CHANDLER ASSET MANAGEMENT

November 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.

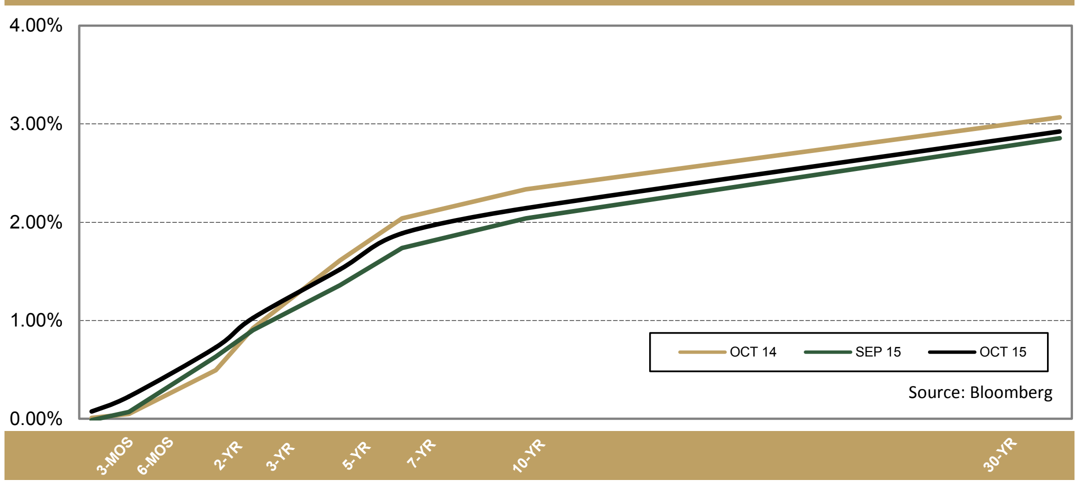
Market Summary

The Federal Open Market Committee (FOMC) left policy rates unchanged at its October 27-28 meeting. Once again there was a dissenting vote by Richmond Federal Reserve Bank President Jeffrey Lacker who wanted to raise the fed funds rate by 25 basis points. Although the domestic economy has been expanding at a moderate pace, inflation remains below target which has kept the FOMC on hold. However, the FOMC explicitly left the possibility of a December fed funds rate hike on the table. Given the strength of the October employment report, and public comments made recently by Fed Chair Yellen indicating that a December rate is a distinct possibility, the probability of a 25 basis point fed funds rate hike in December is greater than 50%. However, more aggressive stimulus from the European Central Bank and/or a weak November US employment report would make it more difficult for the Federal Reserve to begin normalizing the fed funds rate before year-end, in our view. If the FOMC does decide to hike the fed funds rate in December, we believe the probability of a second rate hike within the next 6 months is low, in light of the current economic environment.

US economic data has been mixed. Over the past three months, payrolls have increased by an average of 187,000 per month, compared to the trailing six-month average of 215,000. In October, the unemployment rate declined to 5.0% from 5.1%, but the participation rate remained at a historic low. Meanwhile, housing data has been uneven. Firmer home pricing and muted supply may be keeping some first time home buyers on the sidelines. Consumer confidence remains strong but the manufacturing sector continues to be under pressure, largely due to the strength of the US dollar. According to the advance estimate, third quarter GDP grew at an annualized pace of 1.5%, following growth of 3.9% in the second quarter. Market participants are currently forecasting GDP growth of 2.7% in the fourth quarter.

Interest rate volatility remains elevated due to continued uncertainty regarding the outlook for global economic growth and the timing of the first fed funds rate hike. Yields on 2-year and 10-year Treasury notes increased in October after decreasing in September. Mixed US economic data, divergent central bank monetary policies, and concerns about weakening economic growth in China and other emerging markets have influenced interest rates.

TREASURY YIELDS HAVE BEEN VOLATILE



Interest rate volatility remains elevated. The yield on the two-year Treasury note rose nearly 10 basis points in October to 0.73%, after declining by 8 basis points in September. Meanwhile, the yield on the ten-year Treasury note rose approximately 11 basis points in October to 2.14%, after falling roughly 12 basis points in September. Concerns about slowing global economic growth, softer domestic economic data, continued weakness in oil prices, ongoing uncertainty about Fed monetary policy, and stimulative monetary policy actions in other countries has fueled financial market volatility. During the past three months, the Treasury yield curve has flattened modestly. Based on historical fed tightening cycles, we expect the yield curve to flatten further when the Fed begins normalizing the fed funds rate.

