CHANDLER ASSET MANAGEMENT

September 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.

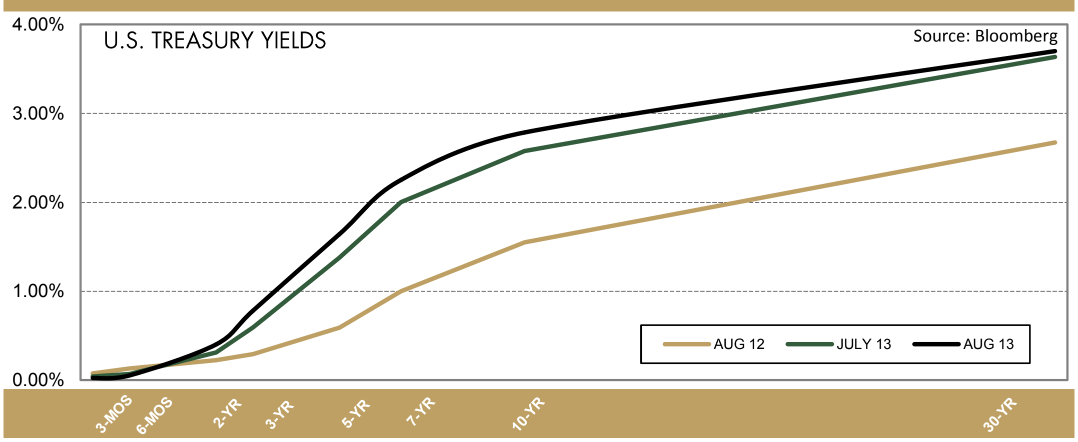
Market Summary

The economy remains on a slow growth trajectory, and the labor market continues to improve modestly. Nonfarm payrolls rose 169,000 in August, which was less than the consensus forecast of 175,000. Average nonfarm payroll growth over the past three months has been about 148,000 per month. The unemployment rate declined to 7.3% from 7.4% due to a decline in the labor participation rate. Overall, the labor market continues to improve at a lackluster pace. Manufacturing and consumer spending trends have been mixed. Housing trends remain generally positive, but there are some signals that rising interest rates could begin to pressure the sector. Meanwhile, geopolitical concerns and uncertainty about Fed policy have continued to create volatility in the financial markets.

There has also been increased volatility in Treasury yields over the past few months. In August, rates generally increased, particularly in the 3-year to 10-year portion of the curve.

The timing of future Fed tapering remains uncertain, but several market participants are expecting the Fed to announce a modest reduction to their bond buying program at the next Federal Open Market Committee meeting on September 18. For the past few months, the Fed has been signaling that changes to the pace of its bond purchases are ahead, but hasn't pinpointed the magnitude or timing of the changes. At its previous meeting in July, the FOMC left the fed funds rate unchanged and we expect the fed funds rate to remain unchanged for at least the next six months. The Fed continues to assure investors that all policy changes will depend on the state of the economy, and that the general thresholds for contractionary policy action are an unemployment rate of 6.5% and/or expectations of 2.5% inflation.

TREASURY YIELDS REMAIN VOLATILE IN AUGUST



There has been increased volatility in Treasury yields over the past few months as Fed policymakers discuss winding down quantitative easing. In August, rates generally increased, particularly in the 3-year to 10-year portion of the curve.

TREASURY YIELDS	8/31/2013	7/31/2013	CHANGE
3 Month	0.02	0.04	(0.02)
2 Year	0.40	0.31	0.09
3 Year	0.78	0.59	0.19
5 Year	1.64	1.38	0.26
7 Year	2.25	2.00	0.25
10 Year	2.79	2.58	0.21
30 Year	3.70	3.64	0.06

Source: Bloomberg

Economic Roundup

Consumer Prices

In July, overall CPI inflation rose to 2.0% on a year-over-year basis from 1.8% in June. The year-over-year Core CPI (CPI less food and energy) rose slightly to 1.7% from 1.6%. The core inflation rate is still 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 July, Retail Sales rose 5.4% on a year-over-year basis. On a month-over-month basis, Retail Sales increased 0.2% in July which was slightly below the 0.3% consensus forecast. Overall, recent consumer spending trends have been healthy, but not robust.

Labor Markets

The August employment report was disappointing as payrolls increased by 169,000 versus the 175,000 consensus estimate. The net revisions for job growth in June and July were -74,000. Average nonfarm payroll growth over the past three months has been about 148,000. Private payrolls increased 152,000 in August while government jobs rose 17,000. The unemployment rate declined to 7.3% from 7.4% due to a decline in the labor participation rate. Overall, the jobs report was lackluster.

