CHANDLER ASSET MANAGEMENT

October 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

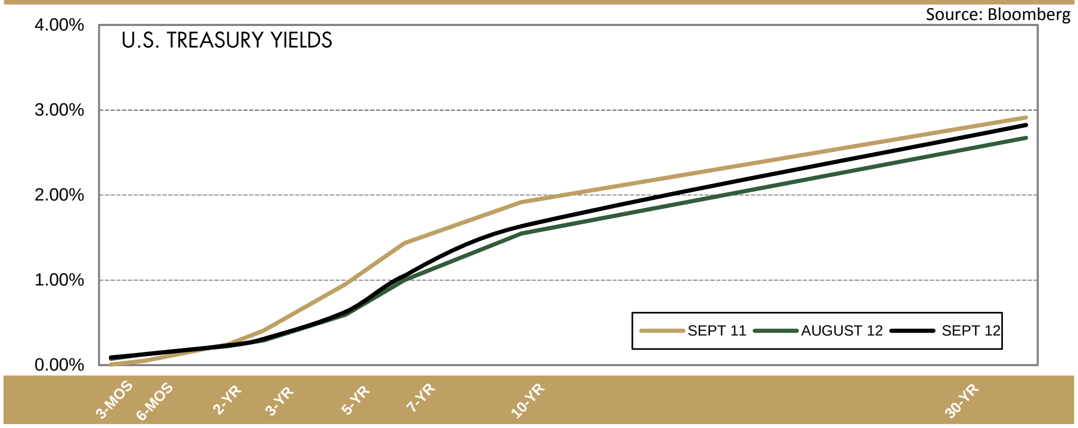
The treasury yield curve steepened slightly in September, though overall treasury rates were little changed amidst a still sluggish domestic economic environment and an uncertain outlook for the global economy. Rates continue to be influenced by the Federal Reserve's accommodative monetary policy.

The domestic economy continues to grow at a slower than desired pace, though many investors are expecting that exceptionally easy monetary policy will help to fuel stronger GDP growth heading into next year. The outlook for the global economy remains uncertain as Europe still struggles to come up with a comprehensive long-term plan to contain the region's debt crisis, and unease about the U.S. potentially reaching a "fiscal cliff" at the end of this year is building. Payroll growth in the U.S. has been modest, with payrolls up 114,000 in September, and the unemployment rate remains elevated.

Over the past month, we believe financial markets have largely been influenced by the Fed's policy action, rather than economic fundamentals, as investors heed to the old adage "Don't fight the Fed." The Federal Open Market Committee left policy rates unchanged at its September meeting and announced additional economic stimulus measures in the form of "QE3" with plans to purchase additional agency mortgage-backed securities at a pace of $40 billion per month for an open-ended period of time. The Fed also expects to keep the fed funds rate at an exceptionally low level through at least mid-2015. Overall, the Fed's actions are aimed at putting downward pressure on long-term interest rates, keeping mortgage rates low to help stimulate the housing market, and fueling stronger economic growth. The Fed lowered its economic growth forecast for the year, but raised its GDP forecasts for 2013 and 2014, largely reflecting the anticipated stimulative effects of QE3.

TREASURY YIELD CURVE STEEPENED SLIGHTLY IN SEPTEMBER

Source: Bloomberg



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TREASURY YIELDS	9/30/12	8/31/12	CHANGE
3 Month	0.09	0.07	0.02
2 Year	0.23	0.22	0.01
3 Year	0.31	0.29	0.02
5 Year	0.63	0.59	0.04
7 Year	1.05	1.00	0.05
10 Year	1.63	1.55	0.08
30 Year	2.82	2.67	0.15

Source: Bloomberg

Economic Roundup

Consumer Prices
In August, overall CPI inflation rose to 1.7% on a year-over-year basis from 1.4% in July, driven by an increase in food and energy prices. The year-over-year Core CPI (CPI less food and energy) declined to 1.9% in August, from 2.1% in July. The core inflation rate is roughly in line with the Fed's inflation target of 2.0%.

