CHANDLER ASSET MANAGEMENT

January 2016

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.

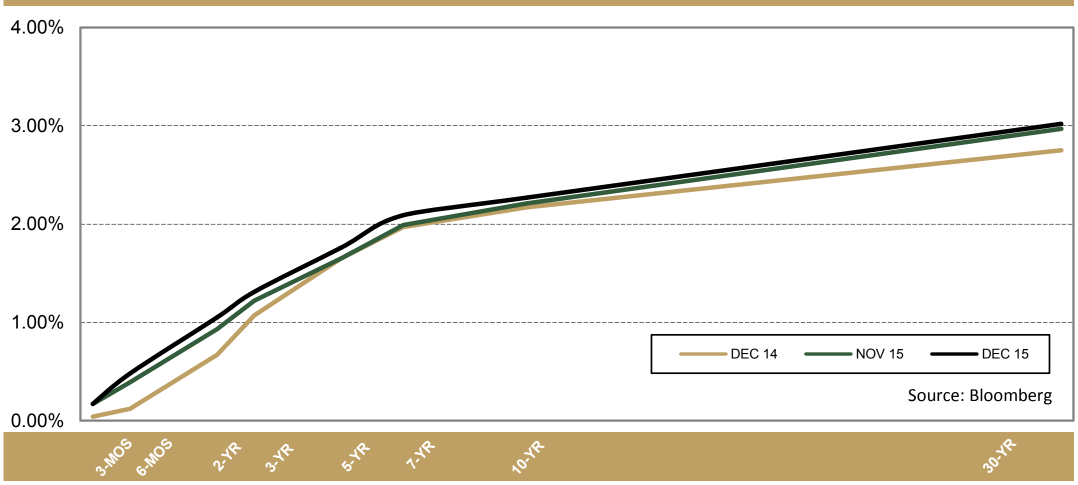
Market Summary

As expected, in December the Federal Open Market Committee (FOMC) increased the fed funds target rate by 25 basis points. It was the first fed funds target rate increase since June 2006. Although the Fed took its first step toward normalizing monetary policy, the tone of the FOMC statement was dovish, suggesting the pace of additional policy tightening will be slower than historical Fed tightening cycles. Policymakers' median projection for the fed funds rate at the end of 2016 is 1.375%. In the longer-run, the target fed funds rate is roughly 3.5%. However, the FOMC has emphasized that monetary policy adjustments will be gradual and the path of the fed funds rate will depend on the economic outlook. Notably, the FOMC will continue to reinvest principal payments from its holdings of Agency and Mortgage-Backed securities and will continue rolling over maturing Treasury securities until normalization of the fed funds rate is well underway. Overall, monetary policy remains highly accommodative and the Fed is proceeding with caution as it moves toward a more normalized policy stance.

Economic data is mixed. Trends in the labor market remain favorable, and consumer confidence rebounded in December. However, the manufacturing sector remains weak and housing sector data has been volatile. The ISM manufacturing index declined to 48.2 in December, to the weakest level since July 2009. In terms of housing, new and existing home sales were recently weaker than expected, but home prices remain firm. Nevertheless, payrolls have increased by an average of 284,000 per month over the past three months, with the unemployment rate at 5.0%, which should provide a strong tailwind for economic growth this year. Third quarter 2015 GDP grew at an annualized pace of 2.0%, following growth of 3.9% in the second quarter. Last month, the consensus forecast called for GDP growth of 2.1% in the fourth quarter of 2015, but many economists have since lowered their forecast significantly. We are expecting GDP growth of about 2.0%-2.5% in 2016.

During 2015, 2-year Treasury yields increased nearly 40 basis points, while 10-year Treasuries increased roughly 10 basis points. This bear flattening (with short-term rates rising more than long-term rates), is consistent with previous Fed tightening cycles and we expect this trend to continue. 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 SHIFTED UPWARD



The yield on the two-year Treasury note rose roughly 12 basis points in December to 1.05%. Meanwhile, the yield on the ten-year Treasury note rose just six basis points in December to 2.27%. Overall, the Treasury yield curve flattened during 2015 in anticipation of monetary policy normalization by the Federal Reserve and we expect this trend to continue. Looking ahead, we believe the pace of subsequent rate hikes will be slower than historical Fed tightening cycles, in light of ongoing sluggishness in the global economy.

