CHANDLER ASSET MANAGEMENT

November 2012

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

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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

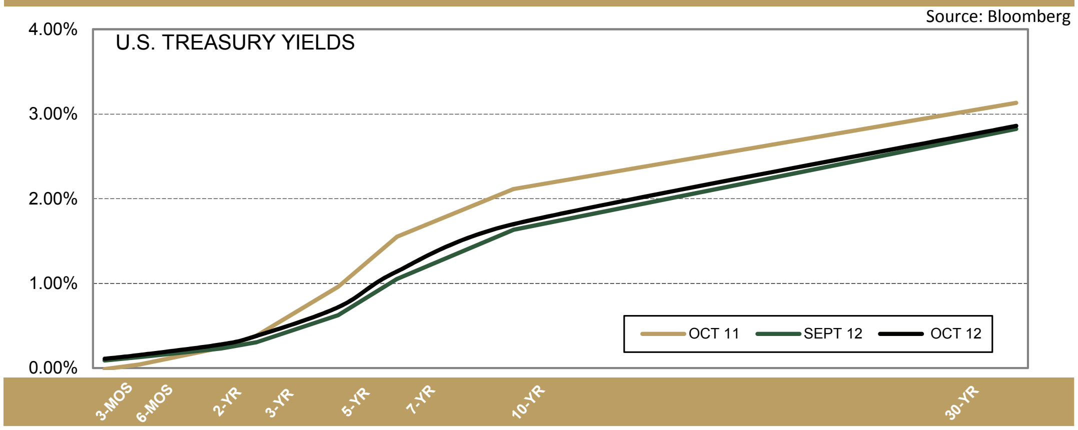
The treasury yield curve rose in October, driven by modest improvements in domestic labor market and housing market data, as well as increased optimism that the European Union would support a bailout of Spain if necessary (reducing the safe haven appeal of U.S. Treasuries). However, rates continue to be influenced by the Federal Reserve's accommodative monetary policy and their desire to keep interest rates contained.

The domestic economy continues to grow at a slower than desired pace. Recent data suggests that the housing market is beginning to rebound, but unemployment remains elevated and manufacturing trends continue to be lackluster. In October, nonfarm payrolls grew by 171,000 (better than expected) but the unemployment rate edged up to 7.9% from 7.8% in September. The outlook for the global economy remains uncertain as Europe still struggles to contain its debt crisis, economic growth trends in China have slowed, and concerns are heightened about the U.S. potentially reaching a "fiscal cliff" at the end of this year.

The Federal Open Market Committee left policy rates unchanged at its October meeting and affirmed its plan to keep the fed funds rate at an exceptionally low level through at least mid-2015. As expected, the Fed did not announce any additional stimulus measures and their assessment of the economy was little changed from September. The Committee did note, however, that there had been an uptick in household spending as well as inflation. The Fed said that it would continue to purchase additional agency mortgage-backed securities at a pace of $40 billion per month, for an open-ended period of time. "Operation Twist" will also continue through the end of this year. The next FOMC meeting is scheduled for December 11-12.

TREASURY YIELD CURVE ROSE SLIGHTLY IN OCTOBER

Source: Bloomberg



Treasury rates across the yield curve rose in October amid increased optimism over Europe's moves to ease its sovereign debt crisis, as well as modest improvement in domestic economic data. However, rates continue to be influenced by the Federal Reserve's accommodative monetary policy and their desire to keep interest rates contained.

TREASURY YIELDS	10/31/2012	9/30/12	CHANGE
3 Month	0.11	0.09	0.02
2 Year	0.28	0.23	0.05
3 Year	0.38	0.31	0.07
5 Year	0.72	0.63	0.09
7 Year	1.14	1.05	0.09
10 Year	1.70	1.63	0.07
30 Year	2.86	2.82	0.04

Source: Bloomberg

Economic Roundup

Consumer Prices

In September, overall CPI inflation rose to 2.0% on a year-over-year basis from 1.7% in August, largely driven by a continued rise in energy prices. The year-over-year Core CPI (CPI less food and energy) rose slightly to 2.0% in September, from 1.9% in August. The core inflation rate is in line with the Fed's inflation target of 2.0%.

Retail Sales

In September, Retail Sales rose 5.4% on a year-over-year basis. On a month-over-month basis, Retail Sales rose 1.1% in September, exceeding the consensus forecast. Spending trends have been modest, but elevated unemployment levels and high gas prices continue to put pressure on the consumer.

Labor Markets

The October employment report showed that payrolls increased by 171,000 (above the consensus estimate of 125,000), following a gain of 148,000 in September. However, the unemployment rate edged up to 7.9% from 7.8% in September, driven by an increase in the labor force. The employment report continues to reflect an overall slow pace of growth in the domestic economy.

