CHANDLER ASSET MANAGEMENT

February 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.

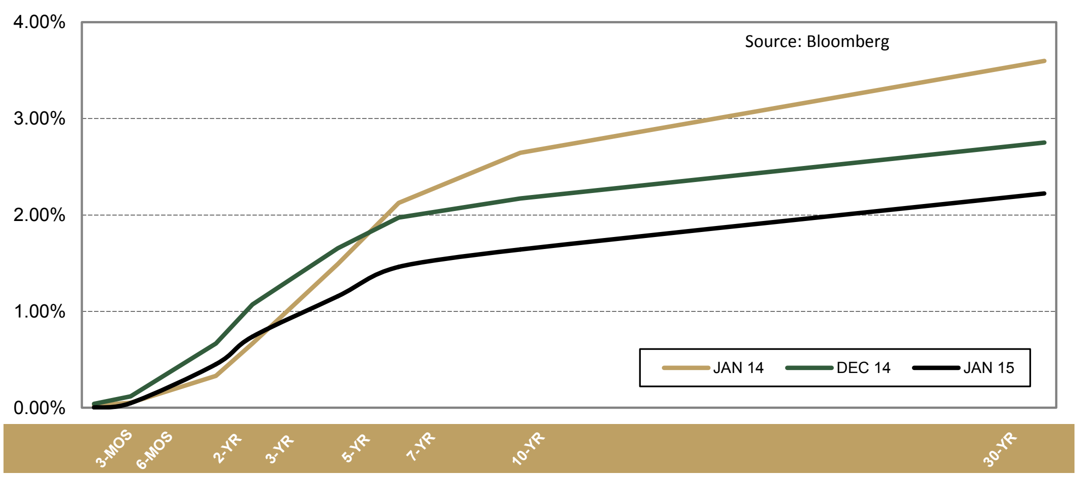
Market Summary

Solid job growth continues to fuel the U.S. economy. Nonfarm payrolls rose by 257,000 in January, following very strong gains of 329,000 and 423,000 in December and November, respectively. The unemployment rate increased to 5.7% from 5.6%, due to an increase in the labor participation rate, suggesting that discouraged workers are returning to the workforce. Wages also increased 0.5%, due in part to an increase in some states' minimum wage. Meanwhile, manufacturing data has recently softened. We believe the strong U.S. dollar and sluggish economic growth abroad may be having a dampening effect on U.S. manufacturing trends. Nevertheless, U.S. consumer confidence readings have been very strong and housing data has recently shown signs of improvement. Overall, we believe the domestic economy continues to grow at a modest pace.

As expected, the Federal Open Market Committee (FOMC) left policy rates unchanged at its first meeting of 2015. The Fed noted that economic activity has been expanding at a moderate pace and job growth has improved, but "market-based measures of inflation compensation have declined substantially in recent months." The Fed also acknowledged it is taking "international developments" into account as it assesses monetary policy. The FOMC reaffirmed it will take a "patient" approach toward normalizing monetary policy, and emphasized once again that policy changes will be data dependent. With inflation low, we believe the Fed faces no urgency to begin raising rates. Once the Fed has confidence that market-based inflation expectations have either troughed or started to rebound, we believe there will be more pressure on the Fed to begin normalizing monetary policy. We continue to believe the first fed funds rate hike is likely to take place sometime in the second half of this year.

The yield on the two-year Treasury note declined in January. Domestic economic data continued to be fairly solid, but concerns about weak global economic growth (particularly in Europe) remained elevated. Ongoing uncertainty about the timing of the Fed's first interest rate hike also fueled market volatility.

THE YIELD CURVE FLATTENED IN JANUARY



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	1/31/2015	12/31/2014	CHANGE
3 Month	0.00	0.04	(0.04)
2 Year	0.45	0.67	(0.22)
3 Year	0.74	1.07	(0.33)
5 Year	1.16	1.65	(0.49)
7 Year	1.46	1.97	(0.51)
10 Year	1.64	2.17	(0.53)
30 Year	2.22	2.75	(0.53)

Source: Bloomberg

Economic Roundup

Consumer Prices

In December, overall Consumer Price Index (CPI) inflation declined to 0.8% on a year-over-year basis from 1.3% in November. The year-over-year Core CPI (CPI less food and energy) also declined to 1.6% in December from 1.7% in November.