Housing Starts

Single-family housing starts fell 2.2% in July to 591,000 from 604,000 in June. Meanwhile multifamily starts rose 24.8% in the month. Housing permits rose 2.7% in July. Recent housing data has been mixed, but mostly favorable.

Credit Spreads Were Little Changed In August

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	0.64	0.63	0.01
5-year A corporate note	0.74	0.77	(0.03)
5-year Agency note	0.26	0.26	0.00

Source: Bloomberg Data as of 8/31/13

Economic Data Remains Indicative of Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(39.1) $Bln JUL 13	(34.5) $Bln JUN 13	(43.5) $Bln JUL 12
GDP	2.5% JUN 13	1.1% MAR 13	1.2% JUN 12
Unemployment Rate	7.3% AUG 13	7.4% JUL 13	8.1% AUG 12
Prime Rate	3.25% AUG 13	3.25% JUL 13	3.25% AUG 12
CRB Index	291.16 AUG 13	283.94 JUL 13	309.59 AUG 12
Oil (West Texas Int.)	$107.65 AUG 13	$105.03 JUL 13	$96.47 AUG 12
Consumer Price Index (y/o/y)	2.0% JUL 13	1.8% JUN 13	1.4% JUL 12
Producer Price Index (y/o/y)	2.1% JUL 13	2.5% JUN 13	0.5% JUL 12
Dollar/EURO	1.32 AUG 13	1.33 JUL 13	1.26 AUG 12

Source: Bloomberg

Europe's Nascent Economic Recovery

After six quarters of declining gross domestic product in the euro zone, economic growth finally turned positive in the second quarter of 2013, marking the end of a long recession in the region. Several recent economic data points have also been indicative of improving economic conditions in Europe. Meanwhile, fears of a potential breakup in the euro zone which rattled the financial markets over the past few years have diminished significantly, due in large part to accommodation from the European Central Bank and stabilization in demand. It appears that market participants have become more complacent about Europe as tail risks from a European breakup have dissipated. Many investors are now looking to Europe for undervalued investment opportunities. However, Europe is not completely out of the woods in our view, as core structural economic issues have not been completely resolved and many of the peripheral countries continue to struggle.

RECENT EURO ZONE ECONOMIC DATA (Aggregate data for euro zone member states)
Positive
Industrial output rose 1.1% in 2Q13 (the fastest pace since 4Q10).
2Q13 GDP rose 0.3% (following 6 quarters of declines).
Construction output rose 1% in 2Q13 (the strongest rise since1Q11).
Manufacturing PMI rose to 51.4 in August from 50.3 in July (above 50 indicates growth).
Consumer confidence rose to -15.6 in August from -17.4 in July (better than expected).
Business Climate Indicator rose to -0.21 in August from -0.52 in July (the 4th monthly increase).
Gross fixed capital formation rose 0.3% in 2Q13 from 1Q13.
Exports rose 3% in June from May (seasonally adjusted basis), while imports rose 2.5%.
Government spending rose 0.4% in 2Q13 from 1Q13 (a sign that austerity is easing).
Neutral
CPI remained unchanged at 1.6% year-over-year in July. Core CPI also remained unchanged at 1.1%.
Unemployment remained steady at 12.1% in July (highest in Greece and Spain, lowest in Austria and Germany).
PPI rose to 0.2% year-over-year in July, after rising at a rate of 0.3% in June (slightly higher than expected).
Retail sales declined 1.3% year-over-year in July, but rose 0.1% from June.
Negative
M3 money supply slowed in July to 2.2% year-over-year from 2.4% in June (lower than expected).
Private sector loans declined 1.9% year-over-year in July, faster than the 1.6% decline in June.

While economic data in the euro zone has improved, GDP growth in the region is still lagging behind growth in other parts of the world such as the United States and China. Moreover, improving economic data in the euro zone has also largely been fueled by gains in core nations such as Germany and France. Meanwhile, economic growth in many of the southern peripheral countries such as Cyprus, Greece, Italy, and Spain, has continued to contract and unemployment levels remain unfavorably high. The unemployment rates in Greece and Spain remain well over 20%. Many of the peripheral countries also continue to contend with very high government debt to GDP ratios. At the end of the first quarter, the sovereign debt to GDP ratios in Greece, Italy, Portugal and Ireland were each above 100%.

