CHANDLER ASSET MANAGEMENT

June 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.

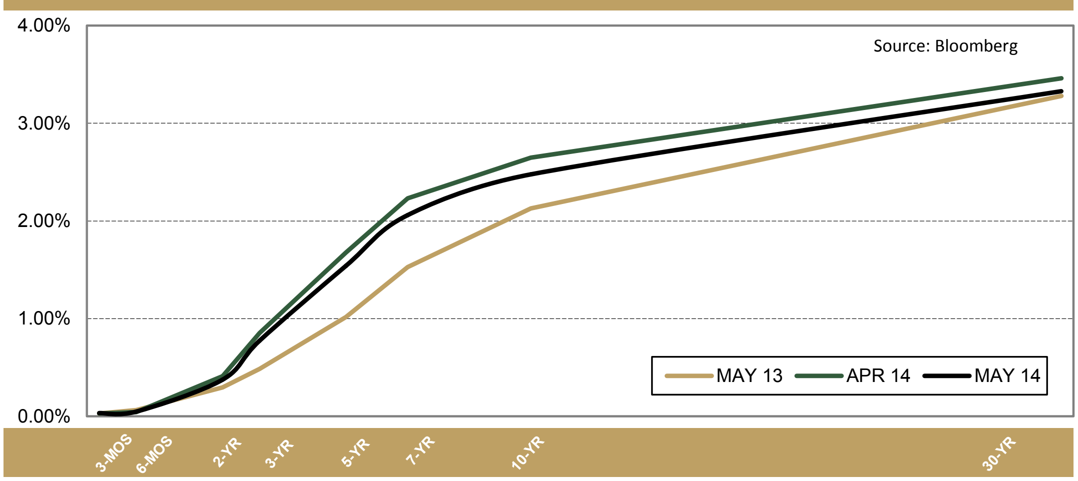
Market Summary

The economy is growing at a modest pace. According to the latest Beige Book report, which was prepared in advance of the upcoming June Federal Open Market Committee (FOMC) meeting, all 12 Federal Reserve Districts reported an expansion in economic activity during April and May. The May employment report was in line with expectations, as nonfarm payrolls grew by 217,000 versus expectations of 213,000. Over the past three months, payrolls have grown by an average of 234,000 per month. The unemployment rate was unchanged in May at 6.3%, which was a little better than expected. Meanwhile, the manufacturing sector has been showing strength and consumer data has also been favorable. Housing data remains somewhat mixed, as firm pricing and higher mortgage rates seem to be curtailing sales volume. Overall, economic activity rebounded from the weather-related slowdown in the winter.

We believe the Federal Reserve (the Fed) will leave policy rates unchanged and announce another $10 billion reduction in asset purchases (to a level of $35 billion from $45 billion) at the upcoming June 17-18 FOMC meeting. We expect the process of unwinding quantitative easing will continue at a steady pace this year. The Fed will host a post-meeting press conference and is expected to update its economic projections.

The yield on the two-year Treasury note edged down further in May, likely driven by an ongoing flight to quality. We believe this has offset the upward pressure on rates driven by the unwinding of quantitative easing along with the anticipation of a potential fed funds rate hike next year.

THE YIELD CURVE FLATTENED IN MAY



During the past three months, the yield curve has flattened even as the Fed has been tapering its purchases of long-term Treasury bonds. Market participants have reacted to mixed domestic economic data, as well as fears of euro zone deflation, geopolitical tensions, and volatility in emerging markets over the past several months. These concerns have fueled a flight to quality, putting downward pressure on longer yields.