Retail Sales

In January, retail sales rose 3.3% on a year-over-year basis, following the same year-over-year gain in December. On a month-over-month basis, retail sales declined 0.8% in January (below the consensus forecast for a 0.5% decline) after declining 0.9% in December. Gasoline sales were a drag on retail sales in both months due to lower prices. Retail sales have been weaker than expected over the past few months, which is surprising in light of strong consumer confidence and consumer sentiment readings. We believe consumer spending is poised to accelerate.

Labor Market

Nonfarm payrolls rose by 257,000 in January, above the consensus forecast of 230,000. The net revisions in nonfarm payrolls for December and November were +86,000 (as payrolls increased by 329,000 and 423,000 in December and November, respectively). Private payrolls rose by 267,000 in January, while government jobs declined by 10,000. The unemployment rate increased to 5.7% from 5.6%, due to an increase in labor participation. The labor participation rate rose to 62.9% from 62.7%, suggesting that discouraged workers are returning to the workforce. Wages also increased 0.5%, following a 0.2% decrease in the prior month, due in part to an increase in some states' minimum wage.

Housing Starts

Single-family housing starts jumped 7.2% in December after declining 5.1% in November.

Credit Spreads Widened Further

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.14	0.13	0.01
2-year A corporate note	0.53	0.54	(0.01)
5-year A corporate note	0.71	0.61	0.10
5-year Agency note	0.13	0.03	0.10

Source: Bloomberg *Data as of 1/31/2015*

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(46.6) $Bln DEC 14	(39.8) $Bln NOV 14	(37.4) $Bln DEC 13
GDP	2.6% DEC 14	5.0% SEP 14	3.5% DEC 13
Unemployment Rate	5.7% JAN 15	5.6% DEC 14	6.6% JAN 14
Prime Rate	3.25% JAN 15	3.25% DEC 14	3.25% JAN 14
CRB Index	218.84 JAN 15	229.96 DEC 14	283.31 JAN 14
Oil (West Texas Int.)	$48.24 JAN 15	$53.27 DEC 14	$97.49 JAN 14
Consumer Price Index (y/o/y)	0.8% DEC 14	1.3% NOV 14	1.5% DEC 13
Producer Price Index (y/o/y)	(0.4)% DEC 14	1.1% NOV 14	1.4% DEC 13
Dollar/EURO	1.13 JAN 15	1.21 DEC 14	1.35 JAN 14

Source: Bloomberg

What Does the ECB's Stimulus Plan Mean for Investors?

Last month, the European Central Bank (ECB) announced an expanded monetary stimulus program aimed at boosting inflation in the euro zone. The ECB intends to expand its balance sheet and purchase over €1 trillion in public and private sector bonds by the fall of 2016. For several months leading up to this announcement, it was unclear if the ECB would ever execute a plan to buy government bonds since the legality was questionable. German officials were opposed to quantitative easing (QE), believing it would keep troubled governments from pushing through structural reforms (i.e. reforms of labor markets, legal systems, tax systems, etc). Over the past few years, the ECB attempted to stimulate the European economy through alternative measures such as interest rate cuts, cheap loan programs to banks, and purchases of asset-backed securities and covered bonds. However, many market participants argued that the ECB would eventually need to take a page out of the Federal Reserve's playbook and start buying government bonds in order to revive the European economy and prevent a deflationary spiral. As such, the ECB's new bond-buying plan is generally in line with what market participants anticipated, but many remain skeptical about its execution and effectiveness.

Highlights of the ECB's bond-buying plan:

- The ECB will purchase a total of €60 billion ($69 billion) per month in assets, including euro zone government debt, bonds issued by European institutions, and private-sector bonds.
- The purchase of government bonds will begin in March 2015 and will continue until there are clear signs that inflation is rising toward the ECB's target of just below 2% (this is likely to take 18+ months).
- The ECB will buy government bonds based on each country's share of the ECB's capital, commensurate with their population and GDP. As of January 1, the biggest holders were Germany (18%), France (14%), Italy (12%), Spain (9%) and the Netherlands (4%).
- Each of the 19 member central banks in the Eurozone will buy bonds issued by its own government, and take the losses in the event of a government default.
- Purchases of securities of European institutions will be subject to loss sharing among euro zone central banks.
- The ECB's purchase plan will include government bonds with an investment-grade credit rating.
- Greece will be ineligible for the ECB's QE program until at least July.