Retail Sales
In August, Retail Sales rose 4.7% on a year-over-year basis. On a month-over-month basis, Retail Sales rose 0.9% in August, slightly higher than the consensus forecast. Consumer spending has rebounded from the depths of the recession, but recent activity has moderated. Elevated unemployment levels are likely restraining consumer spending.

Labor Markets
The September employment report showed that payrolls increased by 114,000, in line with the consensus estimate. The unemployment rate unexpectedly dropped to 7.8% in September from 8.1% in August, even with a slight uptick in the labor force. The household survey, which reports on the unemployment rate, is a smaller sample than the payroll survey and tends to be more volatile, which may suggest a statistical "fluke" and explain part of the unexpected decline. The employment report continues to reflect an overall slow pace of growth in the domestic economy.

Housing Starts
Single-family housing starts rose 5.5% to 535,000 in August, following a 4.5% decline in July. The housing market appears to have stabilized and some data has surprised to the upside this year.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.13	(0.01)
2-year A corporate note	0.56	0.62	(0.06)
5-year A corporate note	0.90	0.95	(0.05)
5-year Agency note	0.26	0.27	(0.01)

Source: Bloomberg Data as of 9/30/12

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.0) $Bln JUL 12	(41.9) $Bln JUN 12	(45.6) $Bln JUN 11
GDP	1.3% JUN 12	2.0% MAR 12	2.5% JUN 11
Unemployment Rate	7.8% SEP 12	8.1% AUG 12	9.0% SEP 11
Prime Rate	3.25% SEP 12	3.25% AUG 12	3.25% SEP 11
CRB Index	309.30 SEP 12	309.59 AUG 12	298.15 SEP 11
Oil (West Texas Int.)	$92.19 SEP 12	$96.47 AUG 12	$79.20 SEP 11
Consumer Price Index (y/o/y)	1.7% AUG 12	1.4% JUL 12	3.8% AUG 11
Producer Price Index (y/o/y)	2.0% AUG 12	0.5% JUL 12	6.6% AUG 11
Dollar/EURO	1.29 SEP 12	1.26 AUG 12	1.34 SEP 11

Source: Bloomberg

Living on the Edge: The U.S. Fiscal Cliff

The U.S. economy has been growing at a substandard pace despite the myriad of efforts by the Federal Reserve to stimulate aggregate demand via traditional monetary policy, Operation Twist, and quantitative easing. Monetary policy is poised to remain highly accommodative for the foreseeable future. Fiscal policy, on the other hand, is poised to reverse course and tighten as the fiscal cliff approaches. The so-called "fiscal cliff" currently presents one of the greatest downside risks to our domestic economy, and many economists agree that it could push the U.S. back into recession. However, many investors are betting that policymakers will take action and put fiscal reform into place before it is too late. While concerns about the fiscal cliff continue to make headlines almost daily, there isn't much transparency about what the cliff is or what exactly will push us over the edge. *What is the fiscal cliff?*

Under current law, several U.S. tax breaks are set to expire and spending cuts are set to go into place at midnight on December 31, 2012. These include an expiration of Bush-era tax cuts (signed into law in 2001 and 2003, and extended for 2 years in 2010), an expiration of the temporary payroll tax holiday (passed in 2010 for one year and extended until January 1, 2013), along with $1.2 trillion in mandatory government spending cuts over 10 years beginning in 2013 (which was part of last year's deal to raise the debt ceiling). In addition, extended unemployment benefits are set to expire along with a number of tax deductions. In total, these changes are expected to cause federal spending to fall and federal taxes to rise by more than $600 billion next year. This event has been dubbed the "fiscal cliff" because of the magnitude and joint timing of the changes. Spending cuts will affect a variety of government departments, but cuts to military spending will be particularly pronounced. According to a report by George Mason University's Center for Regional Analysis, roughly 277,000 public sector workers could lose their job due to government spending cuts tied to the fiscal cliff.

