CHANDLER ASSET MANAGEMENT

January 2015

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.

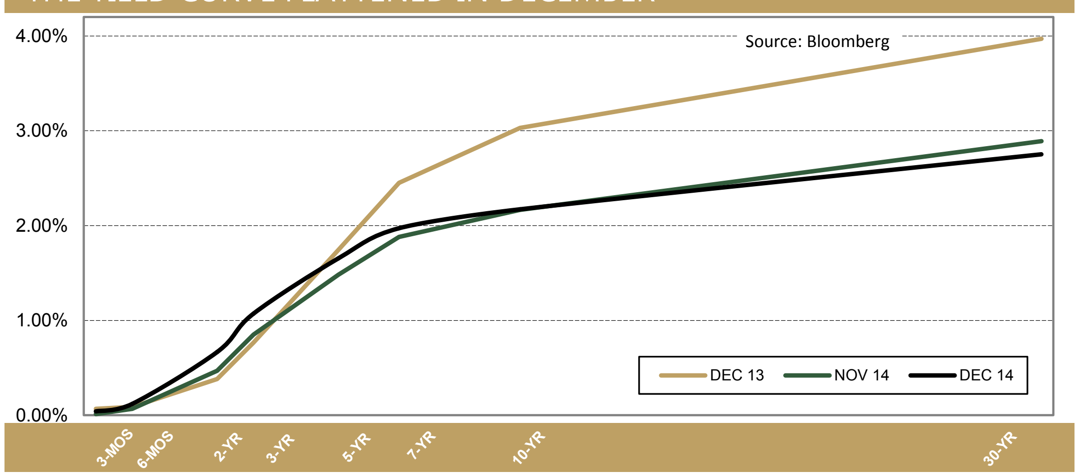
Market Summary

We believe economic data over the past month has remained indicative of modest growth. Nonfarm payrolls rose by 252,000 in December, following strong gains of 353,000 and 261,000 in November and October, respectively. The unemployment rate also declined to 5.6% from 5.8%. However, wages declined 0.2% in December and the labor participation rate also fell to 62.7% from 62.9%. The manufacturing sector continues to expand and consumer confidence was strong heading into 2015. We believe low gas prices should provide an ongoing tailwind for consumer spending. Meanwhile, housing data remains volatile in spite of ongoing low mortgage rates.

The Federal Open Market Committee (FOMC) left policy rates unchanged at its final meeting of 2014. The FOMC indicated that it will take a "patient" approach toward normalizing monetary policy, and implied that the first rate hike is likely to be in (or around) mid-2015 based on the Fed's economic forecasts. Overall, the FOMC's guidance on policy action was consistent with its previous guidance, but the Committee is moving away from its "considerable time" language and emphasizing that policy changes will be data-dependent. During her post-meeting press conference, Fed Chair Yellen indicated that policy rates would likely remain unchanged for at least the next couple of FOMC meetings. This suggests that a rate hike is unlikely to happen any sooner than April, unless there is an unexpected change in economic data. The Committee also expects the fed funds rate to approach a more normalized level by the end of 2017, which suggests that any rate increases are likely to be gradual over the next few years. We expect FOMC members will continue to debate the appropriate timing of the first fed funds rate hike when they meet again on January 27-28, 2015.

The yield on the two-year Treasury note increased in December, following two months of declines. Domestic economic data continued to be fairly solid in December, but concerns about weak global economic growth (particularly in Europe) remained elevated.

THE YIELD CURVE FLATTENED IN DECEMBER



Concerns about weak global economic growth kept downward pressure on longer US Treasury yields, even as the Fed signaled the possibility of a fed funds rate hike this year.

TREASURY YIELDS	12/31/2014	11/30/2014	CHANGE
3 Month	0.04	0.01	0.03
2 Year	0.67	0.47	0.20
3 Year	1.07	0.85	0.22
5 Year	1.65	1.48	0.17
7 Year	1.97	1.88	0.09
10 Year	2.17	2.17	0.00
30 Year	2.75	2.89	(0.14)

Source: Bloomberg

Economic Roundup

Consumer Prices

In November, overall Consumer Price Index (CPI) inflation declined to 1.3% on a year-over-year basis from 1.7% in October. The year-over-year Core CPI (CPI less food and energy) also declined to 1.7% in November from 1.8% in October.

