CHANDLER ASSET MANAGEMENT

August 2013

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

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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.

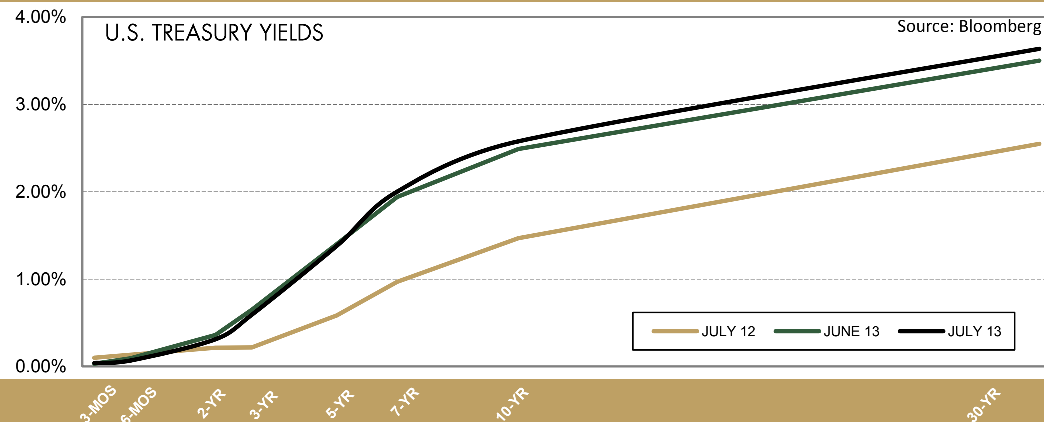
Market Summary

The economy continues to grow at a slow pace driven by modest improvement in the labor market. Nonfarm payrolls rose 162,000 in July, which was less than the consensus forecast of 175,000. Average nonfarm payroll growth over the past 3 months has been about 175,000 per month. The unemployment rate declined to 7.4% from 7.6%. Overall, the jobs report for July was weak, but the labor market continues to improve. Meanwhile, manufacturing trends have been showing positive momentum over the past few months. Housing trends also remain favorable, but there are some early signals that the recent jump in interest rates is beginning to pressure homebuyers.

There has been increased volatility in Treasury yields over the past few months as Fed policymakers discuss winding down quantitative easing. In July, intermediate-term rates declined while very short- and longer-term rates increased.

The Federal Open Market Committee left policy rates unchanged at its July 30-31 meeting and did not announce any changes to the pace of its bond purchases. The Fed continued to assure investors that policy changes will be data dependant and that the general thresholds are an unemployment rate of 6.5% and/or expectations of 2.5% inflation. The Fed slightly downgraded its view of the economy by stating that "economic activity expanded at a modest pace" versus the June statement that "economic activity expanded at a moderate pace." There was no press conference after the release of the July FOMC statement, leaving market participants to continue speculating about the timing of future Fed tapering. The Fed has signaled that changes to the pace of its bond purchases are ahead, but the timing and magnitude remain uncertain and will depend on the economy.

VOLATILITY IN TREASURY YIELDS HAS INCREASED IN JULY



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TREASURY YIELDS	7/31/2013	6/30/2013	CHANGE
3 Month	0.04	0.03	0.01
2 Year	0.31	0.36	(0.05)
3 Year	0.59	0.65	(0.06)
5 Year	1.38	1.40	(0.02)
7 Year	2.00	1.94	0.06
10 Year	2.58	2.49	0.09
30 Year	3.64	3.50	0.14

Source: Bloomberg

Consumer Prices

In June, overall CPI inflation rose to 1.8% on a year-over-year basis from 1.4% in May. The year-over-year Core CPI (CPI less food and energy) declined slightly to 1.6% from 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 June, Retail Sales rose 5.7% on a year-over-year basis. On a month-over-month basis, Retail Sales increased 0.4% in June which was below the +0.8% consensus forecast. Overall, recent consumer spending trends have been healthy.

Labor Markets

The July employment report was disappointing as payrolls increased by 162,000 vs. the 175,000 consensus estimate. The net revisions for job growth in May and June were negative 26,000. Average nonfarm payroll growth over the past three months has been about 175,000. Private payrolls increased 161,000 in July while government jobs rose 1,000. The unemployment rate declined to 7.4% from 7.6%. Overall, the jobs report was somewhat weak.

Housing Starts

Single-family housing starts fell slightly in June to 591,000 from 596,000 in May. Meanwhile, multifamily starts dropped 26.2% in the month. Housing permits also declined in June by 7.5% after falling 2.0% in May. Recent housing data has been generally favorable, but the most recent housing starts report was disappointing.

