CHANDLER ASSET MANAGEMENT

March 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.

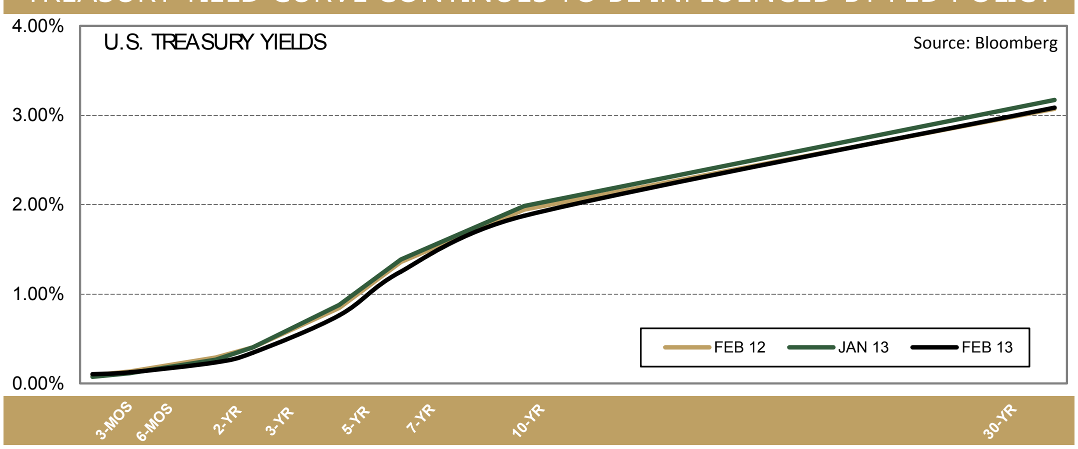
Market Summary

The US economy has grown at a modest pace during the first quarter. Job growth was better than expected in February. Nonfarm payrolls rose 236,000 in the month, exceeding the consensus forecast of 171,000, while the unemployment rate fell to 7.7% from 7.9% in January. The average nonfarm payroll growth over the past 3 months has been 191,000 per month. Recent manufacturing trends have picked up slightly and housing trends remain favorable. Meanwhile, consumer spending trends have held up fairly well, in spite of headwinds from higher payroll taxes, rising gas prices, a delay in tax refunds, and ongoing uncertainty about the government's fiscal policy.

Yields remained within a relatively tight range at low levels in February. The US Treasury yield curve flattened as short-term yields rose slightly while longer-term yields declined. Overall, yields continue to be influenced by the Fed's accommodative monetary policy.

The minutes from the January FOMC meeting indicated that the debate among Fed officials on quantitative easing (QE) is growing. Some Fed members voiced concerns about ongoing bond purchases and their longer-term impact on the economy and the threat of inflation, while others worried about cutting back prematurely on accommodation and the risk of rising interest rates. The minutes raised anxiety that the Fed will begin unwinding its policies before there is a meaningful pickup in employment. However, in early March, Chairman Bernanke defended continuing the central bank's bond buying programs and signaled that the Fed remains committed to providing stimulus to the economy. He cautioned that raising interest rates too soon would be harmful to the economy. The Fed is maintaining its highly accommodative stance for now, and will continue to debate the cost/benefit of QE. The next FOMC meeting is scheduled for March 19 and 20.

TREASURY YIELD CURVE CONTINUES TO BE INFLUENCED BY FED POLICY



The US Treasury yield curve flattened as short-term yields rose slightly while longer-term yields declined in February.

TREASURY YIELDS	2/28/2013	1/31/2013	CHANGE
3 Month	0.10	0.07	0.03
2 Year	0.24	0.26	(0.02)
3 Year	0.34	0.40	(0.06)
5 Year	0.76	0.88	(0.12)
7 Year	1.25	1.39	(0.14)
10 Year	1.88	1.99	(0.11)
30 Year	3.09	3.17	(0.08)

Source: Bloomberg

Consumer Prices

In January, overall CPI inflation fell to 1.6% on a year-over-year basis from 1.7% in December. 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 January, Retail Sales rose 4.4% on a year-over-year basis. On a month-over-month basis, Retail Sales rose 0.1% in January, in line with expectations. Overall, recent consumer spending trends have been modest.

