BOND MARKET REVIEW

A Monthly Review of Fixed Income Markets

CHANDLER ASSET MANAGEMENT

DECEMBER 2017

IN THIS ISSUE:

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.

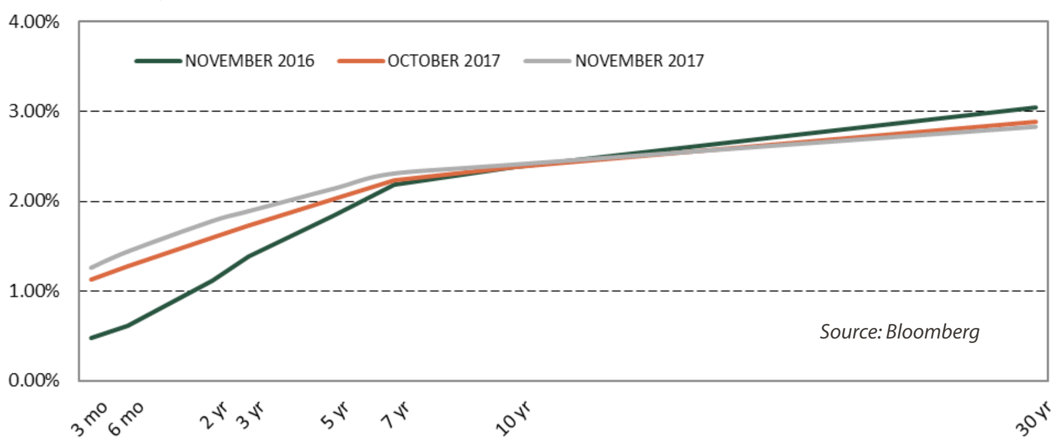
Market Summary

The Federal Open Market Committee (FOMC) raised the fed funds target rate by 25 basis points to a range of 1.25%-1.50% at the December 13 meeting. Nevertheless, the Fed believes the stance of monetary policy remains accommodative. Notably there were two dissenting votes by Fed Presidents Evans and Kashkari, who preferred to keep the fed funds rate unchanged. Neither Evans nor Kashkari will be voting members in 2018. The Fed said economic activity had been "rising at a solid rate." However, overall inflation for items other than food and energy has declined this year. The FOMC's economic projections indicate the Fed still plans to hike the fed funds rate three more times next year to a median level of 2.1%. The Fed also left its long-run fed funds rate forecast unchanged at 2.8%. We expect the Fed to remain on a path toward monetary policy normalization next year. However, we continue to believe that the Fed's terminal rate forecast is too high, and believe the long-run rate is probably closer to 2.0%-2.5%.

GDP grew by 3.3% in the third quarter, following growth of 3.1% in the second quarter and 1.2% in the first quarter. The consensus forecast currently calls for GDP growth of about 2.7% in the current quarter. Overall, recent economic data has been favorable. The economy is at or near full employment, consumer confidence is strong, and leading indicators suggest the economy will continue to grow modestly. This week, House and Senate Republicans reached an agreement on a framework for the final version of the tax reform bill, and it may go to a vote next week. We believe tax reform has the propensity to prolong the current business cycle and provide a tailwind to economic growth, even as we enter the third year of monetary policy tightening by the Fed (the first rate hike following the financial crisis was in December 2015). We are forecasting GDP growth of 2.0%-2.5% in 2018.

The Treasury yield curve continued to flatten in November. The 2-year Treasury yield increased about 18 basis points in November to 1.78% and the 10-year Treasury yield increased about three basis points to 2.41%. The spread between 2-year and 10-year Treasury yields was just 63 basis points at the end of November, compared to 126 at the end of 2016. All else being equal, we believe the Fed's plan to normalize the balance sheet could help promote a steeper yield curve over an intermediate time horizon. Tax reform may also be stimulative to the economy and drive yields at the long end of the curve higher.

The Treasury Yield Curve Flattened Further in November:



The yield curve has flattened meaningfully this year. On a year-over-year basis ending in November, the 2-year Treasury yield increased about 67 basis points while the 10-year Treasury yield was roughly unchanged. Between November 2016 and November 2017, the Federal Reserve raised the fed funds rate three times by a total of 75 basis points, which has fueled the increase in shorter rates.

