CHANDLER ASSET MANAGEMENT

April 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.

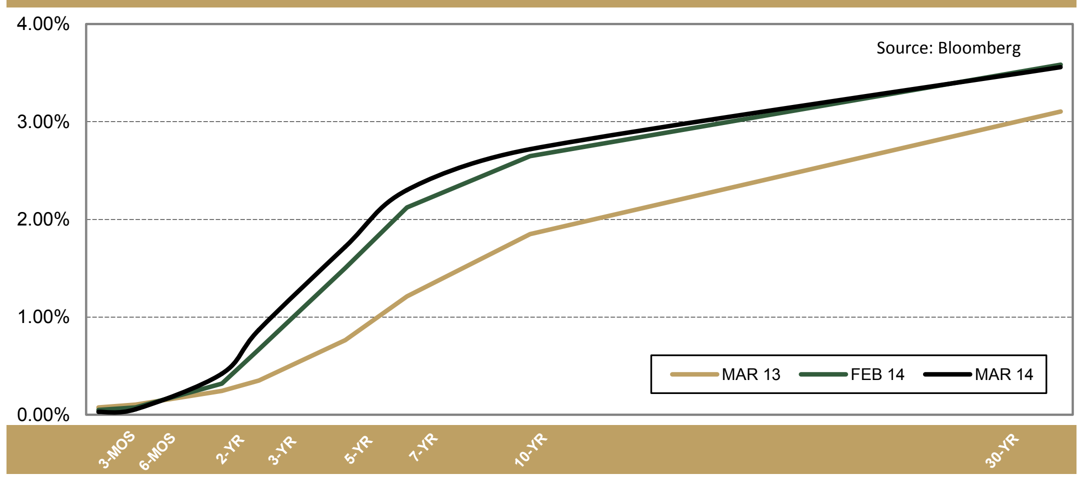
Market Summary

The March employment report was slightly weaker than expected but the labor market seems to be improving gradually. Nonfarm payroll jobs grew by 192,000 in March, versus expectations of 200,000. The unemployment rate was unchanged at 6.7%. For the first quarter of 2014, payrolls rose by 178,000 per month on average, which compares to average growth of 198,000 per month during the fourth quarter of last year. We believe this deceleration is at least partially explained by the severe winter weather that continued into March. Meanwhile manufacturing, housing, and consumer data remains mixed but have been showing some signs of improvement.

The FOMC left policy rates unchanged at its March 18-19 meeting, and announced another $10 billion reduction in asset purchases beginning this month, as expected. The Committee made some changes to its forward guidance on monetary policy. Rather than pointing to 6.5% unemployment as a trigger point for policy change, the Fed is now using more qualitative language and indicated that it will instead be focused on targeting "maximum employment". The Committee will also continue to target a long-run inflation goal of 2%. In her first post-meeting press conference, Chairwoman Yellen rattled the financial markets when she suggested that the first fed funds rate hike could begin 6 months after the taper is complete (which implies spring of 2015). Overall, many market participants viewed Yellen's comments as being more "hawkish" than expected.

The yield on the two-year Treasury note increased in March, driven in part by the ongoing unwinding of quantitative easing by the Federal Reserve along with increased anxiety that the Fed could begin hiking the fed funds rate sooner than market participants have been expecting.

THE YIELD CURVE FLATTENED IN MARCH



During the past three months, the yield curve has flattened despite the Fed's tapering. Market participants are anticipating future fed funds rate hikes which have begun to put upward pressure on shorter-term yields. Meanwhile, lackluster domestic economic data, geopolitical tensions, and fears about emerging market currencies have put downward pressure on longer yields.

TREASURY YIELDS	3/31/2014	2/28/2014	CHANGE
3 Month	0.03	0.05	(0.02)
2 Year	0.42	0.32	0.10
3 Year	0.87	0.67	0.20
5 Year	1.72	1.50	0.22
7 Year	2.30	2.12	0.18
10 Year	2.72	2.65	0.07
30 Year	3.56	3.58	(0.02)

Source: Bloomberg

Economic Roundup

Consumer Prices

In February, overall CPI inflation fell to 1.1% on a year-over-year basis from 1.6% in January. The year-over-year Core CPI (CPI less food and energy) was unchanged at 1.6% in February. 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 February, Retail Sales rose 1.5% on a year-over-year basis versus a gain of 1.9% in January. On a month-over-month basis, Retail Sales excluding autos and gas rose 0.3% in February which was ahead of the consensus forecast of +0.1%. Adverse weather likely continued to hinder retail sales during the month.

Labor Market

The March employment report was slightly weaker than expected as payrolls rose by 192,000 versus the 200,000 consensus estimate. Net revisions for job growth in February and January were +37,000. Private payrolls increased by 192,000 in March and government jobs were flat. The unemployment rate was unchanged at 6.7%, while the consensus projection was 6.6%.

Housing Starts

Single-family housing starts rose 0.3% in February after falling 13.2% in January. Unfavorable weather has likely affected housing trends in the past few months.

