CHANDLER ASSET MANAGEMENT

February 2014

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.

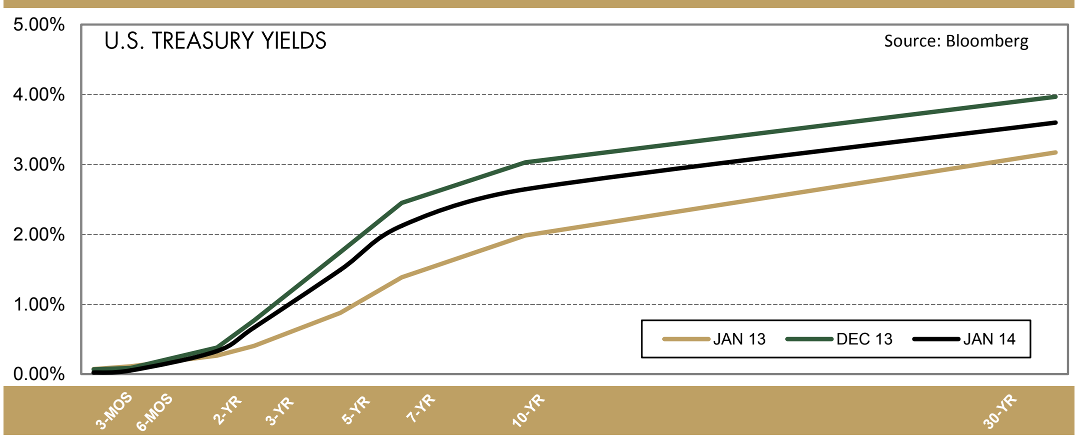
Market Summary

Recent economic data has been somewhat lackluster, and perhaps unfavorable winter weather has been at least partially to blame, but we believe the economy continues to grow at a slow pace. Nonfarm payroll jobs grew just 113,000 in January, versus expectations of 180,000. Private payrolls grew by 142,000 in January while government jobs contracted by 29,000. Though the January employment report was disappointing, some of the details in the report were favorable. Wage growth rose 0.2% in the month, as expected. The unemployment rate dropped to 6.6% in January from 6.7% in December, while the labor force expanded from a historically low level in December. Meanwhile, manufacturing, housing, and consumer data has been mixed. Overall, we believe the economy continues to be on a slow growth trajectory fueled by modest improvement in the labor market.

At its January 28-29 meeting, the FOMC announced that it would continue to taper its asset purchases in February by another $10 billion, as expected. The Fed continues to purchase MBSs at a pace of $30 billion per month and longer-term Treasuries at a pace of $35 billion per month. The path toward winding down quantitative easing continues to be data dependent, and we believe the process of unwinding will likely continue at a steady pace throughout 2014. The January FOMC statement indicated that "growth in economic activity picked up in recent quarters" but it was also noted that unemployment remains elevated and that persistently low inflation could pose risks to the economy. The Fed continues to emphasize that the fed funds target rate is expected to remain low well past when unemployment falls below 6.5%. Notably, Janet Yellen officially took over as Fed chair on February 1.

Treasury yields have continued to be somewhat volatile, as market participants have reacted to economic data and speculation about the pace of the Federal Reserve's tapering of asset purchases. More recently, fears about emerging markets and the subsequent flight to quality has been offsetting to the upward pressure on rates caused by Fed tapering.

TREASURY YIELDS REMAIN VOLATILE IN JANUARY



During the past three months, rates have been somewhat volatile as market participants have reacted to economic data, fears about emerging markets, and speculation about the pace of the Federal Reserve's tapering of asset purchases.

TREASURY YIELDS	1/31/2014	12/31/2013	CHANGE
3 Month	0.02	0.07	(0.05)
2 Year	0.33	0.38	(0.05)
3 Year	0.67	0.77	(0.10)
5 Year	1.49	1.74	(0.25)
7 Year	2.12	2.45	(0.33)
10 Year	2.65	3.03	(0.38)
30 Year	3.60	3.97	(0.37)

Source: Bloomberg

Economic Roundup

Consumer Prices

In December, overall CPI inflation rose to 1.5% on a year-over-year basis from 1.2% in November. The year-over-year Core CPI (CPI less food and energy) was unchanged at 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 December, Retail Sales rose 4.1% on a year-over-year basis versus up 4.2% in November. On a month-over-month basis, Retail Sales excluding autos and gas rose 0.6% in December which exceeded the consensus forecast of 0.3%.

Labor Market

The January employment report was weaker than expected as payrolls rose by just 113,000 versus the 180,000 consensus estimate. Unfavorable weather may have been a contributing factor. Meanwhile, the unemployment rate declined to 6.6% from 6.7%, despite an increase in the labor force. Net revisions for job growth in November and December were +34,000. Average nonfarm payroll growth over the past 3 months has been 154,000 per month. Private payrolls increased by 142,000 in January while government jobs contracted by 29,000.

Housing Starts

Single-family housing starts fell 7.0% in December after rising 20.0% in November. Unfavorable weather may have been at least partially to blame for the December decline.

