CHANDLER ASSET MANAGEMENT

June 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.

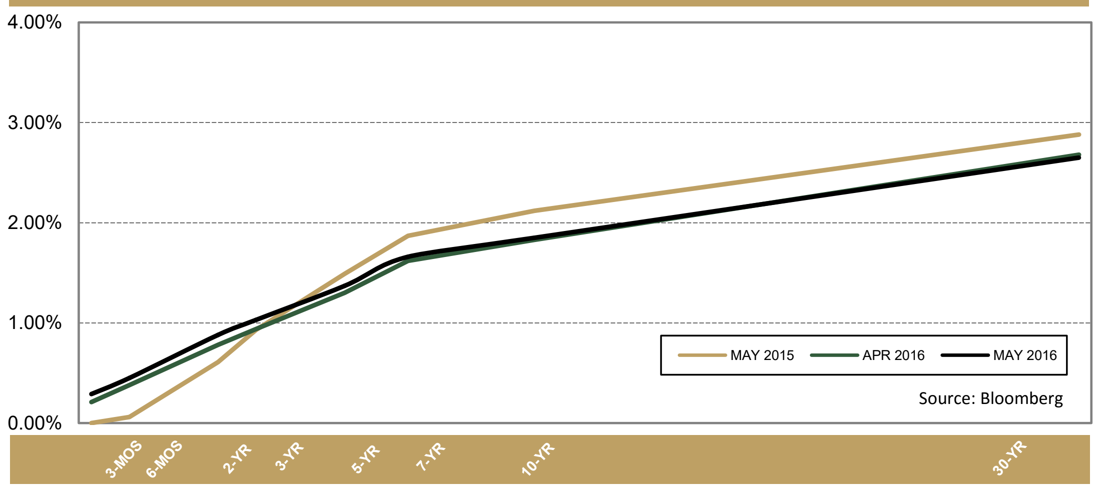
Market Summary

In our view, two rate hikes before year-end are still possible, and at least one is likely. The Federal Reserve (Fed) has emphasized for several months that their policy decisions are data dependent. Given that labor market conditions are near those consistent with maximum sustainable employment (despite a weak May employment report), inflation data is generally in line with the Fed's forecasts, the housing sector is picking up steam, consumer spending appears healthy, the manufacturing sector is showing modest improvement, the price of oil has rebounded from the lows, and the dollar has weakened year-to-date, there may be sufficient data to support a rate hike this month. However, global economic developments including the Brexit vote on June 23 could influence the Fed's policy decision. Since economic data is closely aligned with the Federal Open Market Committee's (FOMC) median 2016 projections, we believe the Fed will be forced to alter its message and revamp its economic projections this month if they do not hike rates. This month's FOMC meeting will be held on June 14-15, followed by a press conference.

Domestic economic data is mixed but generally points to modest growth, in our view. Nonfarm payrolls were much weaker than expected in May, up just 38,000. However, we believe there were nuances (seasonal factors, Verizon strike, etc.) in the data that suggest the report wasn't as weak at it looked on the surface. Notably, wage growth continued to tick up in May, and the unemployment rate dropped to 4.7%. Consumer confidence remains strong and consumer spending has recently improved. The housing sector appears to be heating up and pricing remains firm. Meanwhile, manufacturing trends have improved but remain sluggish. Inflation pressures are contained with the Core PCE index up just 1.6% year-over-year in April. First quarter 2016 GDP grew 0.8%, following growth of 1.4% in the fourth quarter. Market participants are forecasting a modest rebound in GDP growth to 2.2% in the second quarter of 2016.

In May the Treasury yield curve flattened slightly as more market participants priced in the probability of a rate hike this year. The 2-year Treasury yield was up nearly 10 basis points and the 10-year Treasury yield was up just one basis point in May. After the disappointing May employment report on June 3, the two-year Treasury yield declined to 0.77%, and the 10-year Treasury yield declined to 1.70%. Based on fed funds futures, market participants are currently only pricing in the probability of one rate hike before year-end. Inflation remains contained for now, which gives the Fed more leeway to remain highly accommodative. Sluggish global economic growth and highly accomodative monetary policies by other global central banks could also influence the Federal Reserve to remain on hold. However, two rate hikes before year-end would align with the FOMC's central tendency projection. A flattening yield curve is generally consistent with Fed tightening cycles.

