CHANDLER ASSET MANAGEMENT

September 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.

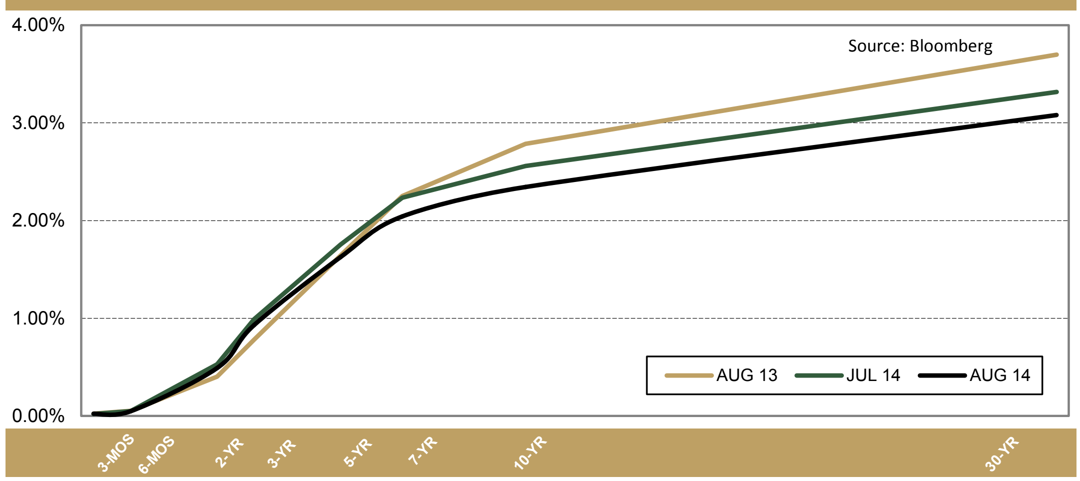
Market Summary

Recent economic news has been favorable and we believe the economy continues to grow at a modest pace. The August employment report was weaker than expected (as payrolls rose by 142,000 versus expectations of 230,000), but the trailing three month moving average of nonfarm payrolls was 207,000, which remains consistent with modest growth. We also believe that the August payroll figure could be revised higher, given that reports for August have typically been volatile and subject to revision. The unemployment rate edged back down to 6.1% in August. The manufacturing sector continues to show strength, with the ISM manufacturing index rising to a stronger than expected 59.0 in August from 57.1 in July. Recent housing data has also shown some modest improvement. Consumer spending data has been mixed, but we believe ongoing improvement in the labor market will continue to support consumer spending and fuel ongoing economic growth.

We believe the Fed remains on course to complete the unwinding of quantitative easing in October. The next Federal Open Market Committee meeting is scheduled for September 16-17. Fed Chair Yellen will host a press conference after the September FOMC meeting and the Fed will provide an update on their economic projections. In our view, most of the recent economic data has been favorable, and the Fed isn't likely to make dramatic changes to their projections based on one month of sluggish job growth, especially since the August jobs number may be subject to revision.

The yield on the two-year Treasury note declined slightly in August, following an increase in June and July. Recent economic data has been mostly favorable. 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, but this has been somewhat offset by geopolitical tensions.

THE YIELD CURVE FLATTENED IN AUGUST



During the past three months, the yield curve has flattened even as the Fed has been tapering its purchases of long-term Treasury bonds. Geopolitical tensions have kept downward pressure on longer yields.

TREASURY YIELDS	8/31/2014	7/31/2014	CHANGE
3 Month	0.02	0.02	0.00
2 Year	0.49	0.53	(0.04)
3 Year	0.93	0.99	(0.06)
5 Year	1.63	1.75	(0.12)
7 Year	2.04	2.23	(0.19)
10 Year	2.34	2.56	(0.22)
30 Year	3.08	3.32	(0.24)

Source: Bloomberg

Economic Roundup

Consumer Prices

In July, overall CPI inflation was 2.0% on a year-over-year basis down from 2.1% in June. The year-over-year Core CPI (CPI less food and energy) was unchanged at 1.9% in July.

Retail Sales

In July, Retail Sales rose 3.7% on a year-over-year basis versus a gain of 4.3% in June. On a month-over-month basis, Retail Sales were flat in July, which was below expectations. Overall, Retail Sales have been softer than expected for the past few months.

Labor Market

The August employment report was weaker than expected as nonfarm payrolls rose by just 142,000 in the month, following gains of 212,000 and 267,000 in July and June, respectively. The consensus forecast for August was 230,000. The net revisions for July and June were -28,000. Private payrolls rose by just 134,000 in August while government jobs rose by 8,000. The unemployment rate edged back down to 6.1% (as expected) from 6.2%, but the participation rate also ticked back down to 62.8% from 62.9%. The trailing three month average monthly increase in nonfarm payrolls was 207,000, which remains consistent with modest growth.