Credit Spreads Tightened in July

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.13	(0.01)
2-year A corporate note	0.63	0.71	(0.08)
5-year A corporate note	0.77	0.86	(0.09)
5-year Agency note	0.26	0.24	0.02

Source: Bloomberg Data as of 7/31/13

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	1.7% JUN 13	1.1% MAR 13	1.2% JUN 12
Unemployment Rate	7.4% JUL 13	7.6% JUN 13	8.2% JUL 12
Prime Rate	3.25% JUL 13	3.25% JUN 13	3.25% JUL 12
CRB Index	283.94 JUL 13	275.62 JUN 13	299.51 JUL 12
Oil (West Texas Int.)	$105.03 JUL 13	$96.56 JUN 13	$88.06 JUL 12
Consumer Price Index (y/o/y)	1.8% JUN 13	1.4% MAY 13	1.7% JUN 12
Producer Price Index (y/o/y)	2.5% JUN 13	1.7% MAY 13	0.7% JUN 12
Dollar/EURO	1.33 JUL 13	1.30 JUN 13	1.23 JUL 12

Source: Bloomberg

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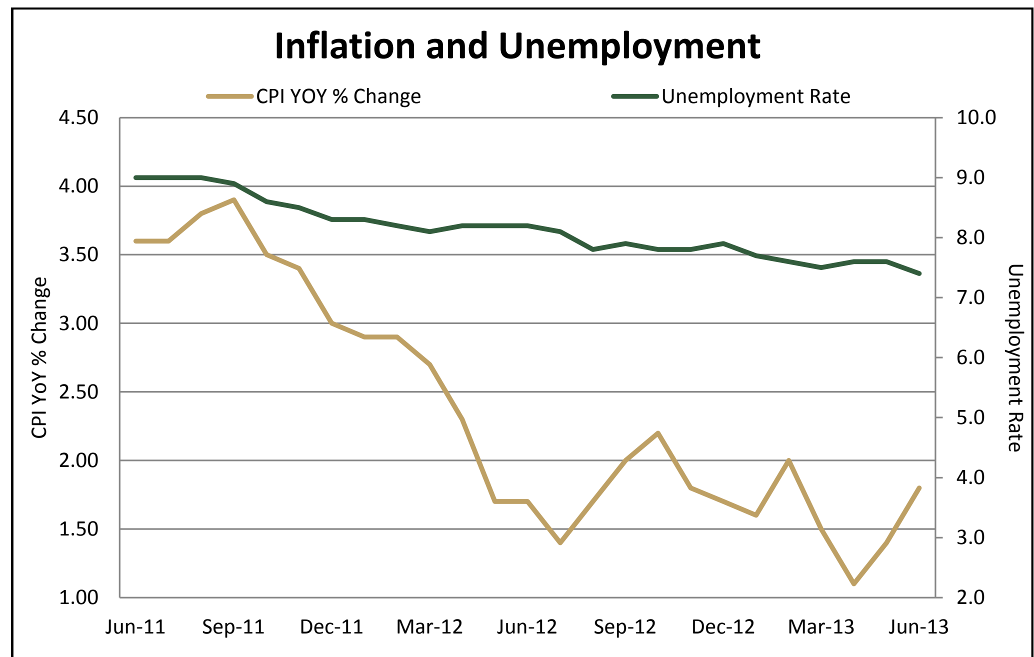
Who's Next? Filling the Chair at the Fed

The term of current Fed Chair Ben Bernanke ends January 31, 2014. The President has said he is likely to make an appointment of the new Chair this fall; an appointment that will have to be vetted and consented to by Congress. There has been considerable analysis and opinion in the financial and political press of late about who will succeed Bernanke as Chairman of the Federal Reserve. Mr. Bernanke, who has led the Fed since 2006, began a welcome policy of transparency regarding Fed thought and actions, for which he will long be remembered. Perhaps higher in the ranks of current thinking about his tenure, is that he imposed the drastic monetary policies known as "Quantitative Easing," QEs 1 through 4, which have worked well to bring the US out of the financial meltdown of 2008 and the "Great Recession" of 2007-2009. Since that time, the unemployment rate has gone from a high of 10% in October 2009 to its July 2013 level of 7.4%, while inflation has remained in check, as the chart on the right shows.



We have shown the Fed balance sheet several times before in our Newsletter, but let us look at it again on the next page.

Fed assets jumped vertically from less than $1 billion to almost $2.5 billion as the crisis began to unfold in 2008. After the initial leap until the present time, assets continued to climb, albeit more gradually, to the current level of approximately $3.5 billion.

Like most seemingly successful strategies, QE came at a price—the expansion of the Fed's balance sheet. The mechanism for implementing QE was the Fed's purchase of an immense amount of US Treasury and mortgage debt. The goal was to take so much of the supply of high quality debt out of the market that scarcity would bring prices higher, and concomitantly bring interest rates down. The low interest rates would then stimulate borrowing and help bring the economy back from the brink. Furthermore, extremely low rates on high quality fixed income debt created significant demand for higher "beta", *i.e.*, riskier, asset classes. As these riskier asset classes, primarily equities and foreign debt, increased in value, consumer balance sheets (particularly IRAs and other retirement savings accounts) began to look much stronger. The net effect was that consumers, with a cushion of savings and normalizing home prices began to feel comfortable spending again.

