CHANDLER ASSET MANAGEMENT

October 2013

# BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

WHAT'S INSIDE



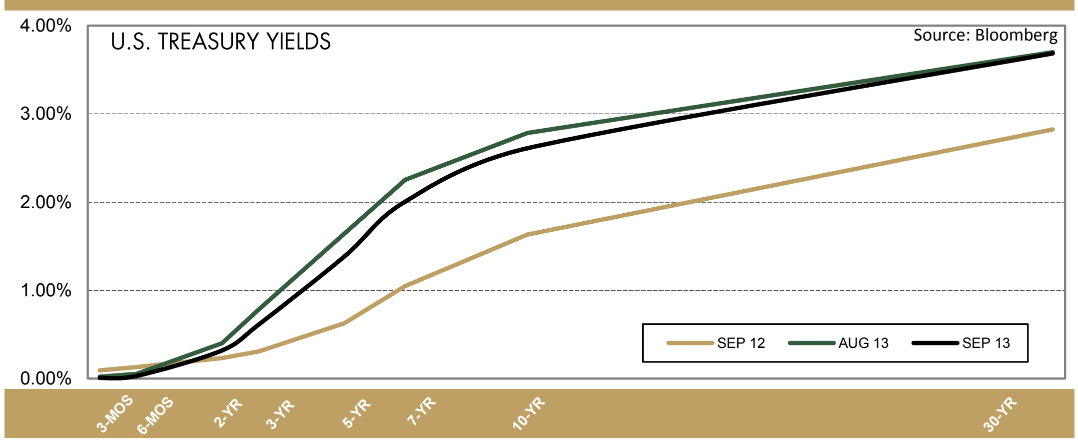
Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our clients' portfolios.

## Market Summary

Economic growth remains lackluster. The partial government shutdown coupled with disagreement over the terms of increasing the US debt limit are likely to negatively impact GDP growth in the fourth quarter. We expect the rhetoric around an increase of the debt ceiling to remain elevated with a resolution taking place at the eleventh-hour, consistent with recent negotiations in Washington. Non-farm payrolls are typically released on the first Friday of every month providing a rich source of data about the strength of the economy. Due to the government shutdown data was not released on October 4; market participants had to rely on more seasoned data as well as secondary private data sources to make conclusions about the direction of the economy. Non-farm payrolls had been trending downward, with a three-month moving average of 148,000 in August versus a three-month moving average of 182,000 in June of this year. Additionally, President Obama formally announced Janet Yellen as the nominee to replace Ben Bernanke as Chairperson of the Federal Reserve; the confirmation process will take place in the fourth quarter of 2013.

In September, the markets were surprised when the Federal Reserve did not announce a reduction in its bond buying program (Quantitative Easing) at the September 18 Federal Open Market Committee (FOMC) meeting. Highly stimulative monetary policy remains in place with the Fed Funds rate remaining in the 0.00 to 0.25% range. The Fed continues to buy a total of $85 billion per month, split between Treasury and Mortgage Backed Securities. The Fed refrained from scaling back Quantitative Easing based on concerns about the strength and sustainability of the recovery; Fed members are looking for more confirming positive data before changing policy. We expect interest rate volatility to remain elevated as the market continues to speculate when the reduction in Quantitative Easing will commence.

### TREASURY YIELDS LOWER IN SEPTEMBER




Treasury rates declined after the decision by the Federal Reserve not to begin tapering their asset purchase program. Additionally, market expectations regarding the start of the monetary policy tightening cycle were pushed back, helping to drive Treasury rates lower.

| TREASURY YIELDS | 9/30/2013 | 8/31/2013 | CHANGE |
|---|---|---|---|
| 3 Month | 0.01 | 0.02 | (0.01) |
| 2 Year | 0.32 | 0.40 | (0.08) |
| 3 Year | 0.61 | 0.78 | (0.17) |
| 5 Year | 1.38 | 1.64 | (0.26) |
| 7 Year | 2.01 | 2.25 | (0.24) |
| 10 Year | 2.61 | 2.79 | (0.18) |
| 30 Year | 3.69 | 3.70 | (0.01) |