Labor Markets

The February employment report showed that payrolls increased by 236,000 (exceeding the consensus estimate of 171,000). The unemployment rate fell to 7.7% from 7.9% in January. Private payrolls were up 246,000 (vs. expectations of 195,000), while government jobs fell 10,000 in February. The net revisions in nonfarm payrolls for December and January were down 15,000. Overall, improvement in the labor market continues to be modest.

Housing Starts

Single-family housing starts rose 0.8% in January to 613,000 from 608,000 in December. Multifamily starts fell 24.1% in January after spiking in December. Though housing starts were weaker than expected in January, there was an ongoing increase in housing permits. Housing permits rose 1.8% in the month which was slightly more than expected. In our view, recent data suggests that the housing market continues to improve.

Credit Spreads Widened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.06	0.10	(0.04)
2-year A corporate note	0.52	0.58	(0.06)
5-year A corporate note	0.82	0.82	0.00
5-year Agency note	0.15	0.21	(0.06)

Source: Bloomberg Data as of 2/28/13

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.1) $Bln DEC 12	(48.2) $Bln NOV 12	(51.7) $Bln DEC 11
GDP	0.1% DEC 12	3.1% SEP 12	4.1% DEC 11
Unemployment Rate	7.7% FEB 13	7.9% JAN 13	8.3% FEB 12
Prime Rate	3.25% FEB 13	3.25% JAN 13	3.25% FEB 12
CRB Index	292.95 FEB 13	303.99 JAN 13	322.43 FEB 12
Oil (West Texas Int.)	$92.05 FEB 13	$97.49 JAN 13	$107.07 FEB 12
Consumer Price Index (y/o/y)	1.6% JAN 13	1.7% DEC 12	2.9% JAN 12
Producer Price Index (y/o/y)	1.4% JAN 13	1.3% DEC 12	4.1% JAN 12
Dollar/EURO	1.31 FEB 13	1.36 JAN 13	1.33 FEB 12

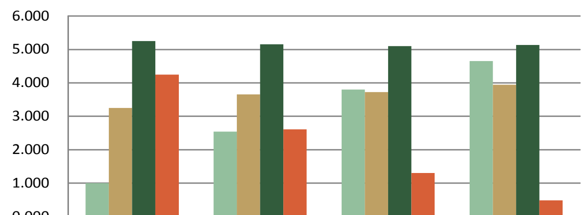
Source: Bloomberg

Monetary Policy: Treasury Yield Curves in a Tightening Cycle

The Federal Reserve has been exceptionally vigilant in utilizing all of the tools at their disposal to promote the dual mandate of price stability and full employment in the current easing cycle. Prior to the financial crisis in 2008 the Federal Reserve adjusted monetary policy almost exclusively through the Fed Funds rate. As the economy strengthened and the unemployment rate dropped, the Fed Funds rate would be set at higher intervals to act as a countercyclical force against the economic recovery to contain inflation and promote price stability. The tightening of monetary policy via the Fed Funds rate also fed through to longer maturity assets with yields increasing generally at all maturity points.

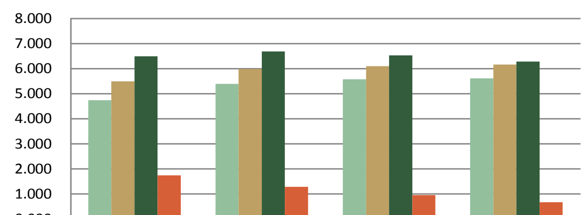
The team at Chandler took a look back at three previous tightening cycles to gain a better perspective on what to expect in the next tightening cycle regarding the Fed Funds rate and the Treasury yield curve. Neither Chandler nor the Federal Reserve are forecasting monetary policy to tighten in the traditional sense during fiscal 2013 – the purpose of the article is to get investors thinking about potential implications for their portfolio when the tightening cycle does commence. It is also important to note that due to the extraordinary measures taken by the Federal Reserve away from traditional monetary policy in the current easing cycle, primarily the various forms of Quantitative Easing (QE) and the corresponding expansion of the Fed's balance sheet, the Federal Reserve will have traditional and non-traditional tools at its disposal to serve as a countercyclical force to the expanding economy. If inflation does surprise to the upside, the Federal Reserve has the ability to sell assets from its balance sheet, in addition to raising interest rates, to aggressively counteract any surge in inflation. Clouding our ability to draw definitive conclusions based on the historical data set is the fact that the Fed Funds target has never been set this low (0.25%), for this long (four plus years), which has over time contributed to the very low current yields on Two-year, Five-year, and Ten-year Treasury notes (see table on first page of newsletter).