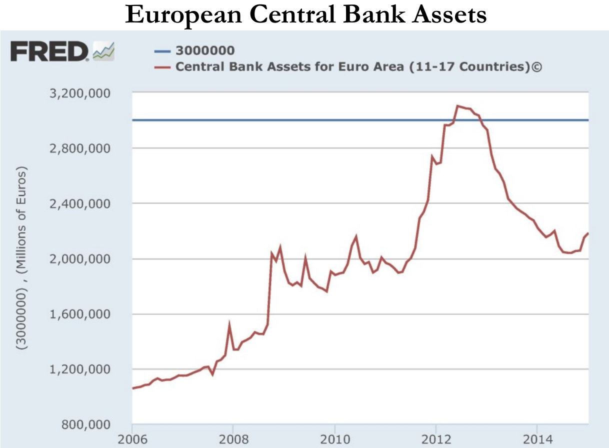
Euro Area Inflation Rate (HICP)

Source: European Central Bank Eurosystem

How does the ECB's plan compare to other QE programs?

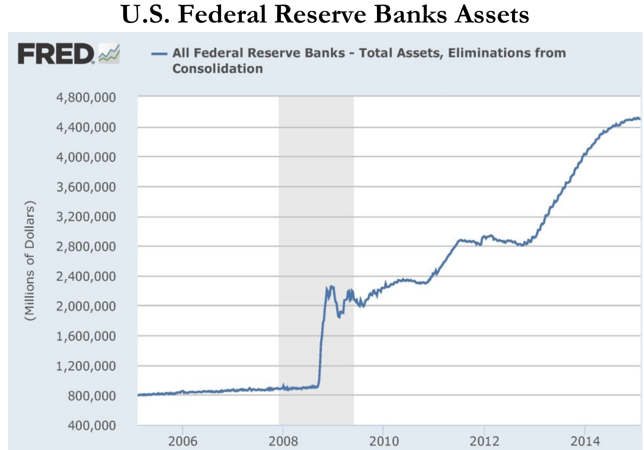
The ECB's balance sheet is currently just over €2 trillion. Through the stimulus program, the ECB aims to expand its balance sheet by roughly €1.14 trillion, an increase of roughly 50%. The ECB's goal is to restore the size of its balance sheet to its 2012 level (or beyond), when it peaked as a percentage of GDP at about 33%. Since 2012, the ECB's balance sheet contracted significantly (to about 21% of GDP) as banks have made early repayment of funds borrowed through the ECB's cheap bank lending programs from 2011 and 2012. By comparison, the Federal Reserve's balance sheet has grown to over $4 trillion, an increase of about $3 trillion (or 300%) since December 2007, and is about 25% of U.S. GDP. This also compares to the Bank of England's quantitative easing program (to roughly 22% of GDP) and Japan's quantitative easing program (to about 60% of GDP and growing). The U.S. was quicker to initiate a quantitative easing program during the U.S. financial crisis, while the ECB delayed its program allowing its economic problems to become more deeply embedded.

European Central Bank Assets



Source: Federal Reserve Bank of St. Louis

U.S. Federal Reserve Banks Assets



Source: Federal Reserve Bank of St. Louis

What impact will the ECB's stimulus program have on investors?

Though it is uncertain if the ECB's stimulus program will be effective in boosting euro zone inflation, we anticipate that it will fuel significant financial market volatility this year. In anticipation of the ECB's announcement last month, the Swiss National Bank unexpectedly removed its currency peg against the euro and cut interest rates by 50 bps to negative 0.75%, sending a shockwave through the financial markets. The following week, the Bank of Canada also unexpectedly cut its benchmark overnight rate by 25 bps to 0.75%, and other central banks have also been cutting their target interest rates. Looking ahead, it is possible that the ECB's quantitative easing program (and the relative weakness of the euro) could prompt even more central banks to make policy changes, particularly in countries that are experiencing tepid inflation and a strengthening currency against the euro. Actions taken by the ECB could indirectly affect the timing of an interest rate hike in the U.S., as the dollar's strength versus the euro continues to put downward pressure on U.S. inflation expectations. Any unexpected central bank policy moves (especially in the U.S.) could create significant volatility in the financial markets. In addition, the success or failure of the ECB's plan to purchase government bonds (which will be challenging given that each country issues bond separately) and to revive the European economy is also likely to create volatility. Sluggish growth in the euro zone economy (second to only the U.S. in size) has been a significant headwind for the global economy and contributed to the recent plunge in oil prices. If the ECB is able to put the euro zone economy on a path toward sustainable growth, there is likely to be a meaningful impact on global currencies, corporate earnings (which are also impacted by currency exchange rates), energy prices, and overall global economic growth. Even if the program is successful, the plan will take months to execute and there are likely to be bumps in the road. Overall, we believe the markets are poised to experience significant volatility this year, and we plan to be opportunistic with valuation changes.

- Shelly Henbest
VP, Credit Analyst