European Central Bank (ECB) policymakers have made strides toward stabilizing the European economy and tackling the region's debt crisis. They have lowered interest rates (the ECB's benchmark interest rate currently stands at a record low of 0.5%, down from 4.25% in 2008) and provided cheap financing to euro zone banks through the Long-Term Refinancing Operations (LTRO), which launched in December 2011. However, governments are largely expected to maintain their austerity policies, in an effort to curtail their heavy sovereign debt loads. In our view, this means the euro zone is unlikely to see a significant jump in economic growth anytime soon. In addition, the ECB is unlikely to keep its key interest rate low for long, given that its primary mandate is to protect price stability (unlike the Federal Reserve's dual mandate of maximizing employment and price stability). As such, we believe investment downside risks still remain and investors should be selective about their exposure to Europe.

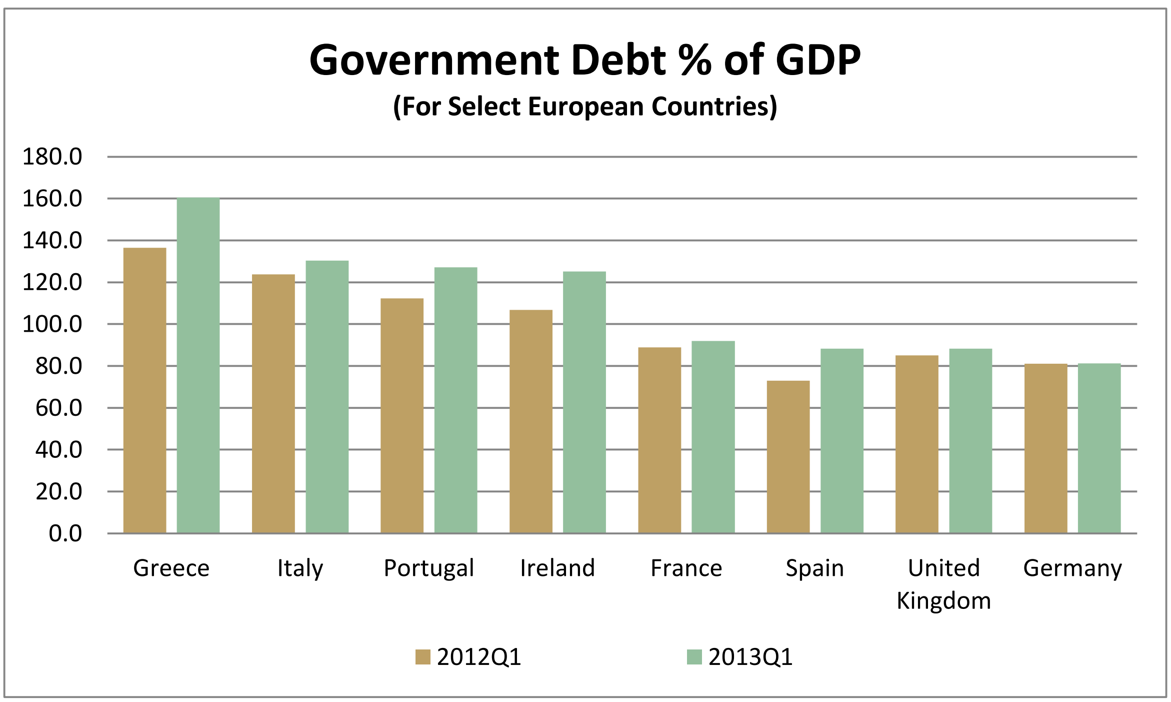
We remain particularly cautious about many European banks, which are still working to implement stricter capital requirements. The euro zone is also still in the early stages of developing a banking union in which the ECB and national supervisory authorities will jointly assess the health of systemically important banks. European leaders are taking steps in the right direction, but structural reforms take time to implement.

Nevertheless, we believe improving economic conditions in Europe could be a tailwind for corporate earnings in the second half of 2013. Economists at BCA Research estimate that corporate operating earnings in the euro zone could rebound meaningfully by the end of this year. They believe the catalysts for improvement in corporate profits will be a decline in borrowing and labor costs, as well as a reduction in government fiscal austerity.

We believe earnings upside exists not only for European-based corporations, but also for U.S.-based multinationals. Whereas Europe has been a weak spot for many corporations (such as Ford, Staples, and Coca-Cola) over the past year, we believe improving economic fundamentals in Europe could contribute to positive earnings surprises for these companies in coming quarters.

- Shelly Henbest

VP, Credit Analyst



Source: eurostat