CHANDLER ASSET MANAGEMENT

November 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.

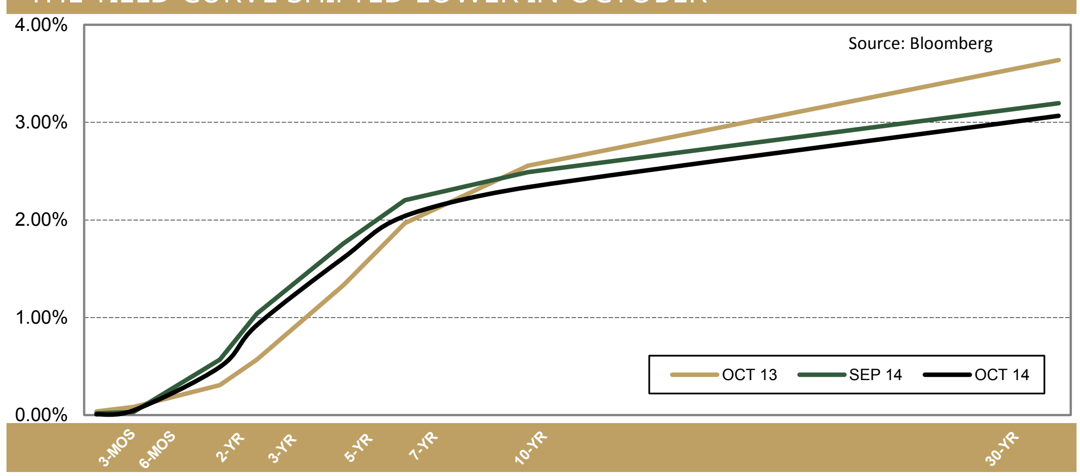
Market Summary

Domestic economic data continued to be mostly favorable in October, but the employment report was somewhat mixed. Nonfarm payrolls rose by 214,000 in October, below the consensus forecast of 240,000. However, the unemployment rate declined to 5.8% from 5.9%. The labor participation rate and wage growth both ticked up slightly. Overall, the employment report was a bit softer than expected, but the labor market continues to improve. Meanwhile, the manufacturing sector continues to show strength. Consumer spending also remains healthy, and we believe ongoing job growth and a recent decline in gas prices should bode well for the holiday shopping season. The housing sector remains volatile and continues to lag behind other sectors of the economy.

In October, the Federal Open Market Committee (FOMC) left policy rates unchanged and announced the end of quantitative easing. The FOMC retained the "considerable time" language in its policy statement relating to the timing of an increase in policy rates and (even with the completion of quantitative easing) monetary policy remains highly accommodative. However, the tone of the Fed's October policy statement was incrementally more hawkish than its previous statement in September. The Fed noted that the economy is expanding at a moderate pace, labor market conditions have improved, and the likelihood of inflation running persistently below target has diminished. The Committee continues to emphasize its policy actions will be data dependent, leaving the timing of future rate hikes uncertain. The next FOMC meeting is scheduled for December 16-17.

The yield on the two-year Treasury note declined in October, reversing its increase in September. Domestic economic data remained fairly strong in October, but concerns about a slowdown in global economic growth (particularly in Europe) were elevated in the month. Geopolitical tensions and fears of an Ebola outbreak also caused volatility in the financial markets during the month.

THE YIELD CURVE SHIFTED LOWER IN OCTOBER



During the past month, the yield curve shifted lower. Mixed global economic data and geopolitical tensions caused increased volatility in the financial markets. These concerns also kept downward pressure on longer yields, even as the Fed completed its program of quantitative easing.

TREASURY YIELDS	10/31/2014	9/30/2014	CHANGE
3 Month	0.01	0.02	(0.01)
2 Year	0.49	0.57	(0.08)
3 Year	0.92	1.04	(0.12)
5 Year	1.61	1.76	(0.15)
7 Year	2.04	2.20	(0.16)
10 Year	2.34	2.49	(0.15)
30 Year	3.07	3.20	(0.13)

Source: Bloomberg

Economic Roundup

Consumer Prices
In September, overall CPI inflation was unchanged at 1.7% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) was also unchanged at 1.7% in September.