TREASURY YIELDS	5/31/2014	4/30/2014	CHANGE
3 Month	0.03	0.03	0.00
2 Year	0.38	0.41	(0.03)
3 Year	0.77	0.85	(0.08)
5 Year	1.54	1.68	(0.14)
7 Year	2.06	2.23	(0.17)
10 Year	2.48	2.65	(0.17)
30 Year	3.33	3.46	(0.13)

Source: Bloomberg

Economic Roundup

Consumer Prices
In April, overall CPI inflation increased to 2.0% on a year-over-year basis from 1.5% in March. The year-over-year Core CPI (CPI less food and energy) also increased slightly to 1.8% in April from 1.7% in March. The core inflation rate is still trending below the Fed's long-term goal of 2.0%.

Retail Sales
In April, Retail Sales rose 4.0% on a year-over-year basis versus a gain of 4.1% in March. On a month-over-month basis, Retail Sales edged up just 0.1% in April versus a gain of 1.5% in March. Overall, Retail Sales were somewhat softer than expected in April, but the trend has improved since the winter months.

Labor Market
The May employment report was in line with expectations as payrolls rose by 217,000 versus the 213,000 consensus estimate. Net revisions for job growth in April and March were -6,000. Private payrolls increased by 216,000 in May and government jobs increased by 1,000. The unemployment rate remained steady at 6.3% and the participation rate was unchanged at 62.8%.

Housing Starts
Single-family housing starts rose just 0.8% in April after rising 9.3% in March. Overall, housing starts rose 13.2% in April, but the gain was largely driven by the multifamily component.

Credit Spreads Tightened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.10	0.11	(0.01)
2-year A corporate note	0.43	0.43	0.00
5-year A corporate note	0.45	0.44	0.01
5-year Agency note	0.09	0.07	0.02

Source: Bloomberg Data as of 5/31/2014

Economic Data Is Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(47.2) $Bln APR 14	(44.2) $Bln MAR 14	(40.4) $Bln APR 13
GDP	(1.0)% MAR 14	2.6% DEC 13	1.1% MAR 13
Unemployment Rate	6.3% MAY 14	6.3% APR 14	7.5% MAY 13
Prime Rate	3.25% MAY 14	3.25% APR 14	3.25% MAY 13
CRB Index	305.48 MAY 14	309.53 APR 14	281.85 MAY 13
Oil (West Texas Int.)	$102.71 MAY 14	$99.74 APR 14	$91.97 MAY 13
Consumer Price Index (y/o/y)	2.0% APR 14	1.5% MAR 14	1.1% APR 13
Producer Price Index (y/o/y)	3.1% APR 14	1.7% MAR 14	0.5% APR 13
Dollar/EURO	1.36 MAY 14	1.39 APR 14	1.30 MAY 13

Source: Bloomberg

Registration of Municipal Advisors: Reinforcing Fiduciary Standards

Five years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), lawmakers and regulators continue to deliver piecemeal financial reform. One area of focus for the Securities Exchange Commission (SEC) is the municipal securities market, which historically had been subject to lower oversight compared to other areas of the financial system. Though much smaller decades ago, municipal securities have grown into a multi-trillion dollar market. During this time, the municipal securities market created a great deal of opportunity for market participants, but not necessarily the corresponding level of oversight.

On January 13, 2014, a new rule went into effect requiring "Municipal Advisors" — a new class of market participants created by Dodd-Frank — to register with the SEC and comply with the regulations set forth by the Municipal Securities Rulemaking Board (MSRB). Furthermore, this rule also imposes a fiduciary responsibility on Municipal Advisors, requiring them to put the interests of their clients before their own. While the rule formally went into effect earlier this year, the filing requirement for those affected begins on July 1, 2014.

While it would seem obvious that those providing investment advice to their clients be held accountable as fiduciaries, that was not always the case. The financial crisis in 2008 revealed a variety of questionable and unethical practices ranging from failure to provide adequate information for client decision-making to investments in complex derivatives to more blatant abuses, such as "pay to play", undisclosed conflicts of interest and bid-rigging schemes. In releasing its enforcement results for the 2013 fiscal year, which resulted in $3.4 billion in sanctions overall, the SEC noted that the municipal securities market has been an area of heightened scrutiny.

