CHANDLER ASSET MANAGEMENT

July 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.

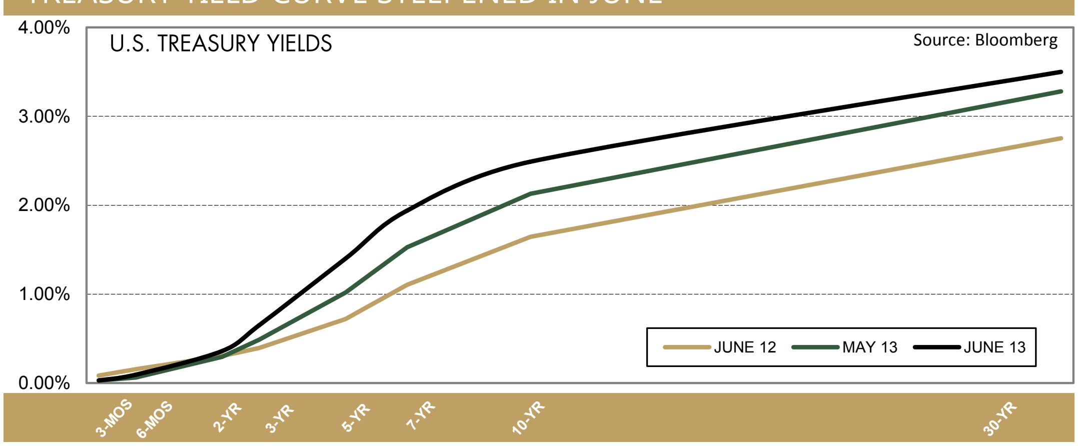
Market Summary

The economy continues to grow slowly. Nonfarm payrolls rose 195,000 in June, which was better than the consensus forecast of 161,000. Average nonfarm payroll growth during the second quarter of 2013 was about 196,000 per month. The unemployment rate remained unchanged in June at 7.6% due to an increase in the labor force. Overall, the labor market continues to improve. Manufacturing trends are beginning to show modest improvement as well, while housing trends remain favorable in spite of the recent jump in interest rates. Consumer spending also remains healthy.

The Treasury yield curve steepened again in June as Fed policymakers continued to discuss winding down quantitative easing. The move has also been influenced by a modest improvement in economic data.

The Federal Open Market Committee left policy rates unchanged at its June 18-19 meeting and assured investors that policy changes continue to be data dependent. The Fed noted that the economy continues to grow at a moderate pace. The labor market has continued to improve, but unemployment remains elevated. Inflation is running below target. 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. During his press conference, Chairman Bernanke indicated that the Fed could begin tapering bond purchases later this year and that asset purchases could end in 2014. However, he emphasized that Fed policy will depend on the state of the economy.

TREASURY YIELD CURVE STEEPENED IN JUNE



The yield curve steepened in June as economic data improved modestly and Fed policy-makers continued to discuss winding down quantitative easing.

TREASURY YIELDS	6/30/2013	5/31/2013	CHANGE
3 Month	0.03	0.03	0.00
2 Year	0.36	0.30	0.06
3 Year	0.65	0.49	0.16
5 Year	1.40	1.02	0.38
7 Year	1.94	1.53	0.41
10 Year	2.49	2.13	0.36
30 Year	3.50	3.28	0.22

Source: Bloomberg

Economic Roundup

Consumer Prices

In May, overall CPI inflation rose to 1.4% on a year-over-year basis from 1.1% in April. The year-over-year Core CPI (CPI less food and energy) was unchanged at 1.7%. The core inflation rate is trending 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 May, Retail Sales rose 4.3% on a year-over-year basis. On a month-over-month basis, Retail Sales increased 0.6% in May, which was slightly better than expected. Overall, recent consumer spending trends have been favorable.

Labor Markets

The June employment report showed that payrolls increased by 195,000 (better than the 161,000 consensus estimate). The net revisions for job growth in April and May were +70,000. Average nonfarm payroll growth over the past 3 months has been about 196,000. Private payrolls increased 202,000 in June while government jobs fell 7,000. The unemployment rate remained unchanged at 7.6% due to an increase in the labor force. Overall, the jobs report was better than expected and job growth is showing positive momentum.

Housing Starts

Single-family housing starts rose slightly in May to 599,000 from 597,000 in April. Housing permits eased 3.1% in the month after rising 12.9% in April. Recent housing data has been mostly favorable.

Credit Spreads Widened in June

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.13	0.12	0.01
2-year A corporate note	0.71	0.54	0.17
5-year A corporate note	0.86	0.79	0.07
5-year Agency note	0.24	0.16	0.08

Source: Bloomberg Data as of 6/30/13

Economic Data Remains Indicative of Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(45.0) $Bln MAY 13	(40.1) $Bln APR 13	(46.2) $Bln MAY 12
GDP	1.8% MAR 13	0.4% DEC 12	2.0% MAR 12
Unemployment Rate	7.6% JUN 13	7.6% MAY 13	8.2% JUN 12
Prime Rate	3.25% JUN 13	3.25% MAY 13	3.25% JUN 12
CRB Index	275.62 JUN 13	281.85 MAY 13	284.19 JUN 12
Oil (West Texas Int.)	$96.56 JUN 13	$91.97 MAY 13	$84.96 JUN 12
Consumer Price Index (y/o/y)	1.4% MAY 13	1.1% APR 13	1.7% MAY 12
Producer Price Index (y/o/y)	1.7% MAY 13	0.6% APR 13	0.6% MAY 12
Dollar/EURO	1.30 JUN 13	1.30 MAY 13	1.27 JUN 12

Source: Bloomberg

Slowing Growth In China And What It Means For The Global Economy

Concerns about China's economy have made headlines in recent weeks, as the country's interbank and money market interest rates soared to record highs last month. The spike in rates along with weakening economic data has fueled investors' anxiety about the safety of China's banking system and the sustainability of the country's economic growth.

