CHANDLER ASSET MANAGEMENT

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.

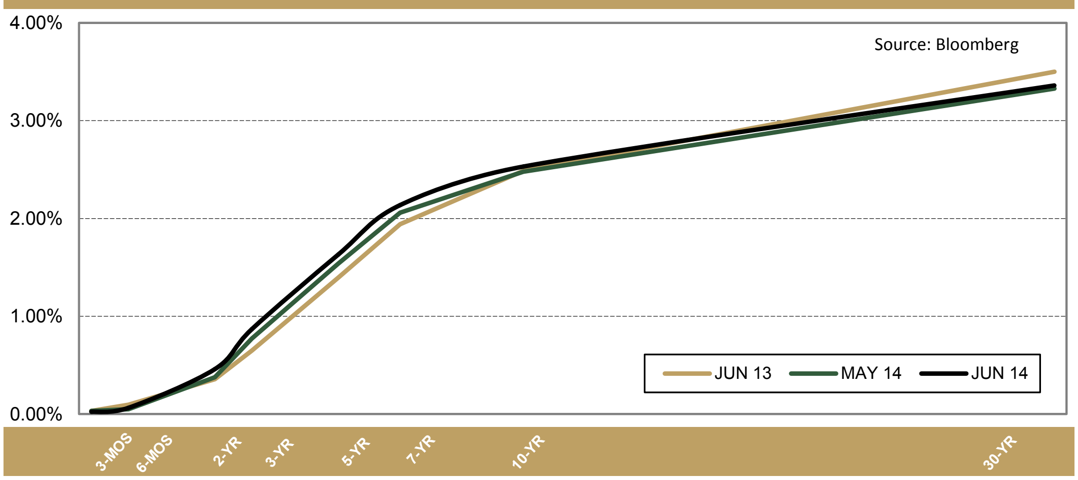
Market Summary

We believe the economy is gaining positive momentum, fueled by ongoing improvement in the labor market. The June employment report was stronger than expected, as nonfarm payrolls grew by 288,000, versus expectations of 215,000. During the second quarter, payrolls grew by an average of 272,000 per month, which compares favorably to the first quarter monthly average of 190,000. Private payrolls grew by 262,000 in June and government jobs rose by 26,000. The unemployment rate declined to 6.1% in June from 6.3% in May, which was a positive surprise. Meanwhile, the manufacturing sector continued to show strength and recent housing data has surprised to the upside.

As expected, the Federal Open Market Committee left policy rates unchanged at its June 17-18 meeting, and announced another $10 billion reduction in asset purchases (to a level of $35 billion per month, comprised of $20 billion in treasuries and $15 billion in mortgage-backed securities). We expect the process of unwinding quantitative easing will continue at a steady pace with the Federal Reserve (Fed) announcing another $10 billion reduction in asset purchases at its July 29-30 meeting. The Fed reduced their GDP growth projections for 2014 to 2.1%-2.3% from 2.8%-3.0%, but improved their outlook for unemployment. At Chair Yellen's press conference, she reinforced that the Fed will continue to monitor the economy and does not project raising short term rates for a considerable amount of time after the asset purchases end.

The yield on the two-year Treasury note increased in June. Improving economic data, the unwinding of quantitative easing by the Fed and the anticipation of a potential fed funds rate hike next year have put upward pressure on rates.

THE YIELD CURVE FLATTENED IN JUNE



During the past three months, the yield curve flattened even as the Fed tapered its purchases of long-term Treasury bonds. Market participants 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, although some of this pressure has recently dissipated.

TREASURY YIELDS	6/30/2014	5/31/2014	CHANGE
3 Month	0.02	0.03	(0.01)
2 Year	0.46	0.38	0.08
3 Year	0.87	0.77	0.10
5 Year	1.63	1.54	0.09
7 Year	2.14	2.06	0.08
10 Year	2.53	2.48	0.05
30 Year	3.36	3.33	0.03

Source: Bloomberg

Economic Roundup

Consumer Prices
In May, overall CPI inflation increased to 2.1% on a year-over-year basis from 2.0% in April. The year-over-year Core CPI (CPI less food and energy) also increased to 2.0% in May from 1.8% in April. The core inflation rate is now trending in line with the Fed's long-term goal of 2.0%.

Retail Sales
In May, Retail Sales rose 4.3% on a year-over-year basis versus a gain of 4.6% in April. On a month-over-month basis, Retail Sales edged up just 0.3% in May, which was below expectations, but the April figure was revised up to 0.5%. Overall, Retail Sales were somewhat softer than expected in May, but better than previously believed in April.

Labor Market
The June employment report was better than expected as payrolls rose by 288,000 versus the 215,000 consensus estimate. Net revisions for job growth in April and March were +29,000. Private payrolls increased by 262,000 in June and government jobs increased by 26,000. The unemployment rate declined to 6.1% from 6.3%, and the participation rate was unchanged at 62.8%.

Housing Starts
Single-family housing starts fell 5.9% to 625,000 in May after rising 4.6% in April. Multifamily starts also declined 7.6% in May after rising 29.2% in April.