May 2004 - June 2006



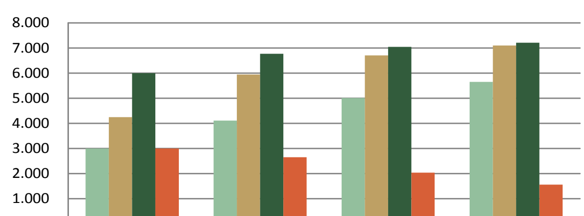
	Fed Funds Target	2 year	5 year	10 year
Start Date 5/31/2004	1.000	2.544	3.798	4.653
Mid Date 6/30/2005	3.250	3.657	3.722	3.943
End Date 6/30/2006	5.250	5.158	5.100	5.138
Change	4.250	2.614	1.302	0.486

May 1999 - May 2000



	Fed Funds Target	2 year	5 year	10 year
Start Date 5/31/1999	4.750	5.402	5.580	5.620
Mid Date 11/30/1999	5.500	5.998	6.102	6.172
End Date 5/31/2000	6.500	6.688	6.535	6.292
Change	1.750	1.286	0.956	0.672

January 1994 - February 1995



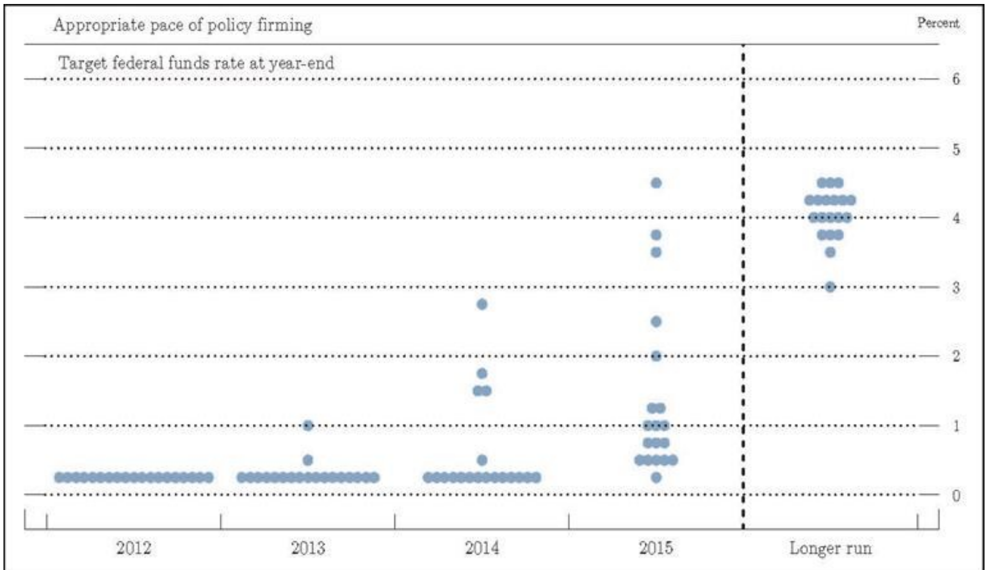
	Fed Funds Target	2 year	5 year	10 year
Start Date 1/31/1994	3.000	4.115	5.014	5.651
Mid Date 7/30/1994	4.250	5.944	6.710	7.100
End Date 2/28/1995	6.000	6.773	7.053	7.214
Change	3.000	2.657	2.039	1.563

