CHANDLER ASSET MANAGEMENT

July 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.

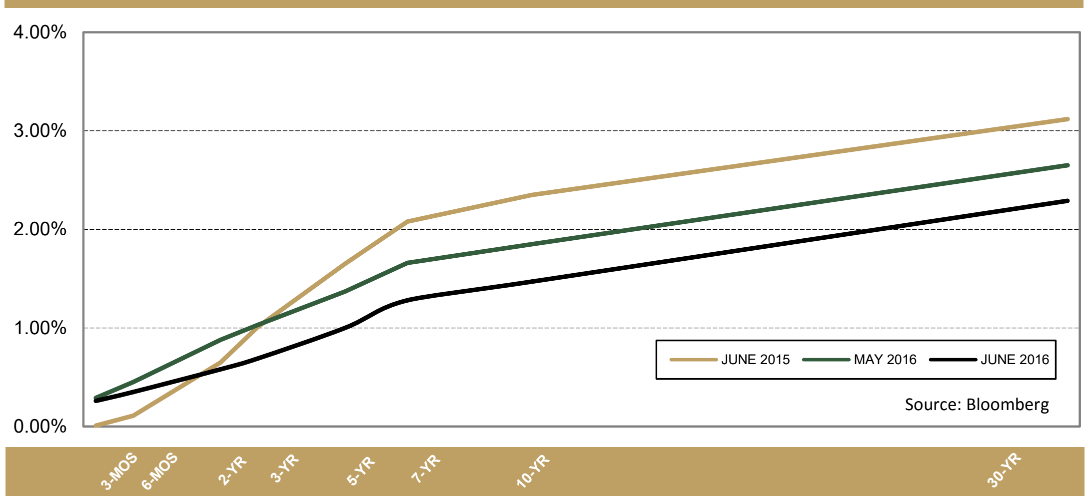
Market Summary

The Federal Open Market Committee (FOMC) voted to keep the fed funds rate unchanged at the June 14-15 meeting. The FOMC statement was mostly balanced, noting that the pace of labor market gains slowed but economic activity picked up. Brexit fears and the corresponding volatility in sovereign bond yields, along with the disappointing May jobs report, likely prompted the Fed to keep monetary policy on hold. In her press conference, Fed Chair Yellen conceded that the Fed can more effectively respond to an overshoot of inflation than they can to a weakening labor market and/or deflation. In hindsight, the Fed's cautious stance in June seems to have been prudent. Just a week later, Britain's unexpected vote to the leave the European Union was a shock to the financial markets and prompted a broad selloff of risk assets and spike in volatility. The long-term implications of the Brexit vote are highly uncertain. Near term, we expect financial market volatility to remain elevated and interest rates to stay lower for longer. We believe the hurdle rate for future fed funds rate hikes has moved materially higher. Furthermore, we expect the Federal Reserve to remain on hold over the near-term.

Although the global economy faces headwinds, domestic economic data continues to point toward modest growth, in our view. Nonfarm payroll growth was lower in the second quarter than the first quarter, but remained high enough to absorb new entrants into the labor market. The unemployment rate was 4.9% in June and wage growth continued to tick higher during the month. Consumer confidence remains strong and consumer spending has recently improved. The housing sector appears healthy and pricing remains firm. Meanwhile, manufacturing trends have improved but remain sluggish. Inflation pressures are muted (for now) with the Core PCE index up just 1.6% year-over-year in May. First quarter 2016 GDP grew 1.1%, following growth of 1.4% in the fourth quarter. Market participants are forecasting a modest rebound in GDP growth to 2.5% in the second quarter of 2016.

In June, the 2-year Treasury yield declined nearly 30 basis points and the 10-year Treasury yield declined almost 38 basis points. Negative interest rates in Europe and Japan, investors' hunt for yield, and a global flight to quality continue to fuel demand for US Treasury securities. Elevated market volatility, the potential for a further slowdown in global economic growth, and highly accommodative monetary policies by other global central banks will continue to influence the Federal Reserve. The FOMC's median projection calls for two rate hikes before year-end, but we believe this projection is unlikely to be met.

