CHANDLER ASSET MANAGEMENT

January 2013

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

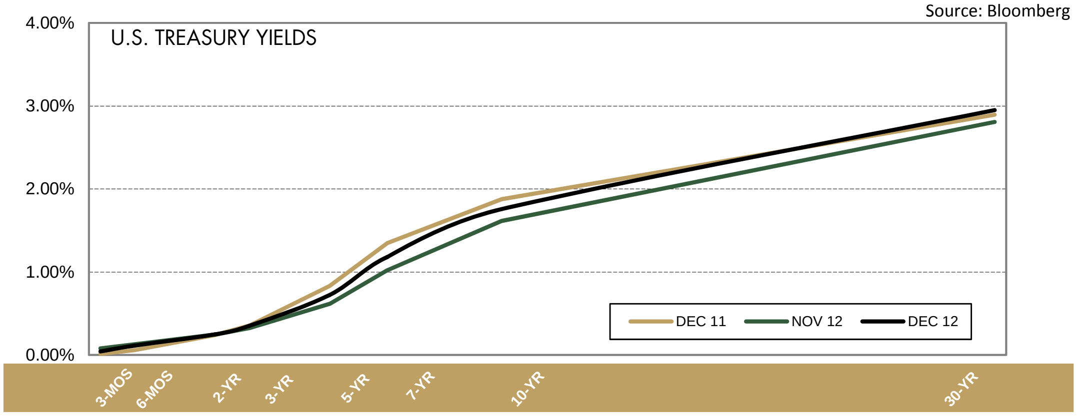
The economy continues to grow at a slower than desired pace. Improvement in the labor market has been modest, while trends in the manufacturing sector have been sluggish and reports on the consumer have been mixed. Payroll growth was in line with expectations in December, up 155,000, and the unemployment rate remains elevated at 7.8%. Housing data, on the other hand, has been favorable and recent reports suggest that the housing market continues to firm. Congress finally passed legislation to avert the fiscal cliff on January 1st; however, they failed to address the debt ceiling and in two months the U.S. will face the need to increase its borrowing limit. Congress is expected to resume negotiations regarding fiscal spending and sequestration as the debt ceiling nears.

Yields remain within a relatively tight range at low levels, as domestic economic growth remains slow and the outlook for the global economy remains tenuous. Rates continue to be influenced by the Federal Reserve's accommodative monetary policy, continued purchase of securities onto their balance sheet, and their desire to keep interest rates contained.

The Federal Open Market Committee left policy rates unchanged at its December meeting at a target range of 0%-0.25%, and announced a plan to implement additional quantitative easing. The Fed said it will purchase longer-term Treasuries at a pace of $45 billion per month for an unspecified period of time beginning this month. This program essentially replaces "Operation Twist" which expired at the end of December. The Fed also said that it will continue to purchase additional agency mortgage-backed securities at a pace of $40 billion per month, for an open-ended period of time. The Fed said that an exceptionally low fed funds rate will be appropriate as long as unemployment remains above 6.5% or until inflation looks set to exceed 2.5%. Overall, the Federal Reserve continues to pursue aggressive stimulus programs, and is forecasting slightly faster economic growth this year and a gradual decline in unemployment.

SHORTER-TERM TREAURY YIELDS DECLINED SLIGHTLY WHILE LONGER-TERM YIELDS ROSE

Source: Bloomberg



Yields have remained within a tight range at low levels, as uncertainties about the domestic and global economy persist. Rates also continue to be influenced by the Federal Reserve's accommodative monetary policy, continued purchase of securities onto their balance sheet, and their desire to keep interest rates contained.

TREASURY YIELDS	12/31/2012	11/30/12	CHANGE
3 Month	0.04	0.08	(0.04)
2 Year	0.25	0.25	0.00
3 Year	0.35	0.32	0.03
5 Year	0.72	0.62	0.10
7 Year	1.18	1.04	0.14
10 Year	1.76	1.62	0.14
30 Year	2.95	2.81	0.14

Source: Bloomberg

Economic Roundup

Consumer Prices
In November, overall CPI inflation fell to 1.8% on a year-over-year basis from 2.2% in October. The year-over-year Core CPI (CPI less food and energy) also fell slightly to 1.9% from 2.0% in October. The core inflation rate is below the Fed's long-term goal of 2.0% and well below the trigger rate for policy action of 2.5%.

Retail Sales
In November, Retail Sales rose 3.7% on a year-over-year basis. On a month-over-month basis, Retail Sales rose 0.3% in November, lower than the consensus forecast of 0.6%. Overall, recent consumer spending trends have been modest.

Labor Markets
The December employment report showed that payrolls increased by 155,000 (in line with the consensus estimate), following a gain of 161,000 in November. Private payrolls advanced 168,000 while government jobs declined by 13,000. The unemployment rate held steady at 7.8% in December. Overall, improvement in the labor market continues to be modest and reflects an overall slow pace of growth in the domestic economy.