It is unclear whether or not policymakers will actually allow all of these tax cuts to expire or put all of the spending cuts into place. These decisions have been delayed until after the Presidential election. At this point, while both candidates have broadly outlined some of their tax and spending plans, neither candidate seems to be providing specific guidance about how they would tackle the fiscal cliff. After the November election, we expect that there will be more clarity about future fiscal policy. However, the potential for ongoing gridlock in Congress could present a significant speed bump to reform.

The consensus view seems to be that regardless of who wins the upcoming presidential election next month, millions of Americans will see their tax bills increase after January 1st when the temporary payroll tax holiday ends. According to an article published in September by the New York Times, *Payroll Tax Cut Is Unlikely to Survive Into Next Year*, the expiration of the payroll tax holiday alone could reduce GDP by as much as 1%. Depending on the actions that policymakers take, that may just be the tip of the iceberg. According to a recent study done by the Tax Policy Center, a typical middle class household would see its taxes go up by about $2,000, if all of the tax breaks expire as scheduled at the end of the year. It is widely estimated that the fiscal cliff in its entirety could shave as much as 3-5% off U.S. GDP in 2013. A contraction in the economy of this magnitude is unprecedented in modern financial times, adding to the difficulty in economists and politicians ascertaining the impact to the U.S. job market and GDP growth. Considering that the consensus forecast calls for GDP growth of roughly 2% in 2013, the fiscal cliff has the potential to send the economy into negative territory (i.e., recession).

> Though the fiscal cliff is still a few months away, we believe ambiguity about fiscal policy is having a negative impact on the overall economy.

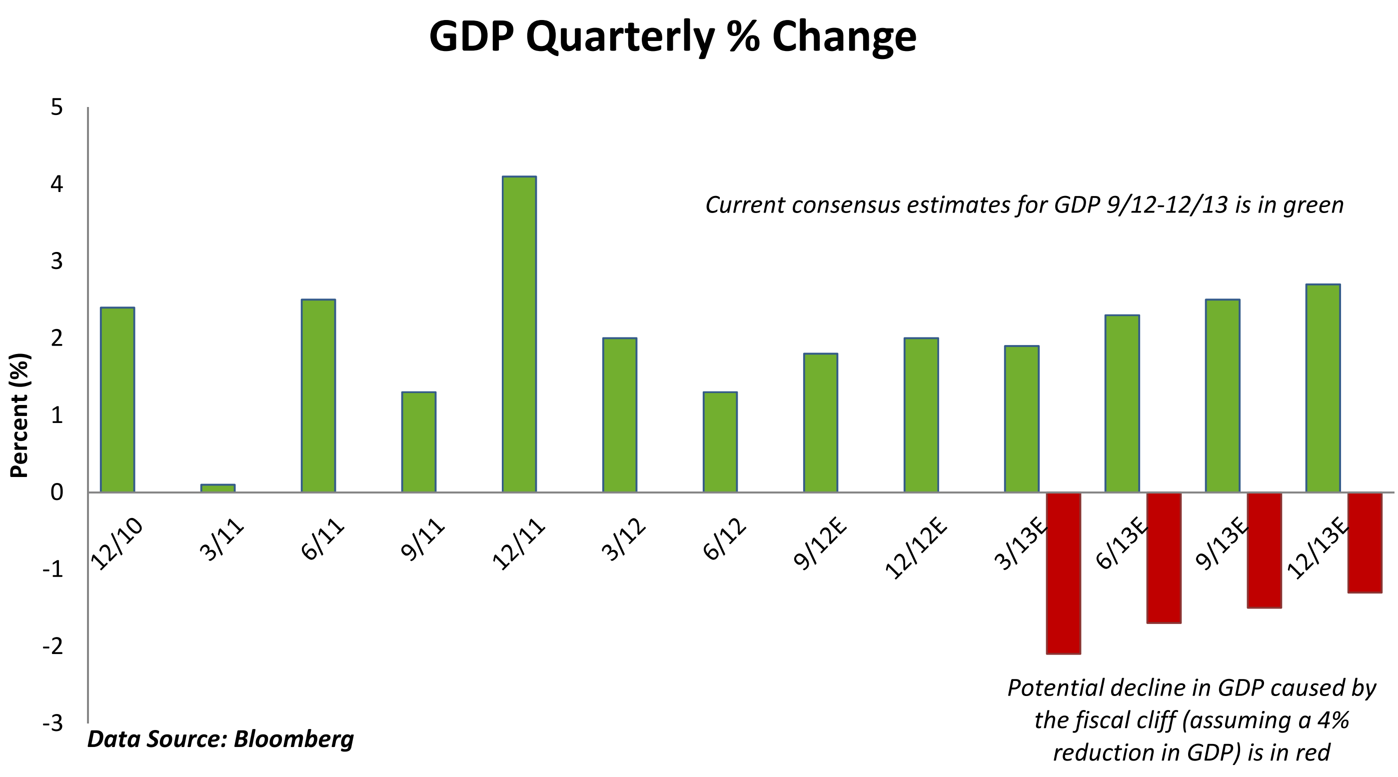
How policymakers address the fiscal cliff will have implications on the country's credit rating. Moody's has indicated that it may downgrade the U.S. credit rating from Aaa if Congress fails to produce a debt reduction plan, and currently has a negative outlook on the rating. The rating agency has said that it plans to wait until after the Presidential election to make a decision. Moody's said it will maintain the country's Aaa rating, but keep the outlook "negative" temporarily if "the method adopted to achieve debt stabilization involved a large, immediate fiscal shock" (i.e., the fiscal cliff). If the fiscal cliff doesn't come to fruition and there is no comprehensive debt reduction plan from Congress, Moody's would be likely to downgrade the U.S. rating by one notch. Recall that in August 2011, S&P downgraded the U.S. credit rating to