THE TREASURY YIELD CURVE FLATTENED SLIGHTLY



In June the Treasury yield curve flattened. Over the past three months, the 2-year Treasury yield declined 14 basis points and the 10-year Treasury yield declined 30 basis points. The flattening is even more pronounced on a year-over-year basis with the 2-year Treasury yield down 6 basis points and the 10-year Treasury yield down nearly 90 basis points.

TREASURY YIELDS	6/30/2016	5/31/2016	CHANGE
3 Month	0.26	0.29	(0.03)
2 Year	0.58	0.88	(0.30)
3 Year	0.69	1.03	(0.34)
5 Year	1.00	1.37	(0.37)
7 Year	1.28	1.66	(0.38)
10 Year	1.47	1.85	(0.38)
30 Year	2.29	2.65	(0.36)

Source: Bloomberg

Economic Roundup

Consumer Prices

The Consumer Price Index (CPI) was up just 1.0% year-over-year in May, vs. 1.1% in April. Core CPI (CPI less food and energy) was up 2.2% year-over-year in May, vs. 2.1% in April. The Personal Consumption Expenditures (PCE) index was up 0.9% year-over-year in May, vs. up 1.1% in April. Core PCE (excluding food and energy) was unchanged in May, up 1.6% year-over-year. Although Core CPI is trending above 2.0%, the Fed's primary inflation gauge is PCE which remains below the Fed's 2.0% target.

Retail Sales

Retail sales rose 2.5% in May on a year-over-year basis, following a 3.0% increase in April. Retail sales were up 0.5% month-over-month. Excluding autos and gas, retail sales were up 0.3% month-over-month, in line with expectations.

Labor Market

Nonfarm payrolls were much stronger than expected in June, up 287,000 versus the consensus forecast of 180,000. However, May payrolls (which were already quite low) were revised down to 11,000 from 38,000. During the second quarter, payrolls increased by an average of 147,000 per month, compared to an average of 196,000 during the first quarter. Job growth has decelerated but remains consistent with slow domestic economic growth. The unemployment rate increased to 4.9% in June from 4.7% in May, as the participation rate increased to 62.7% from 62.6%. 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, edged down to 9.6% from 9.7%. Wages inched up 0.1% in June, following growth of 0.2% in May. On a year-over-year basis, wages were up 2.6% in June.

Housing Starts

Total housing starts slipped 0.3% on a month-over-month basis in May, but were up 9.5% on a year-over-year basis. Month-over-month, single-family starts rose 0.3% in May while multi-family starts declined 1.2%. However, year-over-year, single-family starts were up 10.1% in May and multi-family starts were up 8.4%. Housing starts tend to be volatile on a month-to-month basis and the data is subject to revision. 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 Widened in June

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change (%)
3-month top-rated commercial paper	0.29	0.20	0.09
2-year A corporate note	0.59	0.48	0.11
5-year A corporate note	0.80	0.72	0.08
5-year Agency note	0.19	0.15	0.04

Source: Bloomberg *Data as of 6/30/2016*

Economic Data Points to Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(41.1) $Bln MAY 16	(37.4) $Bln APR 16	(40.2) $Bln MAY 15
GDP	1.1% MAR 16	1.4% DEC 15	0.6% MAR 15
Unemployment Rate	4.9% JUN 16	4.7% MAY 16	5.3% JUN 15
Prime Rate	3.5% JUN 16	3.5% MAY16	3.25% JUN 15
CRB Index	192.57 JUN 16	186.15 MAY 16	227.17 JUN 15
Oil (West Texas Int.)	$48.33 JUN 16	$49.10 MAY 16	$59.47 JUN 15
Consumer Price Index (y/o/y)	1.0% MAY 16	1.1% APR 16	0.0% MAY 15
Producer Price Index (y/o/y)	(2.3%) MAY 16	(1.3%) APR 16	(2.9%) MAY 15
Dollar/EURO	1.11 JUN 16	1.11 MAY 16	1.11 JUN 15

Source: Bloomberg