CHANDLER ASSET MANAGEMENT

May 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.

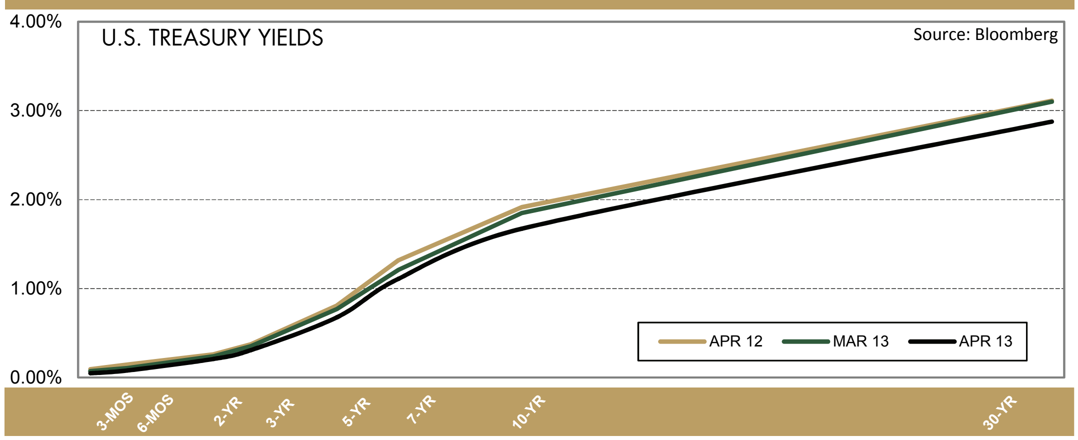
Market Summary

Recent economic data has been somewhat lackluster, although job growth was better than expected in April. Nonfarm payrolls rose 165,000 in the month, exceeding the consensus forecast of 153,000. The net revisions in nonfarm payrolls for February and March were up 114,000. Average nonfarm payroll growth for the first four months of this year has been 195,000 per month. The unemployment rate remains elevated but improved to 7.5% in April from 7.6% in March. Meanwhile, recent manufacturing trends have decelerated and housing trends may have lost some momentum after a relatively strong start to the year. Consumer spending has held up pretty well in spite of this year's increase in payroll taxes, but trends may be softening. Overall, the economy is not showing much positive momentum, which may suggest that the impact of fiscal tightening has begun to trickle through the economy.

Yields declined in April, reflecting weaker than expected economic data. Yields also continue to be influenced by the Fed's accommodative monetary policy.

The Federal Open Market Committee left policy rates unchanged at its April 30-May 1 meeting, as expected. The Fed noted that the economy continues to grow at a moderate pace, but cautioned that fiscal policy has been restraining growth. The Fed also highlighted that the housing market has continued to strengthen, while the labor market has also shown some improvement, though unemployment remains unfavorably high. The Fed will continue to purchase mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month. However, for the first time, the Fed officially stated that it may increase or reduce the pace of its asset purchases, depending on the outlook for the labor market and inflation. With the core inflation rate at just 1.9% in March (well below the Fed's trigger rate for policy action of 2.5%), we believe the Fed's current focus is primarily on growth.

TREASURY YIELD CURVE FLATTENED IN APRIL



Yields declined in April, reflecting weaker than expected economic data.

TREASURY YIELDS	4/30/2013	3/31/2013	CHANGE
3 Month	0.05	0.07	(0.02)
2 Year	0.21	0.24	(0.03)
3 Year	0.31	0.35	(0.04)
5 Year	0.68	0.77	(0.09)
7 Year	1.11	1.21	(0.10)
10 Year	1.67	1.85	(0.18)
30 Year	2.88	3.10	(0.22)

Source: Bloomberg

Economic Roundup

Consumer Prices

In March, overall CPI inflation declined to 1.5% on a year-over-year basis from 2.0% in February. The year-over-year Core CPI (CPI less food and energy) edged down to 1.9% from 2.0%. The core inflation rate is slightly below the Fed's long-term goal of 2.0% and remains below the trigger rate for policy action of 2.5%.

Retail Sales

In March, Retail Sales rose 2.8% on a year-over-year basis. However, on a month-over-month basis, Retail Sales declined 0.4% in March. Overall, recent consumer spending trends have held up 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. However, trends may be decelerating.