Credit Spreads Tightened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.10	0.02
2-year A corporate note	0.41	0.43	(0.02)
5-year A corporate note	0.43	0.45	(0.02)
5-year Agency note	0.08	0.09	(0.01)

Source: Bloomberg

Data as of 6/30/2014

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(44.4) $Bln MAY 14	(47.0) $Bln APR 14	(44.8) $Bln MAY 13
GDP	(2.9)% MAR 14	2.6% DEC 13	1.1% MAR 13
Unemployment Rate	6.1% JUN 14	6.3% MAY 14	7.5% JUN 13
Prime Rate	3.25% JUN 14	3.25% MAY 14	3.25% JUN 13
CRB Index	308.22 JUN 14	305.48 MAY 14	275.62 JUN 13
Oil (West Texas Int.)	$105.37 JUN 14	$102.71 MAY 14	$96.56 JUN 13
Consumer Price Index (y/o/y)	2.1% MAY 14	2.0% APR 14	1.4% MAY 13
Producer Price Index (y/o/y)	2.4% MAY 14	3.1% APR 14	1.6% MAY 13
Dollar/EURO	1.37 JUN 14	1.36 MAY 14	1.30 JUN 13

Source: Bloomberg

Global Growth Outlook and Implications for Domestic Interest Rates

The US economy continues to post lackluster growth since the onset of the financial crisis in 2007. The debate amongst economic thought leaders on whether or not the weak growth is structural (long-term) or cyclical is ongoing. The Federal Reserve, which recently updated their quarterly forecasts at the June 18th Federal Open Market Committee (FOMC) meeting, appears to be conflicted on the topic. GDP forecasts from the FOMC for the next two years are 3.0-3.2% and 2.5-3.0% (2015 and 2016, respectively), however, the longer run forecast is only 2.1-2.3%. Also of interest, the FOMC forecasts for the Fed Funds rate, which Federal Reserve Chair Janet Yellen is discounting, show a terminal Fed Funds rate of close to 4.0%. The team at Chandler is having a difficult time reconciling the FOMC's long-run GDP forecast in the low 2.0% area with a terminal Fed Funds rate of close to 4.0% (www.federalreserve.gov). We think global economic factors, as well as trends specific to the US economy, will serve to limit the increase in domestic and global interest rates as the US and Global economies continue to recover, albeit at a slower pace.

Global GDP, particularly in developed markets, has been somewhat synchronized since 2007. The absolute levels in the various regions represented in the table below are different, but the trends in most are down. In 2007, the average real GDP for the group was 5.0% versus the average forecast GDP in 2016 of only 2.8%. Almost every region represented in the table has a lower GDP forecast in 2016 versus the actual reported GDP number in 2007 with the two exceptions being the US and Canada.

The synchronization of global growth is preventing historical counter-cyclical trends from exerting their influence on weaker growth areas.

The synchronization of global growth is preventing historical counter-cyclical trends from exerting their influence on weaker growth areas. It appears the broad economic trend of this decade will be low growth and disinflation as no dominant macro-economic growth oriented theme in a specific region is pushing up the global economy. The majority of developed market central banks have highly stimulative monetary policies in place yet the average GDP growth rate in the table below was only 1.8% in 2013. China is putting policies in place to mitigate their growth rate as the industrialization process continues in a more controlled manner to help dampen some of the imbalances created by the continuous transformation of their economy. In 2007, China posted real GDP of 14.2% while the forecast for 2016 is only 7.2%, a pretty severe downward adjustment. In Europe, the single currency and unified monetary policy dictated by the European Central Bank (ECB) precludes the weaker European economies from having the ability to gain global competitiveness via currency devaluation. The average forecasted growth rate in 2016 for Germany, France, Spain and Italy is only 1.5%, not much of a recovery from the depths of the financial crisis. The projected growth rate in Japan remains abysmal, forecasted to be 1.2% in 2016, although the Bank of Japan is currently in the midst of very aggressive unconventional monetary policy adjustments to try to change the trajectory of their economy.

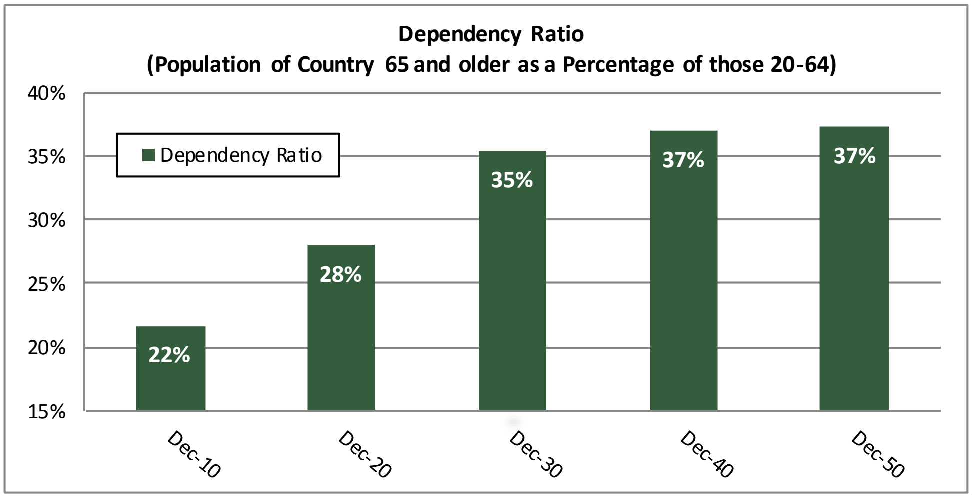
Although the forecast for US GDP growth in 2016 looks respectable versus the peer group represented in the table, we are concerned about some of the long-term