Retail Sales
In September, Retail Sales rose 4.3% on a year-over-year basis versus a gain of 5.0% in August. On a month-over-month basis, Retail Sales declined 0.3% in September, which was weaker versus the expectation of a 0.1% decline. Auto and gasoline sales were a drag on the September figure. Overall, consumer spending appears healthy but not robust.

Labor Market
The October employment report was mixed. Nonfarm payrolls rose by 214,000 in the month, below the consensus forecast of 240,000. However, the unemployment rate declined to 5.8% from 5.9%. The net revisions in nonfarm payrolls for September and August were +31,000 (with gains of 256,000 and 203,000 in September and August, respectively). Private payrolls rose by 209,000 in October while government jobs rose by 5,000. The labor participation rate remains low but ticked back up to 62.8% from 62.7%. Meanwhile, wage growth also edged up 0.1% in October after being flat in September. Overall, the employment report was a little softer than expected but the labor market continues to improve.

Housing Starts
Housing data remains volatile. Single-family housing starts rose 1.1% in September after declining 2.0% in August. Multifamily starts rose 16.7% in September after falling 28.7% in August.

Credit Spreads Widened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.14	0.14	0.00
2-year A corporate note	0.54	0.50	0.04
5-year A corporate note	0.59	0.54	0.05
5-year Agency note	0.09	0.05	0.04

Source: Bloomberg *Data as of 10/31/2014*

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(43.0) $Bln SEP 14	(40.0) $Bln AUG 14	(42.3) $Bln SEP 13
GDP	3.5% SEP 14	(4.6)% JUN 14	4.5% SEP 13
Unemployment Rate	5.8% OCT 14	5.9% SEP 14	7.2% OCT 13
Prime Rate	3.25% OCT 14	3.25% SEP 14	3.25% OCT 13
CRB Index	271.96 OCT 14	278.55 SEP 14	277.86 OCT 13
Oil (West Texas Int.)	$80.54 OCT 14	$91.16 SEP 14	$96.38 OCT 13
Consumer Price Index (y/o/y)	1.7% SEP 14	1.7% AUG 14	1.2% SEP 13
Producer Price Index (y/o/y)	2.2% SEP 14	2.3% AUG 14	0.3% SEP 13
Dollar/EURO	1.25 OCT 14	1.26 SEP 14	1.36 OCT 13

Source: Bloomberg

Credit and MBS Option Adjusted Spreads in Tightening Cycles

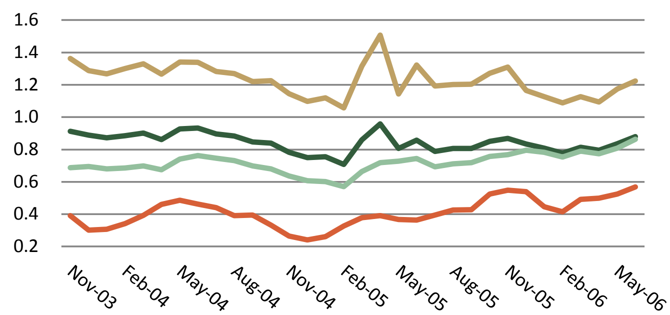
Market volatility is poised to increase as the low interest rate environment of the past several years comes to a conclusion. One of the largest concerns for both institutional and retail investors looking forward into fiscal 2015 and beyond is the timing, speed, and overall change in the Fed Funds rate. Multiple factors, both domestic and international, are clouding investors' ability to predict both the start date of the tightening cycle, as well as the overall magnitude of the change in the Fed Funds rate once the process commences.

