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.

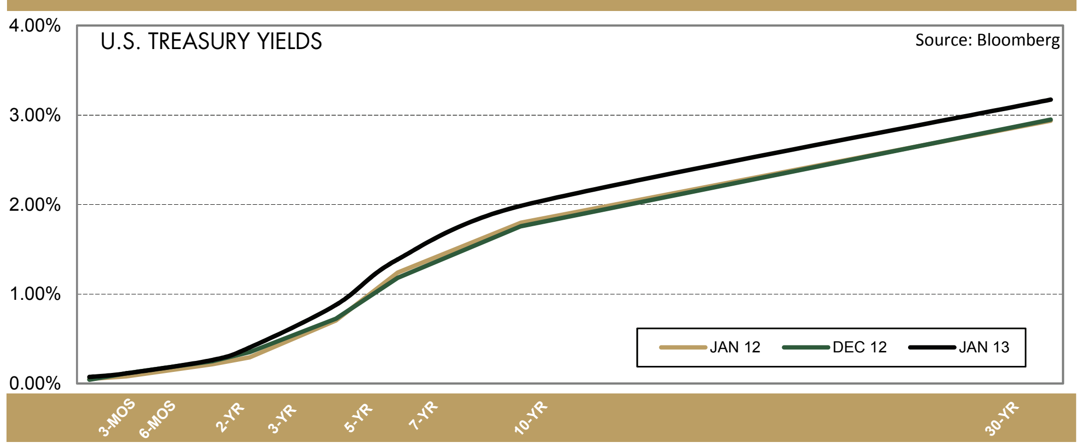
Market Summary

Recent data suggests that first quarter economic growth is off to a slow start. Improvement in the labor market remained modest in January, with payrolls advancing just 157,000, and the unemployment rate edged up slightly to 7.9% from 7.8% in December. Manufacturing trends appear to have picked up slightly in January with a better than expected ISM manufacturing report. Meanwhile, higher payroll taxes, rising gas prices and uncertainty about the government's fiscal policy appears to be weighing on consumers. Housing data has remained mostly favorable, though lack of supply seems to be tempering sales volume. Government budget and spending issues remain largely unresolved. On February 4th, the President approved a bill to temporarily suspend the debt limit, giving lawmakers until mid-April to pass a budget or have their pay withheld.

Yields remained within a relatively tight range at low levels in January due to the Federal Reserve's accommodative monetary policy and continued European sovereign debt risk.

The Federal Open Market Committee left policy rates unchanged at its first meeting of the year on January 29th and 30th. The Committee will continue with quantitative easing, buying longer term Treasuries at a pace of $45 billion per month and agency mortgage-backed securities at a pace of $40 billion per month. The Fed has stated that an exceptionally low fed funds rate will be maintained as long as unemployment remains above 6.5% or until inflation looks set to exceed 2.5%. The Fed noted that growth in economic activity had recently weakened, but attributed it primarily to weather-related and other "transitory factors". The FOMC's statement indicated that "although strains in global financial markets have eased somewhat, the Committee continues to see downside risks to the economic outlook", which likely refers to ongoing uncertainty about fiscal policy in the US and abroad.

TREASURY YIELD CURVE ROSE SLIGHTLY IN JANUARY



Yields remained within a relatively tight range at low levels in January, influenced by the Fed's accommodative monetary policy.

TREASURY YIELDS	1/31/2013	12/31/2012	CHANGE
3 Month	0.07	0.04	0.03
2 Year	0.26	0.25	0.01
3 Year	0.40	0.35	0.05
5 Year	0.88	0.72	0.16
7 Year	1.39	1.18	0.21
10 Year	1.99	1.76	0.23
30 Year	3.17	2.95	0.22

Source: Bloomberg

Economic Roundup

Consumer Prices
In December, overall CPI inflation fell to 1.7% on a year-over-year basis from 1.8% in November. The year-over-year Core CPI (CPI less food and energy) was unchanged at 1.9%. The core inflation rate remains 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 December, Retail Sales rose 4.7% on a year-over-year basis. On a month-over-month basis, Retail Sales rose 0.5% in December, better than the consensus forecast of 0.2%. Overall, recent consumer spending trends have been modest.