Source: Bloomberg

**Consumer Prices**

In August, overall CPI inflation rose to 1.5% on a year-over-year basis from 2.0% in July. The year-over-year Core CPI (CPI less food and energy) rose slightly to 1.8% from 1.7%. 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 August, Retail Sales rose 4.7% on a year-over-year basis. On a month-over-month basis, Retail Sales increased 0.2% in August, which was below the 0.5% consensus forecast; however, the gain in July was revised up to 0.4% from 0.2%. Overall, recent consumer spending trends have been healthy, but not robust.

**Labor Markets**

The September employment report has been delayed due to the federal government shutdown. The market was expecting payroll growth of about 184,000 in September, following lower than expected growth of 169,000 in August.

**Housing Starts**

Single-family housing starts rose 7.0% in August to 628,000 from 587,000 in July. Housing permits fell 3.8% in July. Recent housing data has been mixed but mostly favorable.

## Credit Spreads Were Little Changed in September

| 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 | 0.60 | 0.64 | (0.04) |
| 5-year A corporate note | 0.80 | 0.74 | 0.06 |
| 5-year Agency note | 0.33 | 0.26 | 0.07 |

Source: Bloomberg Data as of 9/30/13

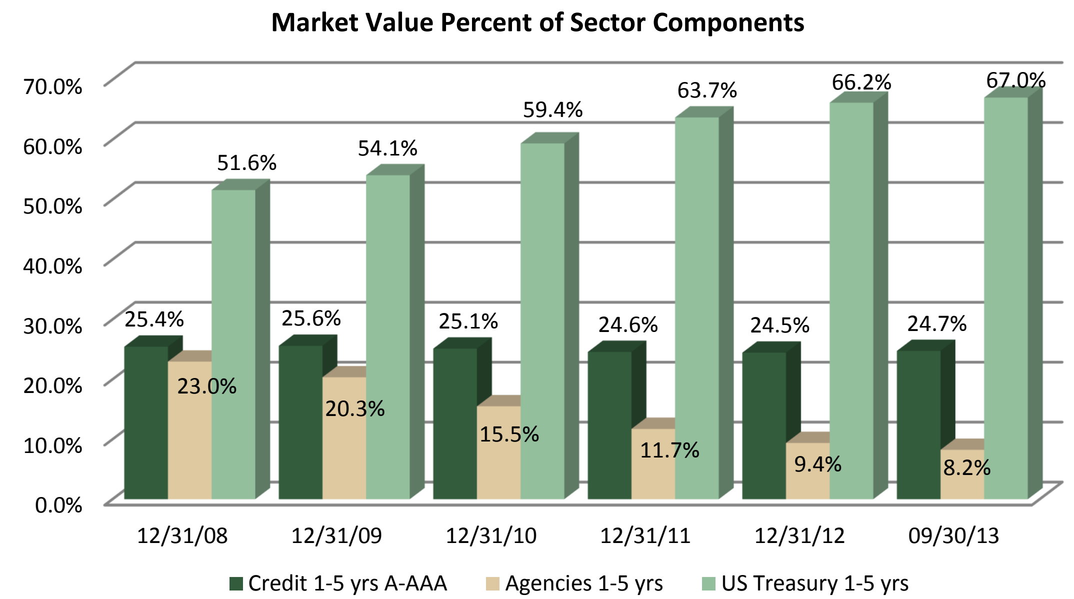
## Economic Data Remains Indicative of Slow Growth

| 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% SEP 13 | 3.25% AUG 13 | 3.25% SEP 12 |
| CRB Index | 285.54 SEP 13 | 291.16 AUG 13 | 309.30 SEP 12 |
| Oil (West Texas Int.) | $102.33 SEP 13 | $107.65 AUG 13 | $92.19 SEP 12 |
| Consumer Price Index (y/o/y) | 1.5% AUG 13 | 2.0% JUL 13 | 1.7% AUG 12 |
| Producer Price Index (y/o/y) | 1.4% AUG 13 | 2.1% JUL 13 | 1.9% AUG 12 |
| Dollar/EURO | 1.35 SEP 13 | 1.32 AUG 13 | 1.29 SEP 12 |