One of the largest domestic concerns is the inability of the highly stimulative monetary policy currently in place to drive inflation up to the Federal Reserve's (Fed) 2.0% target. Based on the most recent quarterly forecast from the Fed released on September 17, the longer run forecast for PCE inflation (Personal Consumption Expenditures Index – the Fed's preferred inflation benchmark) is 2.0%; however the most recent annualized reading is only 1.4%. The global inflation outlook remains precarious as commodity prices have been moving lower and wage inflation is muted, compromising the Fed's objective of stable to higher prices. Additionally, monetary policy is becoming more desynchronized with the Fed looking to tighten policy while the Bank of Japan (BoJ) and the European Central Bank (ECB) continue to loosen policy. Investors need to consider the unintended consequences of a stronger dollar and its implications on the global competitiveness of US based corporations.

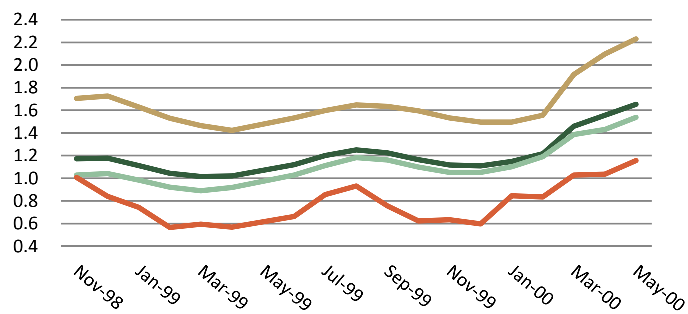
Based on the current trajectory of the domestic economy, the team at Chandler forecasts the Fed will begin to tighten monetary policy in the second half of 2015. In an effort to better understand the potential consequences to high quality fixed income portfolios during periods of monetary policy tightening, the team analyzed Option Adjusted Spreads (OAS) on the credit and MBS (Mortgage Backed Security) indices during the past three tightening cycles. We focused our analysis on the time period six months prior to the start of the tightening cycle through the end of the cycle, utilizing monthly data points on various index sub sectors.

The tightening cycle ending in June 2006 was notable for its length of just over two years and the peak to trough change in rates of 4.25% (*see Chandler Newsletter Article from March 2013: Monetary Policy: Treasury Yield Curves in a Tightening Cycle*). The overall change in the aggregate US Credit index went from 93 bps (basis point, .01 of 1%) to 88 bps, a tightening of five bps during the period. The US credit 'A' cohort moved wider by 12 bps versus the US credit 'BBB' cohort tightening by 12 bps. The MBS portion widened by eight bps but was also more volatile than the other sectors with the OAS dropping down to 36 bps at the mid-point of the tightening cycle (see table on next page). The tightening cycle ending in May of 2000 was relatively short with a trough to peak rate change of 1.75%. All sectors represented in the table experienced spread widening. Given the bursting of the technology stock bubble during this time frame, we believe, exogenous factors other than the monetary policy cycle contributed to the movement of OAS for the sectors. The tightening cycle ending in February 1995 was also relatively short with a trough to peak change in the Fed Funds rate of 3.0%. All credit sectors had stable performance with spread widening between four to seven bps. The MBS OAS experienced dramatic tightening during this time period, moving from 99 bps at the start of the tightening cycle to 44 bps at the conclusion of the

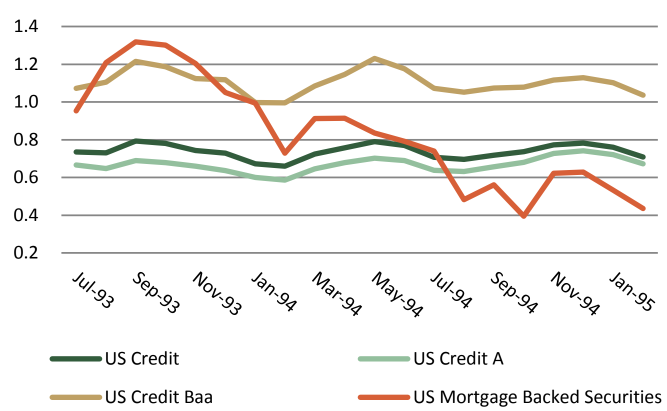
Option Adjusted Spreads / November 2003 - June 2006