TREASURY YIELDS	10/31/2015	9/30/2015	CHANGE
3 Month	0.07	(0.02)	0.09
2 Year	0.73	0.63	0.10
3 Year	1.03	0.90	0.13
5 Year	1.52	1.36	0.16
7 Year	1.89	1.74	0.15
10 Year	2.14	2.04	0.10
30 Year	2.92	2.85	0.07

Source: Bloomberg

Economic Roundup

Consumer Prices

In September, Consumer Price Index (CPI) inflation was flat, vs. up 0.2% in August, on a year-over-year basis. Headline inflation remains depressed by weak commodity prices. Meanwhile, Core CPI (CPI less food and energy) inched up to 1.9% in September, vs. 1.8% in August, on a year-over-year basis. The Personal Consumption Expenditures (PCE) price index declined to 0.2% on a year-over-year basis in September, from 0.3% in August. Core PCE (excluding food and energy) was unchanged at 1.3% on a year-over-year basis in September. Overall, inflation remains below the Fed's 2.0% target.

Retail Sales

Retail sales rose 0.1% on a month-over-month basis in September, in line with expectations. On a year-over-year basis, retail sales rose 2.4% in the month, following a 2.0% year-over-year gain in August. Excluding gas station sales, retail sales were up 4.9% on a year-over-year basis in September. Low gas prices have had a dampening effect on headline retail sales figures, but they should provide a favorable tailwind to consumer discretionary spending. Ongoing improvement in the labor market should also have a positive influence on consumer spending.

Labor Market

The October employment report was much stronger than expected. Nonfarm payrolls rose by 271,000 in October, well above the consensus forecast of 185,000. August and September payrolls were revised up by a total of 12,000. The unemployment rate edged down to 5.0% in October from 5.1% in September. The participation rate was unchanged at a low level of 62.4%. 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, declined to 9.8% from 10.0%. Wages increased 0.4% on a month-over-month basis in October, and were up 2.5% on a year-over-year basis. Over the past three months, payrolls have increased by an average of 187,000 per month, compared to the trailing six-month average of 215,000.

Housing Starts

Total housing starts rose 6.5% in September, exceeding expectations. Single-family housing starts edged up 0.3% while multi-family starts grew 18.3%. Total housing starts were up 17.5% year-over-year in September, with single-family starts up 12.0% and multi-family starts up 27.7% on that basis. Overall, housing sector trends have been mostly favorable, although new home sales were weak in September. Pricing has remained firm, which is likely keeping some first-time home buyers on the sidelines.

Credit Spreads Tightened in October

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change (%)
3-month top-rated commercial paper	0.14	0.25	(0.11)
2-year A corporate note	0.60	0.67	(0.07)
5-year A corporate note	0.90	1.04	(0.14)
5-year Agency note	0.19	0.24	(0.05)

Source: Bloomberg *Data as of 10/31/2015*

Economic Data Has Been Mixed

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.8) $Bln SEP 15	(48.0) $Bln AUG 15	(43.2) $Bln SEP 14
GDP	1.5% SEP 15	3.9% JUN 15	4.3% SEP 14
Unemployment Rate	5.0% OCT 15	5.1% SEP 15	5.7% OCT 14
Prime Rate	3.25% OCT 15	3.25% SEP 15	3.25% OCT 14
CRB Index	195.61 OCT 15	193.76 SEP 15	271.96 OCT 14
Oil (West Texas Int.)	$46.59 OCT 15	$45.09 SEP 15	$80.54 OCT 14
Consumer Price Index (y/o/y)	0.0% SEP 15	0.2% AUG 15	1.7% SEP 14
Producer Price Index (y/o/y)	(4.1%) SEP 15	(2.9%) AUG 15	2.2% SEP 14
Dollar/EURO	1.10 OCT 15	1.12 SEP 15	1.25 OCT 14

Source: Bloomberg