AA+ from AAA due to the country's growing fiscal debt. Policymakers are now charged with the task of balancing plans to reduce the deficit without stifling the economy and sending it back into a recession, a difficult task considering that domestic unemployment remains elevated and that the outlook for the global economy remains tenuous.

The lack of transparency on how policymakers will face the fiscal cliff presents a risk to the economy. We believe uncertainty about the fiscal cliff and the timing of potential fiscal reform is causing U.S. businesses to temporarily curtail their capital expenditures and delay hiring plans. According to a recent survey conducted by the Business Roundtable, a lobbying group of CEOs of top U.S. companies, including Honeywell and General Electric, the number of CEOs that plan to hire more employees in the next 6 months fell to 29% in the third quarter of this year from 36% in the second quarter. The number of CEOs that plan to increase capital spending also fell to 30% in the third quarter from 43% in the second quarter. Orders for core durable goods (durable goods excluding transportation equipment) fell 1.6% in the most recent report for the month of August, following a 1.3% decline in July and a 2.2% decline in June. Furthermore, public sector job uncertainty as well as the uncertainty for private sector workers who are tied to government spending may be dampening consumer spending and making individuals more reluctant to take on additional debt or purchase a house. Though the fiscal cliff is still a few months away, we believe ambiguity about fiscal policy is having a negative impact on the overall economy.

In our view, the upcoming fiscal cliff presents one of the greatest downside risks to our economy and has the potential to tip the U.S. back into recession, if policymakers aren't able to come up with a timely plan for fiscal reform. This comes at a time when the outlook for the global economy is poor, domestic economic data has been weaker than desired, the near-term outlook for GDP is low, and economic growth is largely being fueled by easy monetary policy.

- Shelly Henbest
VP, Credit Analyst



RISKS AND OTHER IMPORTANT CONSIDERATIONS

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