TREASURY YIELDS	Trend (▲/▼)	11/30/2017	10/31/2017	Change
3-Month	▲	1.26	1.13	0.13
2-Year	▲	1.78	1.60	0.18
3-Year	▲	1.89	1.73	0.16
5-Year	▲	2.14	2.02	0.12
7-Year	▲	2.31	2.23	0.08
10-Year	▲	2.41	2.38	0.03
30-Year	▼	2.83	2.88	(0.05)

Source: Bloomberg

Market Data

World Indices
data as of 11/30/2017

		Diff (10/31/17)	% Change
S&P 500	**2,647.58**	72.32	2.81%
NASDAQ	**6,873.97**	146.30	2.17%
DOW JONES	**24,272.35**	895.11	3.83%
FTSE (UK)	**7,326.67**	(166.41)	(2.22%)
DAX (Germany)	**13,023.98**	(205.59)	(1.55%)
Hang Seng (Hong Kong)	**29,177.35**	931.81	3.30%
Nikkei (Japan)	**22,724.96**	713.35	3.24%

Source: Bloomberg

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Economic Roundup

Consumer Prices

The Consumer Price Index (CPI) was up 2.2% year-over-year in November, versus up 2.0% year-over-year in October. Core CPI (CPI less food and energy) was up 1.7% year-over-year in November, versus up 1.8% year-over-year in October. Core CPI remains soft. The Personal Consumption Expenditures (PCE) index was up 1.6% year-over-year in October, versus up 1.7% year-over-year in September. However, Core PCE (excluding food and energy) was unchanged on a year-over-year basis in October, up just 1.4%. PCE inflation remains well below the Fed's 2.0% target.

Retail Sales

On a year-over-year basis, retail sales were up 5.8% in November, versus up 4.9% year-over-year in October. On a month-over-month basis, retail sales increased 0.8% in November, far exceeding expectations. Retail sales also grew 0.8%, excluding autos and gas. This growth bodes well for the all-important holiday shopping season. Meanwhile, the Consumer Confidence index remained very strong in November at 129.5 up from 126.2 in October.

Labor Market

U.S. payrolls rose by 228,000 in November, exceeding the consensus forecast of 190,000. September and October payrolls were revised up by 3,000 in total. On a trailing 3-month and 6-month basis (which smooths out a lot of the hurricane-related volatility), payrolls increased by an average of 170,000 and 178,000 per month, respectively. The unemployment rate and the labor participation rate were unchanged in November at 4.1% and 62.7%, respectively. 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 up to 8.0% in November from 7.9% in October. Wages rose 0.2% in November and were up 2.5% on a year-over-year basis, slightly below expectations.

Housing Starts

Total housing starts were stronger than expected in October, up 13.7%. Single-family starts increased 5.3% in October, while multi-family starts jumped 36.8%. Permits were also stronger than expected in October, up 5.9%. According to the Case-Shiller 20-City home price index, home prices were up 6.2% year-over-year in September, versus up 5.8% year-over-year in August.

Credit Spreads Were Relatively Stable in November

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top rated commercial paper	0.08	0.13	(0.05)
2-year A corporate note	0.39	0.36	0.03
5-year A corporate note	0.53	0.52	0.01
5-year Agency note	0.07	0.08	(0.01)

Source: Bloomberg Data as of 11/30/2017

Economic Data Points to Ongoing Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(48.7) $Bln OCT 17	(44.9) $Bln SEP 17	(43.1) $Bln OCT 16
GDP	3.3% SEP 17	3.1% JUN 17	2.8% SEP 16
Unemployment Rate	4.1% NOV 17	4.1% OCT 17	4.6% NOV 16
Prime Rate	4.25% NOV 17	4.25% OCT 17	3.5% NOV 16
CRB Index	189.17 NOV 17	187.56 OCT 17	189.31 NOV 16
Oil (West Texas Int.)	$57.40 NOV 17	$54.38 OCT 17	$49.44 NOV 16
Consumer Price Index (y/o/y)	2.2% NOV 17	2.0% OCT 17	1.7% NOV 16
Producer Price Index (y/o/y)	4.3% NOV 17	2.9% OCT 17	0.4% NOV 16
Dollar/Euro	1.19 NOV 17	1.16 OCT 17	1.06 NOV 16

Source: Bloomberg