Retail Sales

In November, retail sales rose 5.1% on a year-over-year basis versus a gain of 4.5% in October. On a month-over-month basis, retail sales rose 0.7% in November after increasing 0.5% in October, exceeding expectations. Gasoline sales were a drag on retail sales in both months due to lower prices. Overall, consumer spending is showing positive momentum.

Labor Market

Nonfarm payrolls rose by 252,000 in December (above the consensus forecast of 245,000), following gains of 353,000 and 261,000 in November and October, respectively. The net revisions in nonfarm payrolls for November and October were +50,000. The unemployment rate declined to 5.6% from 5.8%. Private payrolls rose by 240,000 in December, while government jobs rose by 12,000. Meanwhile, the labor participation rate declined to 62.7% from 62.9%. Wages also decreased 0.2%, versus expectations for a 0.2% increase.

Housing Starts

Housing data remains volatile. Single-family housing starts fell 5.4% in November after increasing 8.0% in October.

Credit Spreads Widened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.13	0.13	0.00
2-year A corporate note	0.54	0.54	0.00
5-year A corporate note	0.61	0.65	(0.04)
5-year Agency note	0.03	0.09	(0.06)

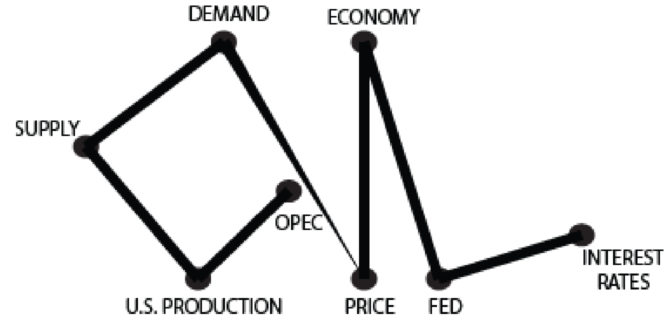
Source: Bloomberg *Data as of 12/31/2014*

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(39.0) $Bln NOV 14	(42.2) $Bln OCT 14	(36.0) $Bln NOV 13
GDP	5.0% SEP 14	4.6% JUN 14	4.5% SEP 13
Unemployment Rate	5.6% DEC 14	5.8% NOV 14	6.7% DEC 13
Prime Rate	3.25% DEC 14	3.25% NOV 14	3.25% DEC 13
CRB Index	229.96 DEC 14	254.37 NOV 14	280.17 DEC 13
Oil (West Texas Int.)	$53.27 DEC 14	$66.15 NOV 14	$98.42 DEC 13
Consumer Price Index (y/o/y)	1.3% NOV 14	1.7% OCT 14	1.2% NOV 13
Producer Price Index (y/o/y)	1.1% NOV 14	1.7% OCT 14	0.8% NOV 13
Dollar/EURO	1.21 DEC 14	1.25 NOV 14	1.37 DEC 13

Source: Bloomberg

Connecting the Oil Dots



Much has been written in recent weeks about the global collapse of oil prices. You have undoubtedly heard dozens of facts and figures by now, creating a multitude of data points or dots on the economic landscape for 2015 and beyond. But what do all of these "dots" (borrowing a term from the Fed's economic "dot plot" of data) mean for the economy overall? More importantly, for fixed income investors, what does this mean for interest rates and their portfolios in 2015?

To attempt to answer this question, we must remind ourselves of some of the more significant events of 2014 – the bigger "dots" if you will. Global oil prices have declined approximately 55% since June and gas prices 30%. As of the writing of this article, Brent (the price oil producers receive internationally) is trading at about $46/barrel, down from a high of $115, and West Texas Intermediate (the US benchmark) is trading at approximately $46/barrel, down from a high of $107. The collapse in prices has been primarily caused by a glut in supply but also weak global demand.