TREASURY YIELDS	12/31/2015	11/30/2015	CHANGE
3 Month	0.17	0.17	0.00
2 Year	1.05	0.93	0.12
3 Year	1.31	1.22	0.09
5 Year	1.76	1.65	0.11
7 Year	2.09	1.99	0.10
10 Year	2.27	2.21	0.06
30 Year	3.02	2.97	0.05

Source: Bloomberg

Economic Roundup

Consumer Prices
In November, the Consumer Price Index (CPI) rose 0.5% on a year-over-year basis, up from 0.2% in October. Year-over-year comparisons have become easier, given the precipitous decline in energy prices at the end of 2014. Meanwhile, Core CPI (CPI less food and energy) was up 2.0% in November on a year-over-year basis, vs. up 1.9% in October. The Personal Consumption Expenditures (PCE) price index was up 0.4% on a year-over-year basis in November, up from 0.2% in October. Core PCE (excluding food and energy) was unchanged in November, up 1.3% on a year-over-year basis. Overall, inflation isn't showing signs up significant upward pressure and remains below the Fed's 2.0% target.

Retail Sales
On a year-over-year basis, retail sales were up 1.4% in November, versus growth of 1.7% in October. On a month-over-month basis, retail sales rose 0.2% in November, below the consensus forecast of 0.3%. However, excluding autos and gas, the figure was up 0.5%, stronger than the consensus forecast. Discretionary categories like restaurants, electronics & appliances, and clothing & accessories posted healthy gains. Online sales were also strong in November.

Labor Market
The December employment report was mostly stronger than expected. Nonfarm payrolls rose by 292,000 in December, above the consensus forecast of 200,000. October and November payrolls were also revised up by a total of 50,000. The unemployment rate was unchanged at 5.0%. The participation rate inched up to 62.6% from 62.5%. However, wages were flat, missing expectations for a 0.2% increase. 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, was unchanged from November at 9.9%. Over the past three months, payrolls have increased by an average of 284,000 per month, compared to the trailing six-month average of 229,000.

Housing Starts
Total housing starts rose 10.5% in November, exceeding expectations. Single-family housing starts rose 7.6% while multi-family starts rose 16.4%. Housing starts tend to be volatile on a month-to-month basis, but the trend is favorable. Housing permits rose 11.0% in November, also exceeding expectations.

Credit Spreads Widened in December

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change (%)
3-month top-rated commercial paper	0.26	0.11	0.15
2-year A corporate note	0.55	0.51	0.04
5-year A corporate note	0.85	0.86	(0.01)
5-year Agency note	0.18	0.22	(0.04)

Source: Bloomberg

Data as of 12/31/2015

Economic Data Remains Mixed

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.4) $Bln NOV 15	(44.6) $Bln OCT 15	(40.0) $Bln NOV 14
GDP	2.0% SEP 15	3.9% JUN 15	4.3% SEP 14
Unemployment Rate	5.0% DEC 15	5.0% NOV 15	5.6% DEC 14
Prime Rate	3.5% DEC 15	3.25% NOV 15	3.25% DEC 14
CRB Index	176.14 DEC 15	182.54 NOV 15	229.96 DEC 14
Oil (West Texas Int.)	$37.04 DEC 15	$41.65 NOV 15	$53.27 DEC 14
Consumer Price Index (y/o/y)	0.5% NOV 15	0.2% OCT 15	1.3% NOV 14
Producer Price Index (y/o/y)	(3.2%) NOV 15	(4.1%) OCT 15	1.1% NOV 14
Dollar/EURO	1.09 DEC 15	1.06 NOV 15	1.21 DEC 14

Source: Bloomberg

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