Labor Markets
The January employment report showed that payrolls increased by 157,000, falling short of the consensus estimate of 175,000. However, payroll growth at the end of last year was stronger than previously believed with a cumulative upward revision to payroll growth in November and December of 156,000. Private payrolls advanced 166,000 in January while government jobs declined by 9,000. The unemployment rate edged up slightly to 7.9% in January from 7.8% in December, driven by an increase in the labor force. 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 rose 8.1% in December to 616,000 from 570,000 in November. Multifamily starts rose 20.3% in December and housing permits rose 0.3%. In our view, recent data suggests that the housing market continues to firm.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.10	0.17	(0.07)
2-year A corporate note	0.58	0.60	(0.02)
5-year A corporate note	0.82	0.86	(0.04)
5-year Agency note	0.21	0.24	(0.03)

Source: Bloomberg Data as of 1/31/13

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(48.7) $Bln NOV 12	(42.1) $Bln OCT 12	(48.8) $Bln NOV 11
GDP	(0.1%) DEC 12	3.1% SEP 12	4.1% DEC 11
Unemployment Rate	7.9% JAN 13	7.8% DEC 12	8.3% JAN 12
Prime Rate	3.25% JAN 13	3.25% DEC 12	3.25% JAN 12
CRB Index	303.99 JAN 13	295.01 DEC 12	312.31 JAN 12
Oil (West Texas Int.)	$97.49 JAN 13	$91.82 DEC 12	$98.48 JAN 12
Consumer Price Index (y/o/y)	1.7% DEC 12	1.8% NOV 12	3.0% DEC 11
Producer Price Index (y/o/y)	1.3% DEC 12	1.5% NOV 12	4.7% DEC 11
Dollar/EURO	1.36 JAN 13	1.32 DEC 12	1.31 JAN 12

Source: Bloomberg

4Q 2012 Corporate Earnings Review and 2013 Outlook

4Q 2012 Corporate Earnings Review

Fourth quarter earnings have been generally better than expected. More than half of the companies in the S&P 500 Index have reported fourth quarter earnings thus far, and of those, nearly 75 percent have posted positive earnings surprises. Sales have also been generally better than expected with roughly two-thirds of companies posting positive sales surprises thus far. According to Bloomberg data, earnings growth has been nearly 9% in aggregate on a year-over-year basis. Financials, Materials, and Utilities have posted the largest year-over-year earnings growth rates, while Health Care, Industrials, and Telecommunication Services have posted year-over-year earnings declines, on average. In terms of earnings surprises, Financials have posted the biggest upside surprises, while Telecommunications Services have posted the most disappointing results. Forward-looking guidance for 2013 has been mixed, but overall analysts' earnings per share estimates for the year have declined slightly (-0.38%) since the unofficial start of earnings season on January 8th. In our view, this signals that guidance has been less favorable than expected, on average.

Thematic highlights from 4Q earnings season:

- Recent trends suggest that banks' overall credit quality continues to improve, although net interest margins remain pressured by the low interest rate environment. Mortgage businesses continue to be a source of earnings strength, but refinancing activity may be slowing. Multiple banks are reducing headcount and remain focused on cost-cutting, especially as costs associated with increased regulation are likely to rise this year.
- Sequestration is likely to provide a significant headwind to revenues this year for companies exposed to the defense industry, such as General Dynamics, Lockheed Martin and Raytheon. However, some companies in the defense industry expect that growth in other areas of their business and in foreign markets will help offset the impact of spending cuts in the US.
- Some companies including Constellation Brands and Texas Instruments have indicated that their businesses have been negatively impacted by uncertainties about government spending and by consumer anxiety stemming from the fiscal cliff and debt ceiling. Most retailers have yet to report their fourth quarter earnings, but some may report that such uncertainty and anxiety hindered results. Looking ahead, ongoing uncertainty about fiscal policy and the potential for significant spending cuts could be a headwind to consumer-related businesses this year, particularly in the first half of the year.
- Sales trends in Europe remain weak for many companies, but trends in emerging markets appear to be strengthening. In particular, Alcoa, DuPont, and 3M were among the companies that signaled improving trends in China.
- Share repurchase activity is likely to be aggressive this year as many companies, such as United Technologies and BlackRock, have authorized substantial share repurchase programs.