Housing Starts
Single-family housing starts declined 4.0% in November to 565,000 from 589,000 in October. However, housing permits rose 3.6% in November. Overall, housing starts fell back slightly in November after two months of strong gains. In our view, recent data suggests that the housing market continues to be firm.

Credit Spreads Were Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.11	0.06
2-year A corporate note	0.60	0.57	0.03
5-year A corporate note	0.86	0.89	(0.03)
5-year Agency note	0.24	0.22	0.02

Source: Bloomberg Data as of 12/31/12

Economic Data Continued at a Slow Pace

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.2) $Bln OCT 12	(40.3) $Bln SEP 12	(45.7) $Bln OCT 11
GDP	3.1% SEP 12	1.3% JUN 12	1.3% SEP 11
Unemployment Rate	7.8% DEC 12	7.8% NOV 12	8.5% DEC 11
Prime Rate	3.25% DEC 12	3.25% NOV 12	3.25% DEC 11
CRB Index	295.01 DEC 12	298.98 NOV 12	305.30 DEC 11
Oil (West Texas Int.)	$91.82 DEC 12	$88.91 NOV 12	$98.83 DEC 11
Consumer Price Index (y/o/y)	1.8% NOV 12	2.2% OCT 12	3.4% NOV 11
Producer Price Index (y/o/y)	1.5% NOV 12	2.3% OCT 12	5.6% NOV 11
Dollar/EURO	1.32 DEC 12	1.30 NOV 12	1.30 DEC 11

Source: Bloomberg

Treasury Debt: How Much is Available for Private Investors?

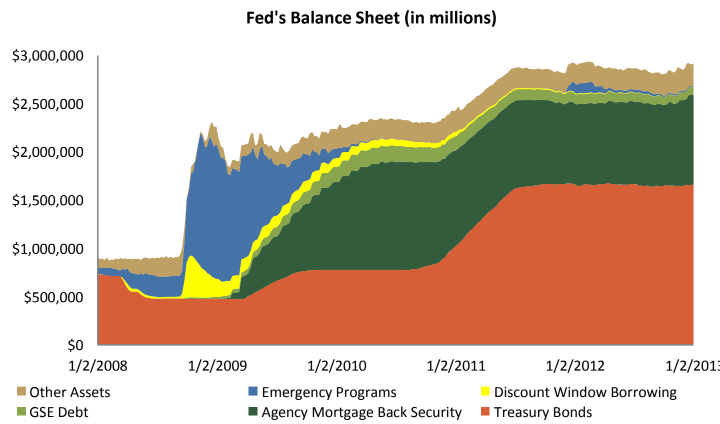
As we have discussed in our previous commentary, the available supply of safe-haven assets has dwindled for investors. The tenuous global economic backdrop has contributed to the lack of safe, sovereign assets as the debt of peripheral European countries are no longer perceived as “risk free”. China does not have a developed global bond market and Japan finances their deficit via the domestic economy, and thus neither represents realistic substitutes for global safe-haven flows. In the current investment environment, arguably the only two sovereign markets with the depth, safety, and transparency to be considered risk free are German Bunds and US Treasuries. Investors covet safe-haven assets, particularly in times of heightened uncertainty, yet there are fewer such assets available on a global basis.

Recently, domestic market sentiment has been strongly impacted by political developments. As part of the fiscal cliff negotiations that concluded at year-end, existing tax rates were extended for the majority of the population. However, significant milestones remain in the coming quarter, including the extension of the debt ceiling above $16.4 trillion, the government’s actions on the impact of sequestration, and the continuing spending resolution for 2013 (which runs out at the end of March). We analyze the changing Treasury debt investment landscape from the perspective of fiscal policy and developments, economic issues, and the Federal Reserve’s objectives.

The level of conventional monetary stimulus being injected into the US economy remains high, and this is unlikely to diminish in 2013. The Fed Funds rate will continue to be pegged at 0.25%. Unconventional monetary policy, primarily the expansion of the Fed’s balance sheet to promote employment (Quantitative Easing), will also remain highly stimulative, but for a less certain timeframe. On the other hand, fiscal policy will likely have a negative effect on the economy, with numerous tax provisions expiring and spending cuts expected to be part of the ongoing negotiations. We anticipate the level of fiscal support for the economy to decline this year.

The Federal Reserve is currently on its fourth iteration of Quantitative Easing (QE4), and the latest consensus estimate for the size of the Fed’s balance sheet at the end of 2013 is nearly $4 trillion (see **Chart 1**). For perspective, at the end of 2012, the Fed’s balance sheet was valued below $3 trillion, and prior to the financial crisis it was at less than $800 billion. This expansion of the Fed’s balance sheet will likely create an inflation problem in the future. Nonetheless, based on the high unemployment rate and the perceived excess capacity within the US economy, the Fed continues to look past the negative implications of a large balance sheet and the monetary stimulus embedded within.