Labor Markets

The April employment report showed that payrolls increased by 165,000 (better than the 153,000 consensus estimate). The unemployment rate fell to 7.5% from 7.6%. Private payrolls increased 176,000 (slightly ahead of expectations), while government jobs fell 11,000 in April. The net revisions in nonfarm payrolls for February and March were up 114,000. Overall, improvement in the labor market remains moderate.

Housing Starts

Single-family housing starts declined 4.8% in March to 619,000 from 650,000 in February. Multi-family starts rose 31.1% in March. Housing permits dropped 3.9% in the month which was weaker than expected. Recent housing data suggests that the housing market may have lost some momentum after a relatively strong start to the year.

Credit Spreads Were Tighter

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.11	0.10	0.01
2-year A corporate note	0.51	0.54	(0.03)
5-year A corporate note	0.81	0.83	(0.02)
5-year Agency note	0.17	0.17	0.00

Source: Bloomberg Data as of 4/30/13

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.8) $Bln MAR 13	(43.6) $Bln FEB 13	(51.7) $Bln MAR 12
GDP	2.5% MAR 13	0.4% DEC 12	2.0% MAR 12
Unemployment Rate	7.5% APR 13	7.6% MAR 13	8.1% APR 12
Prime Rate	3.25% APR 13	3.25% MAR 13	3.25% APR 12
CRB Index	288.13 APR 13	296.39 MAR 13	305.95 APR 12
Oil (West Texas Int.)	$93.46 APR 13	$97.23 MAR 13	$104.87 APR 12
Consumer Price Index (y/o/y)	1.5% MAR 13	2.0% FEB 13	2.7% MAR 12
Producer Price Index (y/o/y)	1.1% MAR 13	1.7% FEB 13	2.8% MAR 12
Dollar/EURO	1.32 APR 13	1.28 MAR 13	1.32 APR 12

Source: Bloomberg

What Is The Fed's Next Move?

Investors' bias has shifted rather dramatically over the past month, as disappointing economic data has fueled speculation that the Fed may accelerate the pace of its asset purchases to provide additional stimulus to the economy. This notion is driven by the fact that the Fed has clearly linked its guidance for policy action to economic markers and moved away from its previous calendar-based guidance. The Fed has said since December 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%. With unemployment currently at 7.5%, and core CPI at 1.9%, the economy appears ripe for further stimulus. However, just weeks ago, some market participants were beginning to think that the Fed would scale back its quantitative easing (QE) program before the end of this year. The recent deceleration of economic growth has made the outlook for QE uncertain.

Fed policymakers seem conflicted by the data. For example, in early April, Federal Reserve Bank of St. Louis President James Bullard said he favored reducing monthly asset purchases by $10 to $15 billion increments. However, just a few weeks later, Mr. Bullard spoke at a conference in New York and warned that inflation remained too low and suggested that the Fed could increase its rate of asset purchases. Richmond Fed President Jeffrey Lacker, who was strongly opposed to additional QE last September, said at the end of April that he would give serious thought to increasing stimulus if disinflation persists. Nevertheless, we believe current monetary policy is largely being steered by Fed Chairman Bernanke, Vice Chairman Yellen, and New York Fed President Dudley, who have all been supportive of QE.

As long as unemployment remains unfavorably high and consumer prices remain under control, the Fed is likely to remain focused on growth. The statement from last week's Federal Open Market Committee meeting indicates that the Fed may increase or reduce the pace of its asset purchases, depending on the outlook for the labor market and inflation. For now, the Fed will continue to purchase mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month. We believe this program is likely to remain on track through the end of this year, and that it is premature to speculate about a reduction in QE.

Why has investor rhetoric recently shifted toward increased QE? We believe the data speaks for itself. As reflected in the tables below, there was a rather dramatic reversal in economic data for March (which was released on a lagged basis throughout the month of April), after a string of positive data for February. Though one month does not necessarily indicate a trend, we believe the impact of fiscal tightening at home and abroad is beginning to negatively impact economic growth. Not only have we seen weaker economic data in the U.S., but fundamental concerns about the growth trajectory in Europe have increased

JANUARY ECONOMIC DATA (SIGNS OF IMPROVEMENT)

Positive	Neutral	Negative
ISM Manufacturing up 3.1 points to 53.1.	Nonfarm payrolls advanced 148,000.	Consumer Confidence down 8.3 points to 58.4.
ISM Non-Manufacturing Index at 55.2.	Core CPI at 1.9%.	Housing Starts declined 8.1%.
Leading Economic Indicators up 0.5%.	PPI at 1.4%.	Chicago Fed National Activity Index at -0.56.
New Home Sales up 14.1%.		
Existing Home Sales up 0.8%.		
Retail sales rose 0.2%.		

