CHANDLER ASSET MANAGEMENT

December 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.

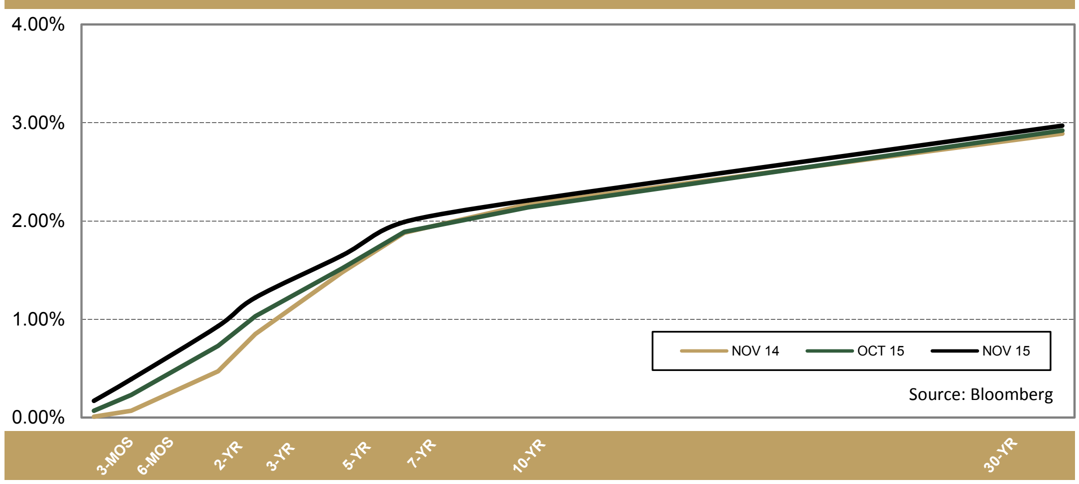
Market Summary

We believe the Federal Open Market Committee (FOMC) is almost certain to hike the fed funds rate by 25 basis points when they meet in mid-December. The Federal Reserve (Fed) can make its case for doing so by pointing to several data points including the strong November employment report, mild firming in headline CPI in October, a jump in unit labor costs during the third quarter, the upward revision to third quarter GDP, and favorable recent economic reports from the 12 Fed districts. In addition, the European Central Bank was widely expected to announce an expanded economic stimulus program this month, but their announcement was more mild than expected. We believe this helps to alleviate additional upward pressure on the dollar and leaves the door open for a rate hike. Assuming the FOMC does raise the fed funds rate this month, the focus of market participants will likely shift toward anticipating the pace of additional rate hikes and other forms of monetary policy normalization. We believe the pace of future rate hikes will be slower than historical Fed tightening cycles, in light of ongoing sluggishness in the global economy.

Although we believe much of data suggests that the US economy can sustain a modest shift toward monetary policy normalization, there are still some pockets of softness in economy. In particular, US manufacturing trends remain weak, with the ISM manufacturing index falling below 50.0 in November. Housing market data is uneven, and consumer confidence recently softened. Retail inventories were elevated heading into the fourth quarter suggesting that margins could be under pressure during the all-important holiday shopping season. Nevertheless, payrolls have increased by an average of 218,000 per month over the past three months and the unemployment rate has declined to 5.0%, which should provide a strong tailwind for economic growth heading into the new year. According to the second estimate, third quarter GDP grew at an annualized pace of 2.1%, following growth of 3.9% in the second quarter. Market participants are currently forecasting GDP growth of 2.6% in the fourth quarter, and 2.5% in 2016.

The Treasury yield curve bear flattened (with short-term rates rising more than long-term rates) in anticipation of a potential fed funds rate hike, which is consistent with previous Fed tightening cycles. In November, the yield on 2-year Treasuries increased more than 20 basis points as the probability of a December fed funds rate hike increased. Over much of the past year, financial market volatility has been elevated due to mixed US economic data, the uncertain timing of the first rate hike, weak global economic growth, divergent global central bank monetary policies, turmoil in Asian stock markets, and geopolitical concerns. Ongoing uncertainty about the future pace of monetary policy normalization, and how the Fed communicates its economic projections, will likely continue to fuel financial market volatility.