Chart 1

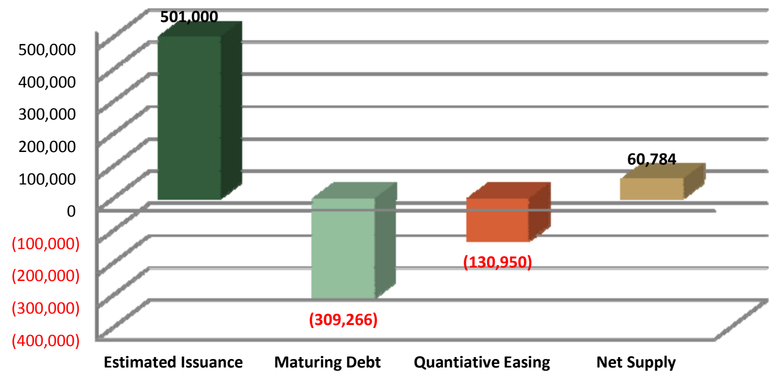


The other potential safe-haven sector in the US, government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, remain under conservatorship by the US Treasury and are required to shrink their retained portfolios by 15% per year beginning in 2013 (as compared to the previous requirement of 10% per annum). As the supply of GSEs continues to contract, the historically attractive yield enhancement from owning Agencies versus Treasuries will continue to trend downward.

Despite an estimated net Q1-2013 issuance of just over $500 billion in US Treasuries, the net amount of new Treasury coupon supply (excluding TIPS and T-Bills) available for the market to absorb is far less. Approximately $300 billion in US Treasuries will mature and the Fed’s QE program anticipates purchases of more than $130 billion, leaving slightly more than $60 billion net new supply for the market (as shown in **Chart 2)**. Thus, even though the US government continues to accumulate large deficits and continues to fund those deficits through issuance of Treasuries, the impact on the net supply to the market has been negligible. With meager net supply far exceeded by normal market demand, the yield on US Treasuries will likely stay close to its current low levels.

Chart 2

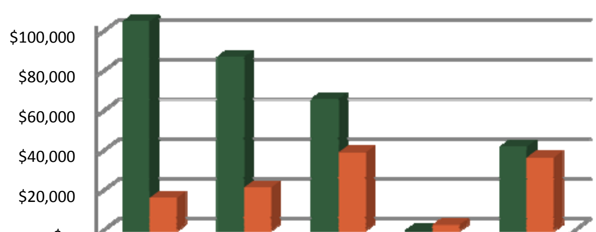
Treasury Coupon Dynamics - 1st Q 2013 (in millions)



Based on the most recent quarterly projections of the Federal Reserve, the committee's long-term goals for unemployment and inflation are 5.2-6.0% and 2.0%, respectively. The Fed has also communicated it is willing to accept inflation running above its 2.0% target, provided that the unemployment rate remains above 6.5% and long-term inflation expectations remain "anchored". We foresee the FOMC will continue actively distorting asset prices—to the detriment of fixed income investors—by keeping the yield on Treasury securities artificially low (see **Chart 3**).

Chart 3

Fed is Constraining Supply in Longer Duration Treasury Assets (in millions)
(Estimates of 1st Quarter 2013)



	4.75 - 5.75 years	5.75 - 7.00 years	7.00 - 10.00 years	10.00 - 20.00 years	20.00 - 30.00 years
Treasury Issuance (quarterly)	$105,000	$87,000	$66,000	$-	$42,000
QE (quarterly / treasury)	$16,200	$21,600	$39,150	$2,700	$36,450

The current supply of new issues confirms the Fed is disproportionately purchasing Treasury assets further out on the yield curve, where investors typically extract the most concession when inflation expectations increase. **Chart 3** shows that in the 10-30 year maturity range, demand almost equals supply (when taking QE4 into account). The Treasury issuances available to investors are much greater with shorter maturities. With the Fed actively choosing to purchase longer term issues, they are also actively constraining investors' opportunities to take a bearish view on long-term inflation expectations.

Despite the significant amount of quarterly US Treasury issuances, rates are unlikely to increase significantly with the Fed's latest iteration of QE. In conclusion, our analysis of fiscal policy and developments, economic issues, and the Fed's goals, confirm the estimated net quarterly supply of $60 billion is not nearly enough to alter current market dynamics. Private investors may need to seek out alternative investment vehicles due to a shortage of Agencies and Treasuries.

- William Dennehy II, CFA
Portfolio Manager

Source for charts: US Treasury and Federal Reserve