Option Adjusted Spreads / November 1998 - May 2000



Option Adjusted Spreads / July 1993 - February 1995



Graph Source: Barclay's Live

Monetary Policy Tightening Cycles	US Credit	US Credit A	US Credit Baa	US MBS
Tightening Cycle Ending June 2006				
Six months pre-tightening (November 2003)	0.91	0.69	1.36	0.39
Start date of tightening (May 2004)	0.93	0.74	1.34	0.49
Mid date (June 2005)	0.86	0.74	1.32	0.36
End date (June 2006)	0.88	0.86	1.22	0.57
Change from start of tightening	(0.05)	0.12	(0.12)	0.08
Tightening Cycle Ending May 2000				
Six months pre-tightening (November 1998)	1.17	1.03	1.71	1.01
Start date of tightening (April 1999)	1.02	0.92	1.42	0.57
Mid date (November 1999)	1.12	1.05	1.53	0.63
End date (May 2000)	1.65	1.54	2.23	1.16
Change from start of tightening	0.63	0.62	0.81	0.59
Tightening Cycle Ending February 1995				
Six months pre-tightening (July 1993)	0.73	0.67	1.07	0.95
Start date of tightening (January 1994)	0.67	0.60	1.00	0.99
Mid date (July 1994)	0.71	0.64	1.07	0.74
End date (February 1995)	0.71	0.67	1.04	0.44
Change from start of tightening	0.04	0.07	0.04	(0.56)

tightening cycle. Given the relative infancy of the MBS market in the early 1990s it appears the sector was trading at very attractive spreads versus the credit sector which contributed to the outperformance during this time period.

Based on the data presented credit sector spreads do not exhibit a widening bias prior to the start of the tightening cycles. In two of the three periods represented the broad credit sector experienced spread tightening in the six months leading up to the initial change in monetary policy, and in the one period where spreads widened in the period preceding the initial tightening, the movement was only two bps wider. Historically, market participants have gravitated towards MBS during periods of stable interest rates and low interest rate volatility to account for the optionality and negative convexity of the asset class. It is difficult to ascertain definitive conclusions about the period preceding the initial tightening of monetary policy specific to MBS as the movements in each of the time periods are wider by 10 bps, tighter by 44 bps, and wider by four bps (ex. Tightening Cycle Ending June 2006, .49-.39= .10 or 10 bps). In the tightening cycles which ended in May of 2000 and February 1995 the pre-tightening MBS OAS of 101 bps and 95 bps, respectively, was attractive on a risk adjusted basis versus the Credit OAS valuation of 117 bps and 73 bps, respectively. The starting point valuation of any asset class matters, regardless of the direction of monetary policy, and in the latter two tightening cycles the MBS OAS was attractively valued.

The mid-date OAS change of the three tightening cycles represented in the graphs and tables is benign. In the two periods where spreads are wider the magnitude is small enough to allow the additional spread, compared to a like maturity Treasury note, to enhance the overall total return of the portfolio. The bias is for spreads to widen late in the tightening cycle. This makes intuitive sense as the Fed is trying to slowdown the economy by raising interest rates and a recessionary economic backdrop becomes more likely.

The Chandler team thinks the Fed will find it challenging to raise the Fed Funds rate much higher than 2.50% at equilibrium. The global macroeconomic backdrop is too weak for the Fed to be as aggressive as they were in the tightening periods ending in June 2006 and February 1995. The team also discounts using the cycle ending in May 2000 as a template for the upcoming cycle as the noise associated with the bursting of the technology bubble makes it difficult to isolate out the spread widening directly attributable to the change in monetary policy. Based on the three prior tightening cycles the data indicates patience is required in determining the appropriate timing to reduce exposure to the credit and MBS sectors to mitigate the risk of widening OAS. In our judgment, six months after the initial tightening of monetary policy is critical in determining if broad asset allocation shifts within fixed income portfolios are prudent.

- William Dennehy II, CFA
SVP, Portfolio Manager

Table Source: Barclay's Live