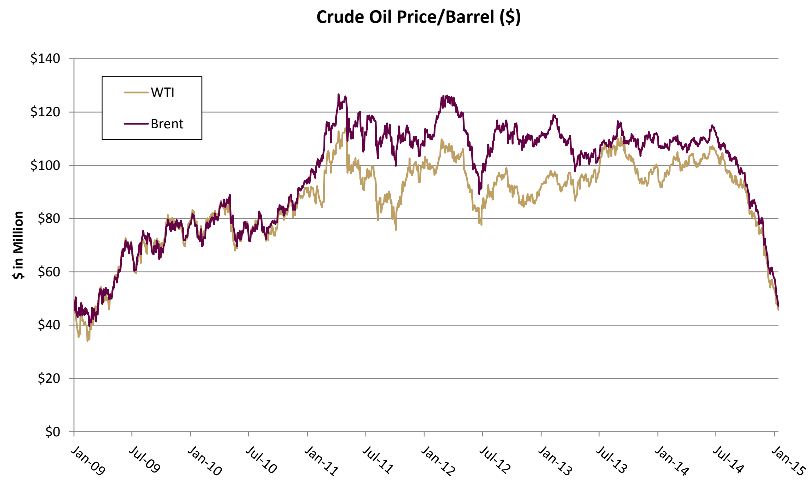
First, let us address the supply problem, which comes from both unexpected and expected factors. The expected factor — for the first time in recent history, the US is contributing to the supply problem. In June, rumors began to circulate that the 40-year-old ban on US oil exports was lifted, and broad approval for exports is expected in the near- to intermediate-term. Fracking technology has advanced and taken off dramatically in recent years, causing shale production to ramp up in the US. Increased oil production has created a "boom" in some states, such as North Dakota, but oil-rich states, such as Texas, Alaska, Oklahoma, Louisiana as well as North Dakota, are now bracing for the negative consequences of the recent plunge in oil prices. In fact, oil is already below break-even costs for most shale and oil-sands producers in North America. More than half of US shale production breaks even at $60, but because of hedging, do not expect to see big cutbacks in shale. The market consensus is that 75% of high-yield shale producers are hedged for 2015 and about 40-45% for 2016. Additionally, technology continues to evolve rapidly, enabling these producers to increase efficiency with the equivalent or fewer rigs.

The unexpected factor, another significant "dot" on the landscape, lies with OPEC's contribution to the supply glut. Historically, OPEC has been the source for disruptions in oil pricing, albeit typically restricting supply and causing prices to spike, if you are "seasoned" enough, you will remember the 1970s energy crisis. However, this time around, OPEC decided not to limit supply in an attempt to retain global market share, regardless of profitability. Oil prices are also currently below budget break-even prices for most OPEC countries. However, Saudi Arabia may be keeping the price down for geopolitical reasons, such as inducing Russia to back down in Ukraine and forcing Iran to capitulate on nuclear production.

We address another "dot" by turning to the demand side of the problem. Global demand for oil continues to weaken. The Eurozone is approaching a recession, with less than 1% year-over-year GDP growth in the third quarter, coupled with 11.5% unemployment, and inflation in the region falling to its lowest level in five years at 0.3%. Meanwhile, China and Japan continue to struggle as both countries wrestle with long-term demographic challenges. Gasoline demand is flat in the US as cars are becoming more fuel-efficient and use of public transportation is growing along with urban renewal. Overall, the US economy is the bright spot on the global landscape with moderate growth, but the rest of the world lacks the same momentum for meaningful demand acceleration.

So far, all of these interconnected economic "dots" have resulted in a very volatile market, which is likely to continue into 2015. The Dow Jones Industrial Average hit record highs in 2014, reaching 18,000 in late December, and showing resilience by rebounding from a 1,000 point decline the first half of the month, to end the year up 9.86%. Treasury yields have also had a wild ride, with the 10-year note currently trading at approximately 2.02%, up from a low of 1.94 % just two days ago, and down from 3.02% at the end of 2013.