Source: Bloomberg

# An Investor's Perspective on the Contracting Agency Sector

Five years since the historic announcement by the US Treasury in September 2008, Fannie Mae and Freddie Mac remain in conservatorship, essentially a division of the US Treasury. The conservatorship status served to shore up investor concerns about the credit worthiness of both Fannie Mae and Freddie Mac, and yields on their respective securities responded in kind. How to ultimately wind down the aforementioned Agencies has been a controversial topic within the United States government since the financial crisis. Many proposals have been put forth by both the President and Congressional leadership over the past several years, but a clear end-game is not yet evident. The latest bipartisan proposal, titled Housing Finance Reform and Taxpayer Protection Act of 2013, was put forth by Republican Senator Bob Corker and Democratic Senator Mark Warner on June 25 of this year, but little progress has been made since. Both Fannie Mae and Freddie Mac remain an integral part of the mortgage market despite the impact the conservatorship status has had on each. We do not anticipate any legislation gaining enough bipartisan support to wind down the Agencies over an intermediate time horizon (3-5 years).




*Source: Bank of America Merrill Lynch Global Bond Indices*
*Credit: US Corps and all Yankees, dollar denominated. Agences: Unsubordinated debt, dollar denominated*

At Chandler, we focus our investment process around three tenets: safety, liquidity, and yield, in that order. Many of our clients have investment mandates that require them to invest in securities that have a final maturity of less than five years. To illustrate the changing market dynamics, particularly in the Agency sector, we analyzed a time series of three high quality market indices in the 1-to-5 year maturity range to better illustrate how the market has evolved (see chart).

The Agency sector of the market has decreased materially, currently representing only 8.2% of the respective market benchmarks (as of 9/30/13) versus 23.0% on 12/31/08. The Credit component of the benchmark has held relatively stable, while the Treasury portion has increased from 51.6% of the benchmark as of 12/31/08 to 67.0% as of 9/30/13. Historically, investors have gravitated to the Agency sector of the market to pick up a modest amount of incremental yield and potential return with a negligible uptick in credit risk. Chandler Asset Management is not beholden to the Agency sector but rather is an advocate of having a diversified portfolio that includes an allocation to the three above mentioned sectors as well as other fixed income assets that meet the tenets of safety, liquidity, and yield. In the past, we have written about the benefits of the Credit sector (see January 2012 article, Investing High Quality Portfolio in a Low Rate Environment and September 2012 article, Considerations for Moving Down in Corporate Credit Quality) and still find the overall yield benefit of the credit sector compelling, however, the focus of this article is concentrated on the Agency sector.

The team at Chandler broke down the components of the Agency 1-5 Year universe into two primary components, non callable (bullet) versus callable issuance (see table on next page). We theorize that due to the insatiable demand for Agency securities coupled with the decreasing amount of supply, the Agency sector is able to issue securities that investors may be mispricing, particularly in the more complicated callable component of the market. The table does not incorporate all Agency issuance available, but rather the focus is only in the index eligible deals (minimum 250m in par). We acknowledge there is substantial issuance that does not meet the minimum index inclusion criteria however in practice we would also argue the smaller deal sizes negatively impact liquidity from an investor's perspective.