Real GDP Growth Rate

	US	Canada	Germany	France	Spain	Italy	Brazil	Russia	India	China	Australia	Japan	Average
12/31/07	1.8	2.0	3.3	2.3	3.5	1.7	6.1	8.5	9.7	14.2	4.6	2.2	5.0
12/31/08	(0.3)	1.2	1.1	(0.1)	0.9	(1.2)	5.2	5.2	8.2	9.6	2.7	(1.0)	2.6
12/31/09	(2.8)	(2.7)	(5.1)	(3.1)	(3.8)	(5.5)	(0.3)	(7.8)	6.6	9.2	1.6	(5.5)	(1.6)
12/31/10	2.5	3.4	4.0	1.7	(0.2)	1.7	7.6	4.5	9.4	10.4	2.2	4.7	4.3
12/31/11	1.8	2.5	3.3	2.0	0.1	0.4	2.8	4.3	7.7	9.3	2.6	(0.5)	3.0
12/31/12	2.8	1.7	0.7	0.0	(1.6)	(2.4)	1.0	3.4	4.8	7.7	3.6	1.5	1.9
12/31/13	1.9	2.0	0.4	0.2	(1.2)	(1.9)	2.5	1.3	4.7	7.7	2.4	1.5	1.8
12/31/14	*2.2*	*2.2*	*2.0*	*0.8*	*1.0*	*0.3*	*1.3*	*0.5*	*N/A*	*7.4*	*3.1*	*1.5*	*2.0*
12/31/15	*3.0*	*2.5*	*2.0*	*1.4*	*1.5*	*1.1*	*1.8*	*1.8*	*5.4*	*7.2*	*3.0*	*1.2*	*2.7*
12/31/16	*3.0*	*2.5*	*1.7*	*1.4*	*1.7*	*1.1*	*2.6*	*2.3*	*6.2*	*7.2*	*3.2*	*1.2*	*2.8*

Source: Bloomberg; 2014-2016 italicized to indicate consensus forecasts secular trends specific to the US economy. The team at Chandler holds the view GDP growth in the next ten years will be lower than the previous twenty years. The primary catalyst for the lower US long-term growth outlook is correlated with unfavorable demographic trends. The US economy is on the precipice of having a 'supply' issue related to the number of available workers as the percentage of the population over the age of 65 expands while the percentage of workers between 20-64 contracts. The Dependency Ratio (Dependency Ratio = Population 65 And Older/Population Ages 20 to 64) is poised to increase from 22.0% at the end of 2010 to 37.0% by 2040, based on population estimates from the US Census Bureau (see table and chart at right). In order for an economy to accelerate at or above the potential growth rate it requires a growing supply of workers. As the growth of workers expands, the impact on the economy is magnified by the consumption habits of the growing work force creating yet more demand for goods, consistent with a multiplier effect. Since the onset of the financial crisis it is well documented that US corporate spending trends related to capital expenditures are soft. Many profitable corporations are using excess earnings to buy back equity shares, instead of investing in their respective businesses, with the goal of improving the share price of the underlying equity. Lack of investment will lead to lower growth over the long-term. We speculate one of the reasons corporations are reluctant to increase their capital expenditures, and have a more proactive outlook to grow their respective companies, is concerns about demographics in the US and the corresponding potential long-run demand for products.

United States	Dec-10	Dec-20	Dec-30	Dec-40	Dec-50
Total Population (in millions)	310,233	341,387	373,504	405,655	439,010
Under 20 years	84,150	90,703	97,682	104,616	112,940
20 to 64 years	185,854	195,880	203,729	219,801	237,523
65 years and older	40,229	54,804	72,092	81,238	88,547
Total Population	100%	100%	100%	100%	100%
Under 20 years	27%	27%	26%	26%	26%
20 to 64 years	60%	57%	55%	54%	54%
65 years and older	13%	16%	19%	20%	20%



The aging of the US population will exert a downward force on the potential growth rate of the country over the coming decade. It appears the lower trend growth the US and global economy is experiencing since the onset of the financial crisis is more structural than cyclical, as the demographic issues highlighted in the US are also evident in most other developed market economies. The lower long-term growth outlook implies interest rates overall will be lower at equilibrium in order to encourage capital investment over the coming decade. We expect the FOMC's forecast for the terminal Fed Funds rate to drift downward in coming quarters as lower global GDP continues to exert its influence across developed market economies.

- William Dennehy II, CFA
SVP, Portfolio Manager

Graph Source: US Census Bureau

RISKS AND OTHER IMPORTANT CONSIDERATIONS