There have been numerous examples of impropriety in which service providers did not act in their clients' interests, resulting in significant fines and sanctions. Some of the actions pursued by the SEC included: a broker/dealer making payments to local firms with connections to a public agency's commissioners to secure underwriting and interest rate swap business; an institution selling highly leveraged derivatives not suitable to school districts without disclosing the risks of these investments; and a national bank secretly rigging over fifty bond reinvestment transactions in relation to repurchase agreements and guaranteed investment contracts. The Municipal Advisors Rule was designed to prevent such abuses in the municipal securities markets by imposing a fiduciary standard.

The Municipal Advisors Rule was designed to prevent abuses in the municipal securities markets by imposing a fiduciary standard.

When it was first proposed, there was a great deal of concern regarding the rule's potentially broad interpretation, especially since municipal advisory activities can encompass a wide range of services beyond debt issuance. Taking into consideration the hundreds of comment letters submitted, lawmakers clarified several areas of the rule — most importantly who is a "Municipal Advisor."

According to amendments to the Securities Act, a Municipal Advisor is "a person (who is not a municipal entity or an employee of a municipal entity) that (1) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues or (2) undertakes the solicitation of a municipal entity."

The rule gives municipal entities confidence in knowing that their service providers are truly accountable to them.

Along with excluding municipal employees and officials acting within the scope of their responsibilities, the rule also excludes certain market participants, such as investment advisers registered under the Investment Advisers Act of 1940, commodity trading advisers registered under the Commodity Exchange Act, both of which are registered with regulatory bodies and have to abide by a fiduciary standard. Also, excluded are broker/dealers serving as underwriters (as defined in Section 2(a)(11) of the Securities Act of 1933), and non-financial professionals, such as attorneys and engineers offering advice related to their respective professions. Based on the exclusion of these groups, it is apparent the rule is intended to ensure that no one exceeds the scope of their professional capacity by providing unauthorized advice to clients.

There are two additional exemptions from this rule worth noting, the "RFP Exemption" and the "Independent Registered Municipal Advisor Exemption." Under the RFP Exemption, market participants can provide investment advice in response to a Request for Proposal (RFP) issued by a municipality (or the municipality's registered municipal advisor), provided the RFP process is conducted on a competitive basis and meets certain criteria. The Independent Registered Municipal Advisor Exemption, on the other hand, permits a market participant to provide advice without violating the rule, so long as the municipal client has engaged an independent registered municipal advisor that meets certain requirements (e.g. the independent registered municipal advisor has not been associated with the market participant seeking to use the exemption for the past two years), along with written acknowledgment from the municipal client indicating that they will rely on their independent registered municipal advisor for advice.

As a registered investment adviser, we have a fiduciary responsibility to our clients to put their interests first.

While the rule and existing SEC guidance go into much further depth beyond the scope of this article, the intent of lawmakers is to put service providers on notice that any unauthorized investment advice with regards to certain funds will not be tolerated. To be clear the rule was not intended to inhibit the market for municipal underwriting, but rather to ensure that those engaged in such undertaking have a fiduciary duty to act in their clients' best interests, as well as to provide additional transparency through registration and strengthen regulatory oversight of the municipal securities market. While the SEC has come out with guidance regarding this new rule, we believe the SEC's actions in enforcing this rule ultimately determine whether the intended transparency and protections are actually created.

While the Municipal Advisors Rule does create additional burdens for market participants, we at Chandler believe in the importance of fiduciary standards as a matter of ensuring integrity in the financial system. The rule gives municipal entities confidence in knowing that their service providers are truly accountable to them. Though lawmakers continue to address other areas of the municipal securities market, as well as the overall financial system, we believe this rule is a positive step forward. In the meantime, we will continue to follow this rule and other regulations relevant to our industry as they emerge.

- Daniel Baig
Marketing & Communications Manager