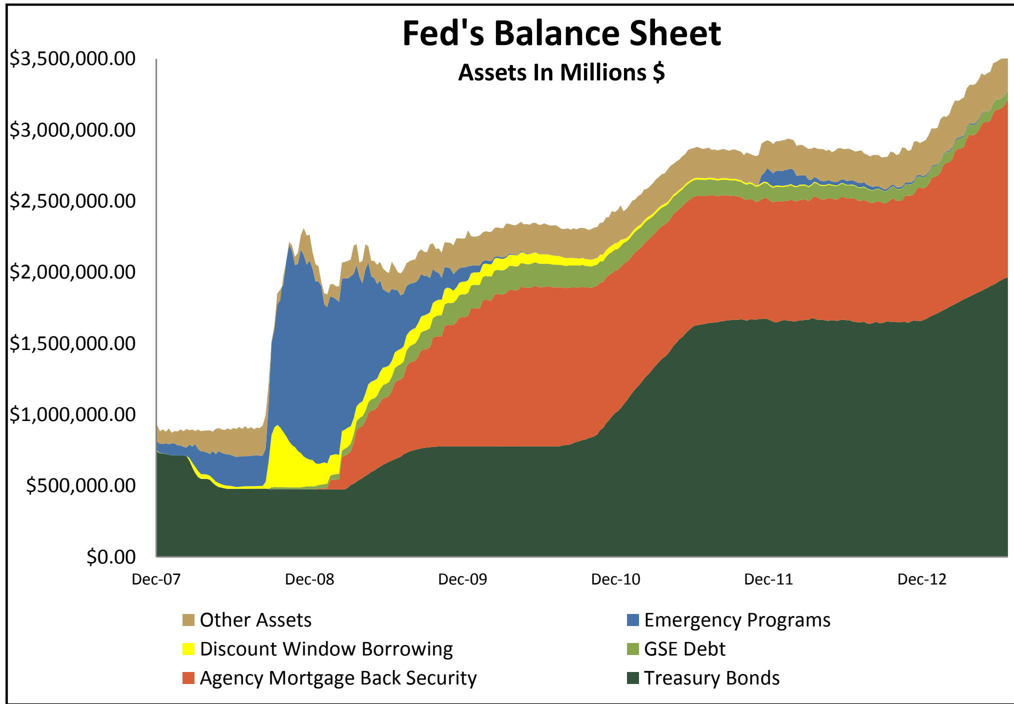
Most market observers believe (and hope!) that over the next few years, the economy will continue to expand, perhaps even at an accelerated pace, and that inflation will remain contained. If the future unfolds in that way, the main focus of the new Fed Chair is likely to be the controlled unwinding of QE. The period of QE unwinding is likely to be both delicate and treacherous. The Fed's twin mandates of full employment and constrained inflation can be at odds, and thus difficult to achieve during the expected unwinding of QE over the next few years.

Given that critical task, who might be the best candidate to lead the Fed next?

Janet Yellen

At this point in the process, the clear leader among market prognosticators is Janet Yellen.

Dr. Yellen is an experienced economist and a veteran at the Fed. She earned her PhD in economics at Yale in 1971 and taught at Harvard University before becoming an economist at the Fed. Since 1980, she has taught macroeconomics to MBA students and done research at UC Berkeley. She served as Chair of President Clinton's Council of Economic Advisers for two years, and was Chair of the Federal Reserve Bank of San Francisco and a voting member of the Federal Open Market Committee (FOMC). She currently serves as a Fed Governor and as Vice-Chair of the Federal Reserve System.



Yellen has been seen as a Fed "Dove," meaning that she is more concerned with unemployment than with price stability. She might be slower to reverse QE than other candidates for the job; perhaps boosting employment while risking higher inflation. Still, in recent years, she has made more balanced statements and is highly regarded within the Fed.

Lawrence Summers

The second major contender is Lawrence Summers, former Treasury Secretary under President Obama, as well as Obama's Director of the National Economic Council. He is somewhat more outspoken than Yellen and is viewed as provocative, or even polarizing. His credentials for taking on the Chairmanship include his work as an economic adviser and Treasury secretary under President Clinton, and his close relationship with President Obama as an adviser. Currently, he seems to be more constructive than Yellen about US near-term economic prospects. Market fears around Summers may be geared more to an unwinding of QE that is too quick, thus presenting a risk to economic growth.

The Field

Other possible candidates include **Donald Kohn**, a 40-year veteran of the Fed; **Roger Ferguson**, an Obama adviser and Chair of the bank supervision committee of the FOMC; **Christina Romer**, another Obama economic adviser; **Alan Blinder**, former Vice-Chair of the FOMC; **Tim Geithner**, former Treasury Secretary and President of the New York Fed; and, finally, **Ben Bernanke** himself—the current Chair and father of QE may be the best person to undo QE.

The next Chairman of the US Federal Reserve, whoever it may be, will face the challenge of developing monetary policies that will invigorate a US economy that is tepid now, and maintain inflation at an acceptable level, while, at the same time, unwinding the Quantitative Easing that is one of the hallmarks of Ben Bernanke's tenure as Fed Chair.

- Kay Chandler, CFA
President

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