivatives to hedge a risk or pension fund and money market investors holding LIBOR based products.

For investors

With the fraudulent LIBOR submissions, pensions, mutual funds and other investors with investments in LIBOR-based securities earned less interest. Since the controversy is not yet resolved, it is too early to estimate the interest income lost by investors in short, liquid investments.

The negative impact on investors does not stop there. Many bank stocks and debt continue to trade at discounts to the general market, negatively affecting anyone who owns bank issued securities, both equities and fixed income.

Conclusion

The scope of the financial arrangements affected by LIBOR makes the proportions of this scandal staggering. The full impact on investors and borrowers is yet to be realized as the scandal works its way through regulatory, criminal and civil jurisdictions. Likely outcomes include reform of the procedure for calculating LIBOR, with a shift to actual borrowing or funding costs reported automatically, rather than costs reported by interested parties, and tighter regulation and oversight of the entire process, along with increased transparency. Regulatory bodies have started imposing punitive fines and investors are considering actions for remedial relief.

- Sofia Anastopoulos, CFA
VP, Client Service