Housing Starts

Single-family housing starts rose 8.3% in July to 656,000 following a 4.4% decline in June. Multifamily starts rose 28.9% in July after falling 3.1% in June.

Credit Spreads Widened Slightly

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.11	0.12	(0.01)
2-year A corporate note	0.44	0.43	0.01
5-year A corporate note	0.45	0.43	0.02
5-year Agency note	0.16	0.09	0.07

Source: Bloomberg Data as of 8/31/2014

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.5) $Bln JUL 14	(40.8) $Bln JUN 14	(39.4) $Bln JUL 13
GDP	4.2% JUN 14	(2.1)% MAR 14	1.8% JUN 13
Unemployment Rate	6.1% AUG 14	6.2% JUL 14	7.2% AUG 13
Prime Rate	3.25% AUG 14	3.25% JUL 14	3.25% AUG 13
CRB Index	292.75 AUG 14	294.43 JUL 14	291.16 AUG 13
Oil (West Texas Int.)	$95.96 AUG 14	$98.17 JUL 14	$107.65 AUG 13
Consumer Price Index (y/o/y)	2.0% JUL 14	2.1% JUN 14	2.0% JUL 13
Producer Price Index (y/o/y)	2.9% JUL 14	2.7% JUN 14	2.1% JUL 13
Dollar/EURO	1.31 AUG 14	1.34 JUL 14	1.32 AUG 13

Source: Bloomberg

Rotation at the Fed - What Does it Mean for Policy in 2015?

Though the precise timing and magnitude of a future fed funds rate hike is uncertain, most market participants expect the Federal Open Market Committee (FOMC) will vote to begin hiking interest rates sometime in the second or third quarter of next year. This expectation is largely based on guidance provided by the FOMC in their effort to provide transparency to the market. What some market participants may be overlooking, however, is that composition of the FOMC will change in 2015, and potentially half of the votes will be cast by new members. This upcoming shuffle on the Committee makes the outlook for policy changes somewhat more challenging to predict and will likely fuel market volatility.

The FOMC is typically made up of twelve voting members, including seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four additional Reserve Bank Presidents who rotate annually. The remaining seven Reserve Bank presidents (given that there are twelve Reserve Banks in total) attend the FOMC meetings and participate in the discussions but do not have a vote on policy changes. The seven members of the Board of Governors, including the Fed Chair, are nominated by the President and confirmed by the Senate.

What is the Federal Open Market Committee (FOMC)?

- The Federal Reserve's monetary policymaking body.
- Responsible for promoting stable prices and maximum employment, in pursuit of long run economic growth.
- Responsible for setting a target for the federal funds rate (the rate that banks charge one another for short-term loans).
- Voting members include the Board of Governors, the President of the Federal Reserve Bank of New York, and Presidents of four other Reserve Banks who serve on a rotating basis.
- The President of the Federal Reserve Bank of New York is a permanent voting member of the FOMC and traditionally serves as the FOMC Vice Chairman. All of the Fed's open market operations (including the buying and selling of U.S. Treasuries) are carried out by the New York Fed.
- All twelve Reserve Bank Presidents participate in FOMC meetings and discussions.
- The Chair of the Board of Governors is also the Chair of the FOMC (currently Janet Yellen).
- The FOMC typically meets eight times per year.

As of today, the voting power of the FOMC is concentrated in the hands of ten people, rather than the typical twelve, as there are two vacant seats on the Board of Governors. In January, four new Reserve Bank Presidents will rotate into the Committee. By early next year there may be six new voting members on the Committee of twelve. In addition, at least one of the current Federal Reserve Bank Presidents (Richard Fisher – Dallas) is facing mandatory retirement in April. Although he would not be a voting member of the FOMC next year, his retirement means there will be another new voice in the room during the FOMC meetings. In an attempt to anticipate what all of these changes could mean for Fed policy, we've taken a closer look at the composition of the current FOMC versus the FOMC in 2015.

Current FOMC Members			
Janet Yellen	Chair, Board of Governors	Term as Chair expires 2018. Overall term expires 2024.	DOVE
William Dudley	Vice Chairman, New York Fed President	Took office in 2009. Turns 65 in 2017 but could potentially serve until 2019 at the option of the board of directors.	DOVE
Stanley Fischer	Board of Governors	Term as Vice Chair of the Board of Governors expires 2018. Overall term expires 2020.	DOVE
Lael Brainard	Board of Governors	Term expires 2026.	MODERATE
Richard Fisher	Dallas Fed President	Turns 65 this year and will face mandatory retirement in April 2015.	HAWK
Narayana Kocherlakota	Minneapolis Fed President	Took office in 2009. Currently 50 years old.	DOVE
Loretta Mester	Cleveland Fed President	Took office in June 2014. Currently 55 years old.	MODERATE
Charles Plosser	Philadelphia Fed President	Took office in 2006. Currently 65 years old & will face mandatory retirement in August 2016.	HAWK
Jerome Powell	Board of Governors	Term expires 2028.	MODERATE
Daniel Tarullo	Board of Governors	Term expires 2022.	DOVE
DOVE: 5		MODERATE: 3	HAWK: 2