Credit Spreads Tightened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.10	0.08	0.02
2-year A corporate note	0.47	0.48	(0.01)
5-year A corporate note	0.48	0.54	(0.06)
5-year Agency note	0.18	0.24	(0.06)

Source: Bloomberg Data as of 3/31/14

Economic Data Has Been Skewed By Harsh Winter Weather

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.3) $Bln FEB 14	(39.3) $Bln JAN 14	(43.3) $Bln FEB 13
GDP	2.6% DEC 13	4.1% SEP 13	0.1% DEC 12
Unemployment Rate	6.7% MAR 14	6.7% FEB 14	7.5% MAR 13
Prime Rate	3.25% MAR 14	3.25% FEB 14	3.25% MAR 13
CRB Index	304.67 MAR 14	302.43 FEB 14	296.39 MAR 13
Oil (West Texas Int.)	$101.58 MAR 14	$102.59 FEB 14	$97.23 MAR 13
Consumer Price Index (y/o/y)	1.1% FEB 14	1.6% JAN 14	2% FEB 13
Producer Price Index (y/o/y)	1.3% FEB 14	1.5% JAN 14	1.8% FEB 13
Dollar/EURO	1.38 MAR 14	1.38 FEB 14	1.28 MAR 13

Source: Bloomberg

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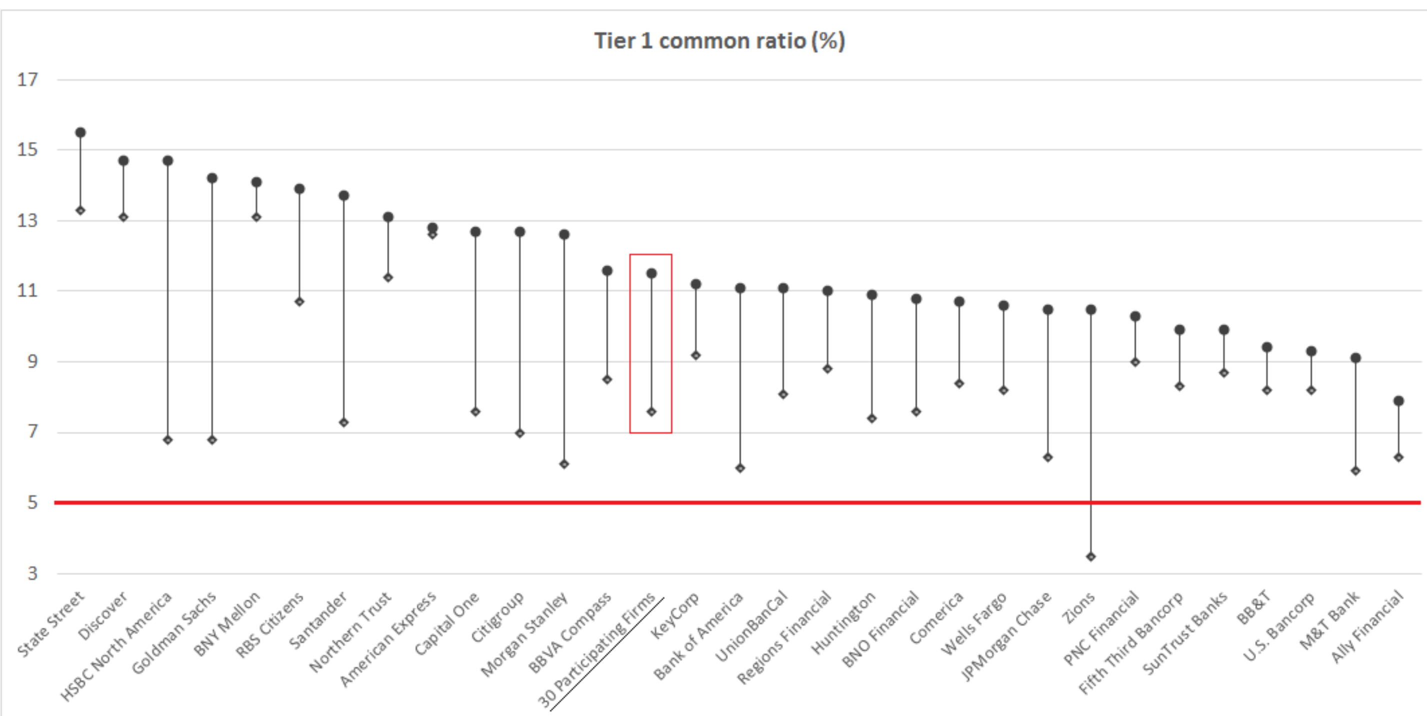
U.S. Banks Hold Up Under Stress

After the 2007-2009 financial crisis, the Federal Reserve (Fed) began conducting annual stress tests of banks' capital adequacy and resiliency to a potential financial stress. Each year, the Fed uses the Dodd-Frank Act stress test and the Comprehensive Capital Analysis & Review test to evaluate how well certain banks hold up under adverse hypothetical economic scenarios. The two-part tests are designed to determine whether or not systemically important banks have sufficient capital to absorb potential losses during a significant downturn in the economy and to evaluate whether or not they could sustain themselves without government support in the event of another financial crisis. The tests are aimed at detecting weakness in the banking system and preventing banks from being too aggressive with their capital distribution plans (such as dividends and stock buybacks). Banks with more than $10 billion in total assets and non-bank firms that are designated by the Financial Stability Oversight Council for supervision by the Federal Reserve are included in the stress tests. This year, 30 large bank holding companies were included in the Fed's annual stress test, up from 18 last year.