THE TREASURY YIELD CURVE FLATTENED



The yield on the two-year Treasury note rose more than 20 basis points in November to 0.93%, suggesting that a 25 basis point increase in the fed funds rate is already priced into the market. Meanwhile, the yield on the ten-year Treasury note rose just 6 basis points in November to 2.21%. Overall, the Treasury yield curve has flattened in recent months in anticipation of monetary policy normalization by the Federal Reserve, which is consistent with previous Fed tightening cycles. Assuming the Fed does begin to hike the fed funds rate later this month, we believe the pace of subsequent rate hikes will be much slower than historical tightening cycles, in light of ongoing sluggishness in the global economy.

TREASURY YIELDS	11/30/2015	10/31/2015	CHANGE
3 Month	0.17	0.07	0.10
2 Year	0.93	0.73	0.20
3 Year	1.22	1.03	0.19
5 Year	1.65	1.52	0.13
7 Year	1.99	1.89	0.10
10 Year	2.21	2.14	0.07
30 Year	2.97	2.92	0.05

Source: Bloomberg

Economic Roundup

Consumer Prices

In October, the Consumer Price Index (CPI) rose 0.2% on a year-over-year basis, up from zero in September. Headline inflation remains depressed by weak commodity prices. Meanwhile, Core CPI (CPI less food and energy) was unchanged from the prior month at 1.9% in October, on a year-over-year basis. The Personal Consumption Expenditures (PCE) price index was up 0.2% on a year-over-year basis in October, unchanged from September. Core PCE (excluding food and energy) was also unchanged, up 1.3% on a year-over-year basis in October. Overall, inflation isn't showing meaningful signs up upward pressure and remains below the Fed's 2.0% target.

Retail Sales

On a year-over-year basis, retail sales were up 1.7% in October, versus growth of 2.2% in September. On a month-over-month basis, retail sales rose just 0.1% in October, below the consensus forecast of 0.3%. Excluding autos and gas, the figure was up 0.3%, in line with consensus. Notably, retail inventories were up 0.8% in September, when month-over-month retail sales were flat, which suggests that retailers may be overstocked heading into the holidays. Fortunately, consumer sentiment remains strong and gas prices remain relatively low which should provide a favorable tailwind to consumer spending in the fourth quarter. Ongoing improvement in the labor market should also have a positive influence on consumer spending.

Labor Market

The November employment report was stronger than expected. Nonfarm payrolls rose by 211,000 in November, above the consensus forecast of 200,000. September and October payrolls were revised up by a total of 35,000. The unemployment rate was unchanged at 5.0%. The participation rate edged up to 62.5% from 62.4%. However, a broader measure of unemployment called the U-6, which includes those whom are marginally attached to the labor force and employed part time for economic reasons, inched up to 9.9% from 9.8%. Wages increased 0.2% on a month-over-month basis in November, and were up 2.3% on a year-over-year basis. Over the past three months, payrolls have increased by an average of 218,000 per month, compared to the trailing six-month average of 213,000.

Housing Starts

Total housing starts fell 11.0% in October, missing expectations. Single-family housing starts declined 2.4% while multi-family starts dropped 25.0%. Housing starts tend to be volatile on a month-to-month basis, but the underlying trend in housing remains mostly favorable. Notably, housing permits rose 4.1% in October, in line with consensus expectations. Pricing has remained firm, which may be keeping some first-time home buyers on the sidelines.

Credit Spreads Tightened in November

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change (%)
3-month top-rated commercial paper	0.11	0.14	(0.03)
2-year A corporate note	0.51	0.60	(0.09)
5-year A corporate note	0.86	0.90	(0.04)
5-year Agency note	0.22	0.19	0.03

Source: Bloomberg *Data as of 11/30/2015*

Economic Data Remains Mixed

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(43.9) $Bln OCT 15	(42.5) $Bln SEP 15	(42.8) $Bln OCT 14
GDP	2.1% SEP 15	3.9% JUN 15	4.3% SEP 14
Unemployment Rate	5.0% NOV 15	5.0% OCT 15	5.8% NOV 14
Prime Rate	3.25% NOV 15	3.25% OCT 15	3.25% NOV 14
CRB Index	182.54 NOV 15	195.61 OCT 15	254.37 NOV 14
Oil (West Texas Int.)	$41.65 NOV 15	$46.59 OCT 15	$66.15 NOV 14
Consumer Price Index (y/o/y)	0.2% OCT 15	0.0% SEP 15	1.7% OCT 14
Producer Price Index (y/o/y)	(4.1%) OCT 15	(4.1%) SEP 15	1.8% OCT 14
Dollar/EURO	1.06 NOV 15	1.10 OCT 15	1.25 NOV 14

Source: Bloomberg