In each of these three historical tightening cycles, a positive spread differential existed between the Fed Funds target and the Two-year Treasury prior to the beginning of a tightening in policy. In the May 2004 – June 2006 period the Fed Funds rate started at 1.00% versus Two-year notes at 2.54%, in May 1999 – May 2000 Fed Funds started at 4.75% versus Two-year notes at 5.40%, and in January 1994 – February 1995 Fed Funds started at 3.00% versus Two-year notes at 4.11% (see chart and tables). Also of note, at the beginning of each of the respective tightening cycles the Treasury curve had a positive slope (i.e., longer maturity notes had higher yields than shorter maturity notes). In all three tightening periods, the shorter the maturity of the Treasury notes, the closer the correlation to the change in the Fed Funds rate at the conclusion of the tightening cycle. The orange bar in the graphs highlights the yield change over the period for each of the respective securities. In all cases the longer the maturity, the smaller the overall change in yield (in the first cycle Ten-year notes change by 0.49%, in the second cycle Ten-year notes change by 0.67%, and in the third cycle Ten-year notes change by 1.56%).

Currently, the spread between the Fed Funds rate and the Two-year Treasury note is close to zero (0.25% versus 0.24%), implying in the next tightening cycle the Two-year note may match the change in the Fed Funds rate based on current valuations in a best case scenario. In longer maturity points, we can conclude the move wider in yields versus the Fed Funds rate will be less than one times the Fed Funds rate change, but clearly the starting point in yields at the beginning of the tightening cycle is crucial. The current low level of yields on both Five- and Ten-year Treasury

Graph Source: US Treasury

notes supports the earlier notion that a tightening of policy is not priced into the market for 2013. We would anticipate longer maturity yields moving higher before the Fed begins raising the Fed Funds rate, thus the Treasury curve is likely to become steeper (differential between Ten-year and Two-year Treasury notes expands) before the commencement of a change in the Fed Funds rate.



Each shaded circle indicates the value (rounded to the nearest 1/4 percentage point) of an individual participant's judgment of the appropriate level of the target Federal Funds rate at the end of the specified calendar year or over the longer run. *Graph Source: Federal Reserve*

The Federal Reserve publishes forecasts for the targeted Fed Funds rate quarterly. The most recent iteration valued the 'long run' central tendency of the Fed Funds rate at 4.0% sometime in 2016 or later. A 4.0% forecast appears to be more consistent with a Federal Reserve that is concerned about inflation. We think the Fed's fears of inflation are aggressive based on two primary factors: changing demographics (both in the US and globally) and the synchronization of developed economies on a global basis. The average age of the population in the United States and globally is rising thereby increasing the demand for assets that pay a predictable stream of income. Despite the move lower in yields in the fixed income market, demand has not waned. We partially attribute the inelasticity of demand for fixed income to the aging population in developed economies. We believe the strong demand for fixed income will cause the differential between short maturity Treasury notes and the Fed Funds rate to contract on a secular basis, which will also lead to lower rates than would otherwise be the case.

The economic slowdown since the financial crisis of 2008 has impacted the global economy, not just the United States. All of the major developed country central banks (Federal Reserve, European Central Bank, and the Bank of Japan) are easing monetary policy to try and stimulate aggregate demand and to grow their economies. The economies of Europe and Japan also face significant demographic hurdles due to aging populations and are arguably in a more precarious situation than the United States despite the upcoming retirement wave of the baby boom generation domestically. If the Federal Reserve were to prematurely and aggressively tighten domestic monetary policy before the global economy was strong enough to absorb the change, the dollar would strengthen relative to other global currencies, likely leading to a domestic economic slowdown. We believe the Federal Reserve has an incentive to keep rates low relative to other developed economies to keep dollar based manufacturers competitive.

So where do Treasury rates normalize after monetary policy is no longer accommodative? If we assume the Federal Reserve will be able to keep the inflation rate at their long-run target of 2.0%, it is difficult to envision the Fed Funds rate trading at much of a premium to inflation. The demographic shifts mean fixed income assets will not have to offer as competitive a yield versus inflation to attract assets. In a normal environment Treasury yield curves are upward sloping. Therefore, assuming a Fed Funds rate 50 basis points above inflation, Two-year Treasury notes trading at a slight yield pick-up to the Fed Funds rate (approximately 2.75%), and 150 basis points for the term premium for Ten-year yields, 4.25% appears to be a good estimate of Ten-year Treasury yields sometime after 2015.

-- William Dennehy II, CFA
SVP, Portfolio Manager