FEBRUARY ECONOMIC DATA (MOSTLY POSITIVE)

Positive	Neutral	Negative
ISM Manufacturing Index at 54.2.	Core CPI at 2.0%.	New Home Sales down 7.6%.
Consumer Confidence up 10 points to 68.0.	PPI 1.8%.	
Nonfarm payrolls up by 332,000.		
ISM Non-Manufacturing Index up 1 point to 56.0.		
Retail Sales up 1.0%		
Leading Economic Indicators up 0.5%.		
Existing Home Sales up 0.2%.		
Housing Starts up 7.3%.		
Chicago Fed National Activity Index at 0.76.		

MARCH ECONOMIC DATA (BELOW EXPECTATIONS)

Positive	Neutral	Negative
Housing Starts up 7.0%.	PPI at 1.1%.	Nonfarm Payrolls up just 138,000.
New Home Sales rose 1.5%.	Core CPI at 1.9%.	ISM Non-Manufacturing Index fell 1.6 points to 54.4.
		ISM Manufacturing Index fell 2.9 points to 51.3.
		Consumer Confidence fell more than 6 points to 61.9.
		Retail Sales declined 0.4%.
		Leading Economic Indicators at -0.1%.
		Existing Home Sales fell 0.6%.
		Chicago Fed National Activity Index fell to -0.23.

Source: Bloomberg

with the ECB cutting policy rates last week and hinting at the possibility of providing additional credit measures to fuel growth. This week, the European Union warned that a recession in the euro zone is likely to continue through the rest of this year. In the U.S., we believe the impact of sequestration (which went into effect on March 1st) may have begun to ripple through the economy over the past two months. We also suspect that rising healthcare costs and the recent increase in payroll taxes have put pressure on consumer spending.

In addition to the deceleration in economic growth during the first quarter, corporate earnings results for the period were also somewhat disappointing. So far, more than 80% of companies in the S&P 500 Index have reported their first quarter 2013 earnings results. According to data compiled by Bloomberg, of those companies that have reported, more than half have posted lower than expected sales for the period. While first quarter earnings per share have been largely better than expected, we believe a lot of the upside has been driven by low-quality factors such as accounting adjustments and share repurchases. In addition, year-over-year earnings growth was generally weak in the first quarter, up just 2.4% on average (compared to 9.2% in the fourth quarter). Sales actually declined 1.4% year-over-year on average, according to Bloomberg data, compared to 3.6% growth in the fourth quarter. Weak topline results are particularly worrisome, considering that revenues are much more difficult than earnings to manipulate with accounting treatments. In addition, we believe management guidance has been more negative than prior quarters, and many companies continue to focus on cost-cutting rather than growth initiatives. Overall, we would characterize first quarter corporate earnings season as being rather lackluster, adding fuel to the speculation that the Fed could step in to provide further stimulus.

We believe the impact of fiscal tightening at home and abroad is beginning to negatively impact economic growth.

The Fed's most recent statement asserted that "fiscal policy is restraining economic growth." This language was more intense than the Fed's previous comment in March that fiscal policy had become "somewhat more restrictive." If fiscal tightening is to blame for the deceleration in March economic data, we believe economic growth is poised to decelerate further, considering that cost-cutting from sequestration still unfolding. However, there is also the possibility that the government will intervene and replace sequestration with a watered down package of spending cuts. We believe last week's better than expected jobs report for April (and the upward revision to payrolls for March and February) reduces the probability of the government making revisions to sequestration and reduces the probability of the Fed adding stimulus. In fact, we believe the rhetoric could shift back toward tapering of asset purchases if the employment report for May is strong.

Our base case scenario assumes that domestic economic growth remains slow and the Fed remains highly accommodative for at least the next 6 months. We also believe sequestration is likely to remain in place over the intermediate-term, and that restrictive fiscal policy will continue to be a drag on the economy. However, we expect that an ongoing recovery in housing through the second half of this year will provide a modest tailwind to economic growth.

- Shelly Henbest

VP, Credit Analyst