A tightening in liquidity, along with an apparently deliberate move by the People's Bank of China to hold back on providing stimulus, drove overnight repo rates to surge as high as 30% in June, essentially freezing credit markets in China. The run-up in rates was driven by a number of factors, including fears that lending activities had become overstretched, speculation in the media that China could be facing a banking crisis, as well as actions by Chinese authorities to induce monetary tightening and discipline speculators in the country's shadow banking system. While China's central bank eventually injected liquidity into the system at the end of June and interbank lending rates have since eased, it has become evident to market participants that China's new leadership may be willing to tolerate higher interest rates and slower economic growth in pursuit of financial sector deleveraging and reform.

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Last November, Xi Jinping was named head of the Communist Party in China and subsequently became President in March. Since he has taken office, Mr. Xi has indicated that he wants to revamp China's economic structure and move toward greater interest rate liberalization (allowing market forces to have a greater influence on interest rates). Also in March, Li Keqiang was elected by the Chinese Congress as Premier (China's head of government and an influential driver of economic policy).

Like Mr. Xi, Mr. Li has vowed to reduce the government's role in the economy and supports private enterprise and fiscal reform. These recent changes in leadership seem to be shifting the trajectory of the Chinese economy to some degree. Policymakers appear willing to accept short-term pain for longer-term gains.

Over the past decade, China's economic growth had been fueled by a number of factors including massive state spending, strong export growth (supported by low-cost labor), a burgeoning real estate market and easy access to credit. However, it appears that these factors are now decelerating.

In 2012, China's GDP grew by 7.8%. It was the first time growth had come in below 8% in more than a decade. For the second quarter of 2013, economists are forecasting GDP growth of roughly 7.6%, a deceleration from first quarter growth of 7.7% (which was below expectations of 8%). Growth is expected to decelerate further in the third quarter to 7.4%, according to Bloomberg. While GDP growth of more than 7% may seem strong when compared to GDP growth of roughly 2% in the U.S., it represents a slowdown for China.

The deceleration in China's economy has been reflected in the recent decline in the country's closely watched purchasing managers' indices as well as the recent weakening in Chinese trade data. Manufacturing investment has declined, as evidenced by the drop in China's HSBC PMI for June to 48.2 (the lowest reading since November 2011). A reading below 50 is indicative of a contraction in factory activity. China's official PMI was 50.1 in June, a decline from 50.8 in May, pointing to lackluster manufacturing growth.

Meanwhile, Chinese exports declined 3.1% in June on a year-over-year basis compared to 1% year-over-year growth in May. In addition, Chinese imports fell 0.7% in June, reflecting weaker demand. Sluggish global economic growth, including an ongoing recession in Europe, has put pressure on China's exports, which has negatively impacted China's manufacturing sector and contributed to the country's overall slowdown.

We believe the most immediate risks related to China's slowdown are to commodity prices (where we have already seen significant volatility) and to second quarter corporate earnings (and second half 2013 forecasts) for companies that generate a significant portion of their revenues in China and/or companies that have been counting on China to be their growth-driver. We believe the slowdown in China also has the potential to spill over to other economies, especially in countries like Australia, South Korea, Taiwan, Indonesia, Japan, and Singapore. Europe, which is already struggling, is also likely to feel additional pain from China's slowdown. In terms of the U.S. economy, the fact that China's policymakers seem to be backing away from providing stimulus at the same time the U.S. Federal Reserve is mapping out its own exit from stimulus does, in our view, add risk to the sustainability of our economic recovery.

We believe the structural changes taking place in China will be a headwind to the global economy over the near term.

We believe speculation in the media about a potential banking crisis in China may be overblown. The difference between what happened in the U.S. during the financial crisis and the trouble that appears to be brewing in China is that all big Chinese banks are owned, or are at least partially controlled, by the government. As such, we believe it is unlikely that Chinese authorities would allow a systemically important bank to fail. Nevertheless, Chinese policymakers have signaled less willingness to provide ongoing stimulus, and any risk to the financial stability of China's banks is a headwind for economic growth in our opinion.

This week, the International Monetary Fund lowered its growth forecast for the global economy to 3.1% in 2013 from its previous forecast of 3.3%. The IMF cited slower growth in developing economies such as China, as well as a deepening recession in the Eurozone, as reasons for the downward revision. The IMF cut its growth forecast for China to 7.7% in 2013 from its previous forecast of 8.3%. The downward revision to the IMF's growth forecast for the U.S. was less severe, down just 0.2 percentage points to 1.7%.

Overall, we believe the structural changes taking place in China will be a headwind to the global economy over the near term. However, we believe the country's new leadership regime is focused on putting China on a longer-term path to stability and consumer-led (rather than government-led) economic growth.

- Shelly Henbest
VP, Credit Analyst