In the tables above and on the next page, we have included our interpretation of the dovish (leaning toward ongoing accommodation) or hawkish (leading toward removing accommodation and/or hiking rates) stance of the current and future FOMC members. We have categorized members that do not seem particularly dovish or hawkish, in our view, as "moderate".

2015 FOMC Members			
Janet Yellen	Chair, Board of Governors	Term as Chair expires 2018. Overall term expires 2024.	DOVE
William Dudley	Vice Chairman, New York Fed President	Took office in 2009. Turns 65 in 2017 but could potentially serve until 2019 at the option of the board of directors.	DOVE
Stanley Fischer	Board of Governors	Term as Vice Chair of the Board of Governors expires 2018. Overall term expires 2020.	DOVE
Lael Brainard	Board of Governors	Term expires 2026.	MODERATE
Charles Evans	Chicago Fed President	Took office in 2007. Currently 56 years old.	DOVE
Jeffrey Lacker	Richmond Fed President	Took office in 2004. Currently 58 years old.	HAWK
Dennis Lockhart	Atlanta Fed President	Took office in 2007. Currently 67 years old, and will face mandatory retirement in 2017.	DOVE
John Williams	San Francisco Fed President	Took office in 2011. Currently 52 years old.	MODERATE
Jerome Powell	Board of Governors	Term expires 2028.	MODERATE
Daniel Tarullo	Board of Governors	Term expires 2022.	DOVE
?	Board of Governors	To be appointed by President Obama and confirmed by Senate.	?
?	Board of Governors	To be appointed by President Obama and confirmed by Senate.	?
DOVE: 6	**MODERATE: 3**	**HAWK: 1**	**VACANCIES: 2**

Non-Voting Fed Presidents in 2015			
Eric Rosengren	Boston Fed President	Took office in 2007. Currently 57 years old.	DOVE
James Bullard	St. Louis Fed President	Took office in 2008. Currently 53 years old.	HAWK
Esther George	Kansas City Fed President	Took office in 2011. Currently 56 years old.	HAWK
?	Dallas Fed President	Richard Fisher turns 65 this year and will face mandatory retirement in April 2015.	?
Narayana Kocherlakota	Minneapolis Fed President	Took office in 2009. Currently 50 years old.	DOVE
Loretta Mester	Cleveland Fed President	Took office in June 2014. Currently 55 years old.	MODERATE
Charles Plosser	Philadelphia Fed President	Took office in 2006. Currently 65 years old, and will face mandatory retirement in August 2016.	HAWK
DOVE: 2	**MODERATE: 1**	**HAWK: 3**	**VACANCIES: 1**

Based on our interpretation of Fed members' stance on policy accommodation, we believe the FOMC is likely to become even more dovish next year, with six voting members having a more dovish stance in 2015, versus five in 2014. Most of the outspoken hawks will be non-voting Fed Presidents in 2015. Surely, there is still uncertainty about who will fill the two vacancies on the Board of Governors, but we tend to believe that President Obama is likely to appoint members with a more dovish or moderate view.

Overall, we believe monetary policy changes will continue to be data-dependent and that price stability and the pace of job growth will ultimately determine how the Fed moves. However, in our view, the upcoming shuffle at the FOMC has the potential to push out the first fed funds rate hike further into 2015 than market participants may currently be expecting. The rotation may also suggest that the Committee will lean toward a more gradual approach to rate hikes, rather than swift tightening. As we get closer to the first fed funds rate hike, we believe ongoing speculation about the timing and magnitude of Fed policy changes will continue to create volatility in the market, and we at Chandler plan to be opportunistic amid potential volatility.

- Shelly Henbest
VP, Credit Analyst

Note: Members of the Board of Governors are appointed for 14-year, staggered terms. The Chairman and Vice Chairman are appointed to 4-year terms but may be reappointed. Members of the Board of Governors often leave their 14-year terms early.

Note: The terms of all twelve Reserve Bank presidents run concurrently, ending on the last day of February of years numbered 6 and 1. A president of a Reserve Bank may take office after a term has begun and may be reappointed after serving a full or incomplete term. Reserve Bank presidents are subject to mandatory retirement at age 65. However, presidents initially appointed after age 55 can, at the option of the board of directors, be permitted to serve until attaining ten years of service or age 75, whichever comes first.
Source: www.federalreserve.gov