The Fed's stress tests include both quantitative and qualitative assessments of banks' capital positions and capital distribution plans. The quantitative component of the tests examine whether or not the banks' regulatory capital ratios could sufficiently meet the minimum requirements under a stress scenario. Meanwhile, the qualitative component of the tests examine such things as the robustness of each bank's capital planning process, their risk-management practices, the reasonableness of the assumptions used for capital planning purposes, and their method of corporate governance and internal controls. In addition, eight banks were subjected to additional testing related to counterparty trading exposure and risk. While the Fed evaluates the banks based on a number of factors, the most critical test is whether the banks can maintain a minimum Tier 1 common equity ratio of at least 5% under the most severe hypothetical economic scenario. The Tier 1 ratio calculates a bank's high-quality capital as a percent of risk-weighted assets. Each bank was evaluated based on its idiosyncratic risks, reflecting in their individual size and complexity. The Fed's most recent stress tests were based on financial reports for the period ending September 30, 2013. In its most severe adverse stress scenario, the Fed hypothetically assumed that U.S. unemployment climbs to 11.25% (from the current level of 6.7%), equity prices plunge 50%, home prices fall 25%, GDP declines nearly 5%, and Europe slips into recession.

In March 2014, the Fed released the results of their most recent bank stress tests. Initially, three banks failed to meet the minimum post-stress Tier 1 common ratio requirement of 5%; Goldman Sachs, Bank of America, and Zions Bancorp. However, Goldman Sachs and Bank of America were able to meet the minimum requirement after submitting adjusted capital plans. Zions did not submit an adjusted capital plan and was therefore the only bank to ultimately fail the Fed's stress test. As such, 29 out of the 30 banks examined



Source: Forbes article 3/24/2014 "Fed Stress Test For Banks: Rationale, Results & Implications". Based on Federal Reserve data.

did pass the test. Notably, last year, Ally Financial was the only bank that did not pass the Fed's test, and this year Ally passed. The banks with the strongest post-stress Tier 1 common ratios this year included Northern Trust, State Street and Bank of New York. American Express and Discover Financial Services also performed well. Out of the 30 banks tested, the Fed objected to the capital plans submitted by Citigroup, HSBC North America, RBS, Santander, and Zions Bancorp. The capital plans for Citigroup, HSBC, RBS and Santander were rejected based on the Fed's qualitative assessment. For Citigroup, the Fed expressed concerns regarding the bank's ability to project revenue and losses under a stressful scenario and said the bank's internal stress testing methods were inadequate. Likewise, the Fed found fault with HSBC for similar reasons. Meanwhile, Zions' capital plans were rejected based on the Fed's quantitative assessment, given Zions' Tier 1 ratio under stress did not meet the minimum requirement. Citigroup, HSBC North America, RBS, Santander, and Zions Bancorp were subsequently restricted from implementing their capital distribution plans (i.e. share buybacks and dividends) and are required to address the Fed's concerns and resubmit their plans. The Fed had no objection to the capital plans of the remaining 25 banks. In aggregate, the 30 banks' tier 1 common capital ratio would hypothetically fall from 11.5% in the third quarter of 2013 to a minimum level of 7.6% under the most severe stress scenario, according to the Fed. Notably, this figure is much higher than the 30 banks' aggregate actual tier 1 common ratio of 5.5% at the beginning of 2009.

The chart on the previous page depicts the projected potential decline in the 30 banks' Tier 1 common ratio under the Fed's severely adverse scenario. The data is based on the assumptions provided with the Dodd-Frank Act stress test. The circle represents each of the banks' actual Q3 2013 Tier 1 common ratios, while the diamond represents the projected minimum Tier 1 common ratio (within the Q4 2013 to Q4 2015 time period) under the most severely adverse scenario, as estimated by the Fed.

We believe this year's stress test results indicate that banks are solidly positioned to withstand a severe downturn in the economy.

Overall, we believe this year's stress test results indicate that banks are solidly positioned to withstand a severe downturn in the economy. We believe this is largely a result of the efforts the banks have made (due largely to increased oversight and regulation) to improve and strengthen their capital positions in recent years. According to the Fed's tests, the 30 banks' aggregate *projected* Tier 1 common ratio under a potentially stressful future economic scenario would exceed the banks' aggregate *actual* Tier 1 common ratio at the beginning of 2009, which indicates how much progress those banks have made at strengthening their balance sheets since the financial crisis. We believe market participants can take some comfort, based on the results of the Fed's stress tests, that banks aren't likely to require another government bailout in the event of a future financial crisis. We also believe that the Fed's careful oversight of banks' capital distribution plans is particularly favorable for bond investors and that this level of regulation is credit positive.

- Shelly Henbest
VP, Credit Analyst

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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