As of 9/30/13, the bullet component of the Agency universe was 76.1% versus 23.9% for the callable component, the highest amount of callable securities in the universe since 12/31/08, but below the 25.9% as of 12/31/07. Based on the data set provided, callable issuance has been on a modest upswing as we believe Agency issuers find the callable market attractively priced. In our view the Relative Comparison portion of the table provides some valuable insight investors need to be cognizant of. In six of the seven periods cited an OAS (Option Adjusted Spread) advantage is evident in the callable component and in all seven periods the callable component has a higher effective yield versus the bullet universe. Typically, a wider spread and greater yield would over time produce a total return advantage, but based on the index return data this is not the case in all seven periods cited. In all periods, the total return from the bullet universe is greater than the callable universe.

| BofA Merrill Lynch 1-5 Year Agency Indices | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 09/30/13 |
|---|---|---|---|---|---|---|---|
| **GVPB (1-5 bullet)** | | | | | | | |
| # issues | 194 | 298 | 315 | 280 | 262 | 238 | 237 |
| Full Market Value | 448,277 | 623,667 | 740,470 | 691,745 | 555,270 | 495,453 | 436,912 |
| Effective Yield | 3.71 | 1.59 | 1.59 | 0.94 | 0.61 | 0.44 | 0.72 |
| OAS (vs govt) | 54 | 81 | 19 | 13 | 26 | 7 | 12 |
| Effective Duration | 2.34 | 2.45 | 2.37 | 2.26 | 2.41 | 2.63 | 2.62 |
| % total | 74.1% | 81.6% | 77.6% | 79.4% | 78.1% | 79.1% | 76.1% |
| YTD return | 7.814 | 8.628 | 2.528 | 3.536 | 2.617 | 1.522 | (0.079) |
| **GVPC (1-5 non bullet)** | | | | | | | |
| # issues | 316 | 265 | 350 | 363 | 338 | 315 | 335 |
| Full Market Value | 156,509 | 140,452 | 214,194 | 179,610 | 155,917 | 131,165 | 137,125 |
| Effective Yield | 3.84 | 1.85 | 1.67 | 1.25 | 0.74 | 0.46 | 0.83 |
| OAS (vs govt) | 64 | 107 | 69 | 23 | 38 | 5 | 15 |
| Effective Duration | 1.02 | 0.51 | 1.31 | 1.71 | 1.31 | 1.37 | 2.05 |
| % total | 25.9% | 18.4% | 22.4% | 20.6% | 21.9% | 20.9% | 23.9% |
| YTD return | 6.001 | 4.836 | 2.136 | 1.238 | 1.668 | 0.845 | (0.117) |
| Relative Comparison | | | | | | | |
| OAS Advantage (callable vs. bullets) | 10 | 26 | 50 | 10 | 12 | (2) | 3 |
| Effective Yield Advantage (callable vs. bullets) | 0.13 | 0.26 | 0.08 | 0.31 | 0.13 | 0.02 | 0.11 |
| YTD Return Advantage (callable vs. bullets) | (1.813) | (3.792) | (0.392) | (2.298) | (0.949) | (0.677) | (0.038) |

*Source: Bank of America Merrill Lynch Global Bond Indices*

Other data in the table help us confirm that investors need to be especially vigilant in evaluating callable securities so as not to be susceptible to chronic underperformance versus bullet securities. We highlight a few data points of particular interest:

- 12/31/09 - Despite an OAS advantage of 50 basis points for callable securities the following year the total return of the callable universe was 2.298% below that of the bullet universe.
- 12/31/10 - Despite an effective yield advantage of 0.31%, the following year the callable universe underperformed the bullet universe by 0.949%.
- 9/30/13 - The effective duration of the callable universe increased to 2.05 versus 1.37 at year end, highlighting the extension risk of the callable universe and implying investors heavily exposed to the callable sector were likely constrained to buy cheaper fixed income assets when the markets re-priced yields wider in the 3rd quarter of 2013.

Chandler is not advocating that a high quality portfolio have zero exposure to callable securities. In practice the team has had a difficult time identifying securities that are attractively priced relative to the potential extension risk embedded in a callable security and we think the data presented above supports that conclusion. Chandler continues to advocate well diversified portfolios by sector, credit quality, and structure, and we caution investors about the negative implications due to the changing demand and supply dynamics of the Agency sector.

William Dennehy II, CFA
SVP, Portfolio Manager

RISKS AND OTHER IMPORTANT CONSIDERATIONS