CHANDLER ASSET MANAGEMENT

August 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.

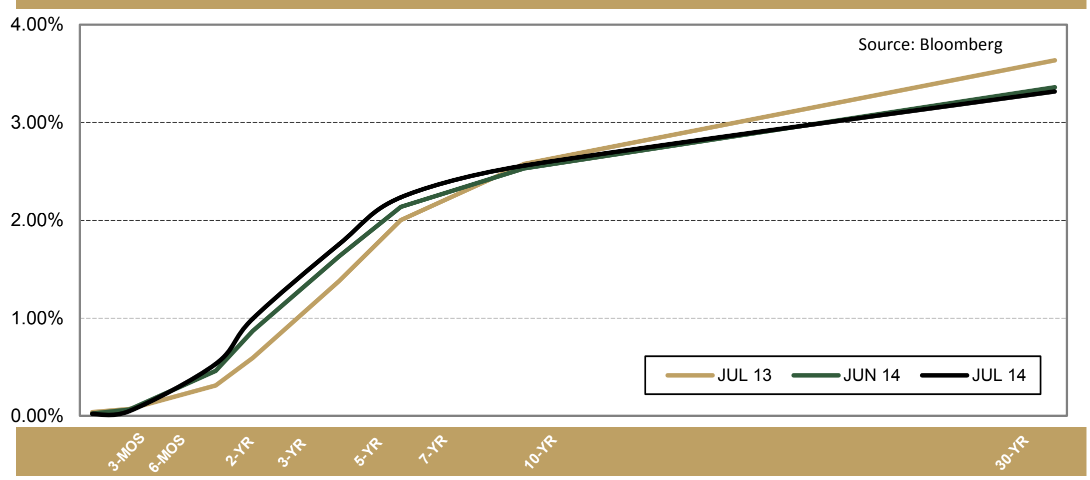
Market Summary

The economy continues to expand at a modest pace, fueled by ongoing improvement in the labor market. The July employment report was softer than expected, but the prior two months were revised higher and the trailing three month average increase in nonfarm payrolls is 245,000. In July, nonfarm payrolls rose by 209,000. The unemployment rate edged up to 6.2% from 6.1%, but the participation rate also ticked up to 62.9% from 62.8%. Meanwhile, the manufacturing sector continued to show strength in July with the ISM manufacturing index rising to a stronger than expected 57.1 from 55.3 in June. Recent housing data has been mixed but consumer spending trends remain healthy.

As expected, the Federal Open Market Committee left policy rates unchanged at its July 29-30 meeting, and announced another $10 billion reduction in asset purchases (to a level of $25 billion per month from $35 billion, comprised of $15 billion in treasuries and $10 billion in mortgage-backed securities). We expect the process of unwinding quantitative easing will be completed in October. Policy rates are expected to remain low for a considerable time after the taper is complete, and the Fed indicated that the rise in policy rates is likely to be slow.

The yield on the two-year Treasury note rose in July, following an increase in June. Economic data has improved, reflecting a pickup in economic growth after a sluggish first quarter. The unwinding of quantitative easing by the Federal Reserve along with the anticipation of a potential fed funds rate hike next year have also put upward pressure on rates.

THE YIELD CURVE FLATTENED IN JULY



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 and geopolitical tensions. These concerns have kept downward pressure on longer yields, although some of this pressure has recently dissipated.

TREASURY YIELDS	7/31/2014	6/30/2014	CHANGE
3 Month	0.02	0.02	0.00
2 Year	0.53	0.46	0.07
3 Year	0.99	0.87	0.12
5 Year	1.75	1.63	0.12
7 Year	2.23	2.14	0.09
10 Year	2.56	2.53	0.03
30 Year	3.32	3.36	(0.04)

Source: Bloomberg

Economic Roundup

Consumer Prices
In June, overall CPI inflation was 2.1% on a year-over-year basis unchanged from April. The year-over-year Core CPI (CPI less food and energy) slightly decreased to 1.9% in June from 2.0% in May.

Retail Sales
In June, Retail Sales rose 4.3% on a year-over-year basis versus a gain of 4.6% in May. On a month-over-month basis, Retail Sales edged up just 0.2% in June, which was below expectations, but the May figure was revised up to 0.5%. Overall, Retail Sales were somewhat softer than expected in June, but better than previously believed in May.

Labor Market
The July employment report was softer than expected as payrolls rose by 209,000 versus the 233,000 consensus estimate. Net revisions for job growth in June and May were +15,000. The trailing three month average monthly increase in nonfarm payrolls is 245,000. Private payrolls increased by 198,000 in July and government jobs increased by 11,000. The unemployment rate edged up to 6.2% from 6.1%, as the participation rate ticked up to 62.9% from 62.8%.

Housing Starts
Single-family housing starts fell 9.0% in June to 575,000 following a 2.6% decline in May. Multifamily starts also declined 9.9% in June after falling 14.7% in May.