So what does all of this mean for the economy and interest rates in 2015? Although the Fed views the recent plunge in oil prices as "transitory", if prices remain at or below current levels for an extended period of time, it could potentially affect the liftoff date for raising target overnight rates. Currently, our view projects liftoff somewhere around the middle of 2015, but many factors can influence this timing. The Fed analyzes the overall health of the economy in an effort to realize their dual mandate of full employment and stable prices. The recent release of the Fed minutes had a few FOMC members predicting a "quite large" boost to domestic spending due to lower energy prices and most central bankers were not concerned about how plunging oil prices could actually hurt the global economy. US GDP grew at a rate of 5% in the third quarter, exceeding consensus expectations, with a rate of approximately 2.5%-3.0% projected for 2015. Consumer spending accounts for over two-thirds of the US economy. Lower oil prices translate into lower gas prices at the pump, and more dollars in the consumer's pocket to be spent elsewhere. We are in line with the thinking of the central bankers that this is a net gain for the economy. From a global perspective, countries that subsidize oil (both developed and emerging) will likely benefit. Additionally, energy dependent businesses, such as transportation and utilities, could benefit from lower costs. Possibly counteracting that positive impact is the contraction of the energy industry and associated capital expenditures. The industry accounts for 7.7% of US GDP and 9.2 million American jobs along with $15 trillion in investment from banks and governments globally. This contraction could also spread to the financial industry as well as others. However, we believe lower oil prices translate into a net positive for the economy overall.



The Fed analyzes overall economic growth; however, the key aspects of the Committee's dual mandate are full employment and price stability, two more significant points in our "connect the dots" analogy. Unemployment in the US has dropped from 6.7% to 5.6% in 2014, and the December gain of 252,000 jobs marks the 11th straight month of job growth of at least 200,000. However, wage growth remains weak, and slack remains in the labor market with a historically low labor force participation rate at 62.7%. The Fed is projecting full employment at approximately 5.2% next year. The US appears to be well on track towards satisfying the employment aspect of the Fed's mandate, barring any unforeseen downturn in 2015. The Fed's other mandate of price stability, particularly inflation, remains tenuous. The PCE (Personal Consumption Expenditures) Index, the Fed's preferred measure of inflation, was up a meager 1.2% last quarter, and Core PCE (excluding food and energy) was up 1.4%, with no meaningful progress in the past year towards the Fed's 2% target. Needless to say, depressed oil prices may exacerbate the situation, and the strong US dollar, projected to strengthen even more this year, could also dampen demand for US products globally. The Fed has indicated a desire to normalize interest rates as economic conditions warrant, but as stated earlier and reflected in the most recent Fed minutes, the depressed level of oil prices and how long they remain low might not delay the timing of the beginning of the Fed's rate normalization process as many market participants expect.

In addition to the Fed's rate normalization strategy and timing, a broad flight to quality could cause more rate volatility in 2015 – yet another dot to connect. Geopolitical risks could drive global investors into the safe haven of US Treasuries, causing prices to rise and yields to fall. This has occurred numerous times in the last several years. The behavior of OPEC countries is unpredictable, and peace in the Middle East is fragile at best, particularly between Israel and Iran. Russia's economy is faltering significantly with the drop in the price of oil. If any of these fragile "dots" become unbalanced or act unilaterally, we could see more volatility and investor flight to quality. Additionally, if deflation and recessionary conditions accelerate in the Eurozone or Asia, further capital flight to the US could result. Even in today's economy, relatively speaking, the 10-year US Treasury at 2.02% is a much better risk-adjusted investment than the comparable German Bund at 0.51% (Bloomberg, 1/8/15).

So in conclusion, how do we connect the dots? We think lower oil prices will increase demand, so prices will gradually drift, rising in the intermediate-term, with significant volatility along the way. Over an intermediate time frame, shale production should decline only slightly, assuming the price of oil does not improve. A possible tipping point for the Saudis decreasing supply could be Iran curbing its nuclear program and Russia scaling back its involvement in Ukraine. We believe there is less room to the downside in oil prices at current levels, but would not be surprised by a range of $40-$70 per barrel of oil in 2015 with more room to the upside. The Energy Information Administration is forecasting Brent at $58 per barrel and $54 per barrel for WTI in 2015 on average. Even if oil prices remain at their current levels, we do not believe it will be enough impetus for the Fed to significantly delay rate normalization at a gradual pace, but it may make for a bumpy ride along the way.

- Julie Hughes, *VP, Portfolio Strategist*

- Scott Prickett, *SVP, Portfolio Strategist*

Graph Source: Bloomberg