Slow, but positive, economic growth should provide support for corporate earnings and credit quality this year

2013 Outlook

Over the next twelve months, we expect the economy will continue to grow at a slow pace. Momentum heading into the year was weak, following a 0.1% decline in GDP during the fourth quarter of 2012 (according to the advance estimate). Market participants are currently forecasting GDP growth of just 1.5% in the first quarter of 2013, though growth is expected to accelerate throughout the year for a full year average growth rate of 2.0%. Slow, but positive, economic growth should provide support for corporate earnings and credit quality this year, particularly as many companies have spent the past few years focusing on efficiency and strengthening their balance sheet.

However, we see a number of headwinds to the economy and corporate earnings this year. We anticipate headwinds to consumer spending from higher taxes (a 2% increase in payroll taxes due to the expiration of the payroll tax holiday), higher gas prices (average prices have risen more than 7% since the end of 2012), and weakening consumer confidence (which dropped to 58.6 in January from 66.7 in December). Government spending cuts are also likely to put pressure on the overall economy. Federal defense spending declined 22.2% during the fourth quarter of 2012. Uncertainties about taxes and government spending remain, including whether or not across-the-board spending cuts, known as sequestration, will actually kick in on March 1st. The government is currently operating without a budget and without a ceiling on its debt. On February 4th, the President approved legislation suspending the debt ceiling through May 18th. The bill requires the Senate to pass a budget by mid-April and threatens to withhold lawmakers' pay if it fails to do so. These issues are likely to weigh on consumer confidence and economic growth for the next few months, but conditions should improve in the second half of the year with increased clarity from the government.

While we see potential challenges to the economy, there are several factors that should be positive for corporate earnings and the financial markets. The Federal Reserve's ongoing accommodation and continued improvement in the housing market should be positive for the economy. Reacceleration of growth in China, more stabilization in Europe, and the potential for an uptick in business capital spending should also have a positive impact. Corporate earnings comparisons should also get easier in the 4th quarter of the year, when companies cycle through disruptions from Hurricane Sandy and anxiety about the fiscal cliff. We believe the Federal Reserve's accommodative stance throughout the year will provide support for economic growth and financial market valuations. Recent housing market data has also been favorable, with prices firming and demand outpacing supply. In addition, recent data suggests that unemployment, manufacturing, and inflation may be stabilizing in the euro-zone. Throughout February, several European banks are expected to begin repaying their loans under the ECB's Longer Term Refinancing Operations program, which was implemented a year ago in order to avert a credit crunch. This is another indication that market conditions may be improving in the euro-zone. Moreover, manufacturing data out of Asia at the end of January suggested the region is also improving. The official purchasing managers' index from the China Federation of Logistics was 50.4 in January (a reading over 50 indicates expansion), while HSBC's China PMI reached a two-year high of 52.3 in January. Furthermore, recent comments from a number of corporate management teams suggest that China's growth is rebounding.

We believe stockholder friendly transactions will be on the upswing in 2013, at the expense of bondholders

In terms of corporate credit, we believe quality remains robust, but fundamentals likely peaked in 2012. The benefits from cost cutting to improve profitability are largely behind us and we believe stockholder friendly transactions will be on the upswing in 2013 at the expense of bondholders. Debt financing is relatively inexpensive, and corporations are under pressure to support equity prices. As such, many companies have recently announced higher dividends and aggressive share repurchase programs, often funded through new debt issuances. M&A activity also poses a risk, especially as multinational corporations look to expand into emerging markets. For other companies, assets sales, restructurings, break-ups and/or spin-offs could put pressure on credit quality. We believe shareholder-friendly activity is the biggest threat to corporate credit quality this year, and thus, we will be looking to avoid names more exposed to event risk going forward.

- Shelly Henbest
VP, Credit Analyst