Credit Spreads Were Relatively Unchanged

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.12	0.00
2-year A corporate note	0.43	0.41	0.02
5-year A corporate note	0.43	0.43	0.00
5-year Agency note	0.09	0.08	0.01

Source: Bloomberg Data as of 7/31/2014

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(41.5) $Bln JUN 14	(44.7) $Bln MAY 14	(36.6) $Bln JUN 13
GDP	4.0% JUN 14	(2.1)% MAR 14	1.8% JUN 13
Unemployment Rate	6.2% JUL 14	6.1% JUN 14	7.3% JUL 13
Prime Rate	3.25% JUL 14	3.25% JUN 14	3.25% JUL 13
CRB Index	294.43 JUL 14	308.22 JUN 14	283.94 JUL 13
Oil (West Texas Int.)	$98.17 JUL 14	$105.37 JUN 14	$105.03 JUL 13
Consumer Price Index (y/o/y)	2.1% JUN 14	2.1% MAY 14	1.8% JUN 13
Producer Price Index (y/o/y)	2.7% JUN 14	2.4% MAY 14	2.3% JUN 13
Dollar/EURO	1.34 JUL 14	1.37 JUN 14	1.33 JUL 13

Source: Bloomberg

Implications of Institutional Prime Money Market Fund Regulation

The financial crisis of 2008 brought money market funds (MMF) into the crosshairs of regulators as defaults and substantial outflows stressed many funds. In response to the Reserve Primary Fund (A large institutional prime MMF) "breaking the buck" and several other institutional prime MMFs requiring substantial capital contributions from their sponsors to maintain their stable $1.00 net asset value (NAV), the Securities and Exchange Commission (SEC) was forced to act. These events reminded investors that institutional prime MMFs (those that can invest a majority of their assets in non-government backed securities) contain risks and could result in a potential loss of principal. Regulators understood a stable NAV MMF is a critical building block for investors, thus the SEC made reform a focus.

MMF regulation is one of the last major regulatory actions resulting from the financial crisis of 2008. On July 23, 2014 the SEC voted to incorporate structural changes to the MMF industry that will help prevent systemic risk during periods of abnormal stress. Over the next two years investors in institutional prime MMFs and the overall market will digest and implement a new regulatory framework. The two primary changes to institutional prime MMFs are:

1. Allowing institutional prime MMFs to have a floating NAV
2. Liquidity fees and redemption gates

A floating NAV implies an investor is not guaranteed to receive the full amount of their deposit back when requested. For instance, an investor deposits $10,000 into an institutional prime MMF when the NAV is $1.00 per share, later the investor needs the money and may have to redeem their shares at a NAV of $.99 per share. The investor lost $100 on their MMF investment. While we feel events like this will be rare, several market forces could cause the NAV to slip below $1.00. Very large credit events, like the Reserve Primary Fund's large Lehman Brothers holding in 2008, or a sharp rise in short term interest rates could force the fund sponsor to reduce the NAV below $1.00. Fund sponsors consider "breaking the buck" a last resort, as their funds' reputation will be tarnished by such an event. Many investors took the stability and creditworthiness of institutional prime MMFs for granted; but with the new regulations, fund due diligence will become even more important.

The SEC established a mechanism to prevent runs (excessive withdrawals) on institutional prime funds by implementing liquidity fees and redemption gates during periods of stress. Liquidity fees are designed to discourage investors from withdrawing funds during periods of market stress. Institutional prime funds will be allowed to impose a fee up to 2% on funds withdrawn if the fund's weekly liquidity falls below 30% of the fund's total assets. Secondly, the fund would be required to impose a 1% fee on funds withdrawn if the fund's weekly liquidity falls below 10% of the fund's total assets. Instead of imposing liquidity fees on redemptions, the SEC granted fund sponsors the ability to temporally suspend redemptions using redemption gates. If a fund's weekly liquidity falls below 30% of total assets, the fund would have the ability to suspend redemptions for up 10 business days, but not more than 10 business days in any 90 day period. While the new regulations are designed to add stability to the market, they may fundamentally change the way investors view certain MMFs.

Regulators understood a stable net asset value money market fund is a critical building block for investors, thus the SEC made reform a focus.

We feel many institutional prime MMF investors value a stable NAV and unconstrained liquidity for their funds. Over the next two years we will focus on how/which investors shift their funds to and from different money market instruments. Most MMF investors, even ones with high risk tolerance, consider their MMF holdings in a similar spirit as our local agency clients consider their entire investment program--safety, liquidity and yield. The new reforms have the potential to go against the first two tenets, a floating

NAV could jeopardize the preservation of principal (safety), and liquidity fees and redemption gates could reduce overall liquidity of funds. We expect flows out of institutional prime MMF market, a nearly trillion dollar market, but determining where stable NAV funds migrate to is the ultimate question.

Institutional prime money market funds will likely prematurely build liquidity in anticipation of potential outflows...

As investors potentially shift their allocations to different funds or asset classes, the market for short maturity securities could become dislocated between securities with "credit" risk and government securities. Demand for commercial paper, certificate of deposits and short maturity corporate notes could decline as investors shift funds away from institutional prime MMFs. On the other hand, demand for short maturity U.S. government and agency securities could rise as investors may look to government MMFs for safety. The shifting of assets could increase credit spreads while also driving down government yields as government MMFs fight for already scarce government bonds.

Institutional prime MMFs will likely prematurely build liquidity in anticipation of potential outflows to decrease interest rate risk and preserve their $1.00 NAV. We believe that funds will reduce their weighted average maturity by carrying more overnight and very short maturity investments, like repurchase agreements. As funds reduce their overall maturity profile, longer securities (9-12 months) could see some cheapening as funds would not want to increase their maturity profile in fear they may potentially have large liquidity needs. The two year phase-in of the SEC regulations will provide debt issuers and investors ample time to logically position their exposure before the regulations are implemented. Banks, who are traditionally large issuers of debt to institutional prime MMFs, will likely shift their funding mix to elevate any financing pressures they may experience with these changes.

At Chandler, we welcome situations where market dynamics create opportunities to purchase attractively valued securities. Investors with a disciplined investment process and rigorous credit evaluation are poised to benefit from the regulatory changes taking place.

- Jeff Probst, CFA
VP, Portfolio Manager