Housing Starts

Single-family housing starts rose 11% to 603,000 in September, on top of a 7% increase in August. Recent data suggests that the housing market is beginning to rebound.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.08	0.12	(0.04)
2-year A corporate note	0.49	0.56	(0.07)
5-year A corporate note	0.79	0.90	(0.11)
5-year Agency note	0.25	0.26	(0.01)

Source: Bloomberg Data as of 10/31/12

Economic Data Was Mixed or Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(44.2) $Bln AUG 12	(42.5) $Bln JUL 12	(44.8) $Bln AUG 11
GDP	2.0% SEP 12	1.3% JUN 12	1.3% SEP 11
Unemployment Rate	7.9% OCT 12	7.8% SEP 12	8.9% OCT 11
Prime Rate	3.25% OCT 12	3.25% SEP 12	3.25% OCT 11
CRB Index	295.84 OCT 12	309.30 SEP 12	319.84 OCT 11
Oil (West Texas Int.)	$86.24 OCT 12	$92.19 SEP 12	$93.19 OCT 11
Consumer Price Index (y/o/y)	2.0% SEP 12	1.7% AUG 12	3.9% SEP 11
Producer Price Index (y/o/y)	2.1% SEP 12	2.0% AUG 12	7.0% SEP 11
Dollar/EURO	1.30 OCT 12	1.29 SEP 12	1.39 OCT 11

Source: Bloomberg

Economic and Market Impact of the 2012 Election

The reelection of President Obama, a Republican House and Democratic controlled Senate set up a split government faced with an economy that has yet to gain solid footing in the midst of fiscal and regulatory uncertainty.

The 2012 election presented the country with a striking contrast – a choice between two vastly different perspectives of the role of government and visions of the future. Policy can have profound consequences on the economy and on markets. Continued split control of the government, along with accompanying partisanship and gridlock, will likely temper the effects the election has on the economy. Concern by both parties for the precarious condition of the economy, and international forces beyond direct control of the congress, will also likely moderate near-term consequences. This month we will consider possible consequences of the election in several key areas.

The Fiscal Cliff

The fiscal cliff will be on top of the agenda post-election. As detailed in the October issue of the Chandler newsletter, the fiscal cliff is the expiration of certain tax breaks and spending cuts that will take effect at midnight on December 31, 2012. These include the end of Bush tax cuts, the expiration of the temporary payroll tax holiday, and the mandatory government spending cuts agreed to last year as part of the compromise deal to raise the debt ceiling. When the "super committee" charged with reaching a bipartisan consensus to reduce the deficit failed to reach agreement, the compromise legislation included these automatic cuts. Extended unemployment benefits are also set to expire, as will a number of tax deductions. Together, these changes are expected to cause federal spending to fall and federal taxes to rise by more than $600 billion next year. Unchecked, this drain on a tenuous economy would increase the likelihood of a recession.

The immediate market response to any action that limits the fiscal drag will likely be positive. The removal of this uncertainty will be welcome news to the economy and market.

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Interest Rates

Typically, taxes, the deficit, economic growth, and fiscal and monetary policy affect interest rates. The two primary drivers of current low interest rates – monetary policy and the European crisis - are not dependent on the outcome of the election. The Fed is independent of partisan politics and its course is not expected to change until 2015. The situation in Europe, which has also exerted downward pressure on U.S. interest rates as global investors view U.S. Treasury securities as the risk-free standard, will not be directly affected by the outcome.

In normal times, a split government is preferable for interest rates and the bond market. An across-the-board Republican victory would have brought lower taxes, potentially exacerbating the deficit, which is negative for interest rates (Higher rates). Alternatively, had President Obama's reelection been accompanied by a Democratic re-taking of the House of Representatives, this may have been viewed as a sign of unconstrained spending, also a negative for interest rates. The split government may be the most favorable outcome for the bond market.

Economic Uncertainty and Market Volatility

Postponement of major decisions and stopgap measures have characterized the past few years. This uncertainty has weighed on the economy and caused increased volatility in the market. How well reelected President Obama and Congress appear to work together and their perceived flexibility to reaching solutions will go a long way to reducing uncertainty and with it, market volatility. A strengthening spirit of cooperation can help reduce uncertainty and allow the sorts of decisions that can drive growth.

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Federal Budget Deficit

After the immediate problem of the fiscal cliff is addressed, the hope is that the Administration and the new Congress will turn their attention earnestly to getting the U.S. fiscal house in order. Two critical components of the fiscal environment are: entitlements and tax reform. Social Security and Medicare are entitlements that are trending on an unsustainable path. Under the current tax code, U.S, corporate taxes are amongst the world's highest.

How the Administration and Congress address this challenge will affect how the economy performs. If lawmakers address the fiscal cliff merely by postponing real decision-making and do not reach a deal regarding the federal deficit, the economy will likely continue along at a lackluster pace that does not generate the growth necessary to meaningfully reduce unemployment. On the other hand, if they work together in a manner that overhauls taxes and revamps entitlements – Medicare and Social Security – the economy may grow fast enough in a way to bring unemployment down.

Bowles-Simpson Plan

The report presented to the White House by its National Commission on Fiscal Responsibility and Reform, known as the Bowles-Simpson Plan, was not well-received by the Obama Administration when it was first presented in 2010. It presented a bipartisan set of tactics that tackled entitlements and the tax code. How receptive the Administration is to revisiting and implementing these now may determine how successful reaching long-term solutions will be this time around.

Tax Changes

The Obama administration has made clear its intention to raise taxes as a way of addressing the deficit. Taxes will likely be increased for higher income individuals and lowered for corporations. Again successful passage of any tax changes will depend on bipartisan cooperation. A serious confrontation of the federal budget deficit problem will likely include both tax increases and spending cuts. Any actions that clarify taxes or spending will mollify uncertainty.

In Practice

Over the course of a campaign, many promises are made. These include creating millions of jobs, bringing the unemployment rate down and keeping interest rates low and gas prices cheap. The President's ability to affect the economy is only indirect. Much of what will happen now that the 2012 election is over will depend on the President's willingness to work with the Congress and the spirit of cooperation that will materialize between the two branches. And of course, this takes place in a global economy.

- Sofia Anastopoulos, CFA
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