Credit Spreads Widened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.11	0.08	0.03
2-year A corporate note	0.51	0.55	(0.04)
5-year A corporate note	0.59	0.55	0.04
5-year Agency note	0.27	0.29	(0.02)

Source: Bloomberg   Data as of 1/31/14

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.7) $Bln DEC 13	(34.6) $Bln NOV 13	(38.3) $Bln DEC 12
GDP	3.2% DEC 13	4.1% SEP 13	0.1% DEC 12
Unemployment Rate	6.6% JAN 14	6.7% DEC 13	7.9% JAN 13
Prime Rate	3.25% JAN 14	3.25% DEC 13	3.25% JAN 13
CRB Index	283.31 JAN 14	280.17 DEC 13	303.99 JAN 13
Oil (West Texas Int.)	$97.49 JAN 14	$98.42 DEC 13	$97.49 JAN 13
Consumer Price Index (y/o/y)	1.5% DEC 13	1.2% NOV 13	1.7% DEC 12
Producer Price Index (y/o/y)	1.2% DEC 13	0.7% NOV 13	1.4% DEC 12
Dollar/EURO	1.35 JAN 14	1.37 DEC 13	1.36 JAN 13

Source: Bloomberg

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Emerging Markets and the Impact on U.S. Fixed Income

Investors' fears of a potential crisis in emerging markets have become elevated in recent weeks, fueling financial market volatility. The safe-haven demand for U.S. Treasuries has increased as investors have been shifting away from emerging market assets. In January, the 10-year Treasury yield declined 38 basis points, as increased demand put downward pressure on yields. Meanwhile, the MSCI Emerging Markets Index (largely recognized as the most comprehensive index of emerging market equities) fell by 7% during the month.

Until recently, low interest rates in developed markets led investors to seek higher returns in emerging markets. The concern now is that the flow of capital investment into emerging markets fueled in part by U.S. quantitative easing over the past few years will reverse as the Fed tapers its asset purchases. Historically, a strengthening in the U.S. dollar has put downward pressure on emerging market currencies. Investor anxiety is centered on (but not limited to) a group of developing countries called the "Fragile Five" – Brazil, India, Indonesia, South Africa, and Turkey. Some market participants fear that a sudden flight of capital out of these countries could fuel a currency crisis, reminiscent of the Asian financial crisis in 1997, or lead to a global financial contagion. In theory, rising real interest rates in the U.S. (fueled by Fed tapering and less easy monetary policy), along with a favorable investment climate and an improving economy, should attract investors, driving increased demand for (and value of) the U.S. dollar. At the same time, concerns that emerging market economies (including China – the largest emerging market country) are cooling, could divert capital flows away from those countries and put downward pressure on their currencies. For the "Fragile Five", particularly unfavorable economic conditions (characterized by weak economic growth, high levels of inflation, and large current account deficits) could potentially put significant downward pressure on their currencies and make it difficult for them to obtain foreign capital. An exodus of foreign capital coupled with a depreciation of the domestic currency would be problematic for certain developing countries because their large deficits are financed through external borrowing, and they must obtain foreign capital to pay back the principal and interest on their loans. Some market participants fear that the "Fragile Five" and other developing countries with significant short-term refinancing needs could be at risk of default if capital flows suddenly dry up, their foreign exchange reserves become insufficient, or if they experience sharp depreciations in their currencies.

MSCI Emerging Markets Index (January 31, 2013—January 31, 2014)

Source: Bloomberg

Financial markets could continue to experience volatility as investors question the sustainability of China's economic growth and as the U.S. Federal Reserve continues to unwind quantitative easing.

In our view, fears of a currency crisis and subsequent financial contagion reminiscent of the Asian financial crisis are overblown. Emerging markets have changed since the 1990's and most now function with free floating currencies and have stronger foreign currency reserves. Markets with free-floating currencies are essentially self-correcting; as the value of the currency weakens, the country's exports should become cheaper, which should boost demand. We believe the issues facing emerging market economies will be contained, and are unlikely to drag the global economy into a crisis. However, we do believe that the financial markets could continue to experience volatility as investors question the sustainability of China's economic growth (with China's PMI falling to a 6-month low of 50.5 in January) and as the U.S. Federal Reserve continues to unwind quantitative easing. This volatility and uncertainty could be somewhat damaging to confidence and overall demand.

What does this mean for fixed income investors? Chandler has no direct exposure to sovereign emerging market debt. However, we do anticipate that ongoing concerns about emerging market economies could put downward pressure on Treasury yields over the next six to twelve months (while the U.S. Federal Reserve tapers its asset purchases), partially offsetting the upward force on rates caused by the winding down of quantitative easing and expectations for improving economic growth. Within the corporate bond market we could see a potential increase in credit spreads, though we think the impact of currency fluctuations on corporate earnings would generally be muted by companies' geographic sales diversification and/or currency hedging mechanisms. In our view, the corporations that could be most affected by turmoil in emerging markets would be the Industrial Basics (commodities, metals, mining, chemicals, energy), those tied to manufacturing, or any companies that are highly sensitive to changes in global growth. However, an improving economic landscape in the U.S. and in Europe should help to offset weakness in emerging markets. Overall, we have a modest bias against corporate bond issuers with outsized exposure to emerging markets over the near- to intermediate-term, and favor companies that are poised to benefit from U.S. domestic economic growth and a potential upswing in U.S. consumer spending.

- Shelly Henbest

VP, Credit Analyst