THE TREASURY YIELD CURVE FLATTENED SLIGHTLY



In May the Treasury yield curve flattened slightly as more market participants priced in the probability of a rate hike this year. Over the past three months, the yield curve shifted up. Over much of the past year, financial market volatility has been elevated due to weak global economic growth, unstable commodity prices, and divergent global central bank monetary policy. These concerns will likely continue to fuel financial market volatility over the medium-term.

TREASURY YIELDS	5/31/2016	4/30/2016	CHANGE
3 Month	0.29	0.21	0.08
2 Year	0.88	0.78	0.10
3 Year	1.03	0.94	0.09
5 Year	1.37	1.30	0.07
7 Year	1.66	1.62	0.04
10 Year	1.85	1.83	0.02
30 Year	2.65	2.68	(0.03)

Source: Bloomberg

Economic Roundup

Consumer Prices

Inflation pressures remain contained for now. The Consumer Price Index (CPI) was up just 1.1% year-over-year in April, vs. 0.9% in March. Core CPI (CPI less food and energy) was up just 2.1% year-over-year in April, vs. 2.2% in March. The Personal Consumption Expenditures (PCE) index was up 1.1% year-over-year in April, vs. up 0.8% in March. Core PCE (excluding food and energy) was unchanged in April, up 1.6% year-over-year. Although inflation remains below the Fed's 2.0% longer-term target, Core PCE is aligned with the Fed's median 2016 projection.

Retail Sales

The April retail sales report was unexpectedly strong. Retail sales rose 3.0% in April on a year-over-year basis, up from 1.7% in March. Retail sales rose 1.3% month-over-month in April. Excluding autos and gas, retail sales were up a solid 0.6% month-over-month.

Labor Market

Nonfarm payrolls rose just 38,000 in May, much lower than the consensus forecast of 160,000. In addition, March and April payrolls were revised down by a combined total of 59,000. We believe seasonal factors, timing of the data collection, and the recent Verizon strike all potentially negatively impacted the numbers. The unemployment rate declined to 4.7% from 5.0%. A broader measure of unemployment called the U-6, which includes those who are marginally attached to the labor force and employed part time for economic reasons, was unchanged at 9.7%. Wages rose 0.2% in May, following growth of 0.4% in April. On a year-over-year basis, wages were up 2.5% in May. On a trailing three-month basis, payrolls increased by an average of 116,000 per month, compared to 200,000 on a trailing twelve-month basis. The participation rate declined to 62.6% in May from 62.8% in April. Although the May jobs report was arguably much weaker than expected, we believe labor market conditions remain consistent with modest economic growth.

Housing Starts

Total housing starts rose 6.6% on a month-over-month basis in April, above expectations. Both single- and multi-family starts increased in April. Housing starts tend to be volatile on a month-to-month basis and the data is subject to revision. On a year-over-year basis, housing starts were down 1.7% in April. Single-family starts were up 4.3% year-over-year, but multi-family starts were down 11.7% year-over-year. Multi-family starts were particularly strong in 2015, making the year-over-year comparison challenging. We believe underlying trends in the housing market remain healthy.

Credit Spreads Were Little Changed May

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change (%)
3-month top-rated commercial paper	0.20	0.29	(0.09)
2-year A corporate note	0.48	0.46	0.02
5-year A corporate note	0.72	0.71	0.01
5-year Agency note	0.15	0.15	0.00

Source: Bloomberg *Data as of 5/31/2016*

Economic Data Points to Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(37.4) $Bln APR 16	(35.5) $Bln MAR 16	(40.9) $Bln APR 15
GDP	0.8% MAR 16	1.4% DEC 15	0.6% MAR 15
Unemployment Rate	4.7% MAY 16	5.0% APR 16	5.5% MAY 15
Prime Rate	3.5% MAY 16	3.5% APR 16	3.25% MAY 15
CRB Index	186.15 MAY 16	184.61 APR 16	223.18 MAY 15
Oil (West Texas Int.)	$49.10 MAY 16	$45.92 APR 16	$60.30 MAY 15
Consumer Price Index (y/o/y)	1.1% APR 16	0.9% MAR 16	(0.2%) APR 15
Producer Price Index (y/o/y)	(1.3%) APR 16	(1.9%) MAR 16	(4.5%) APR 15
Dollar/EURO	1.11 MAY 16	1.15 APR 16	1.10 MAY 15

Source: Bloomberg

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