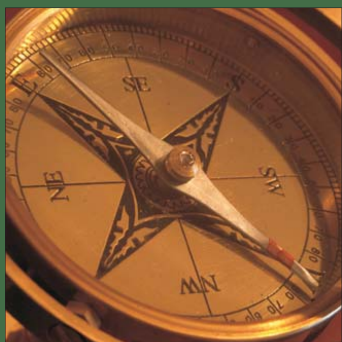
CHANDLER ASSET MANAGEMENT

April 2007

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS



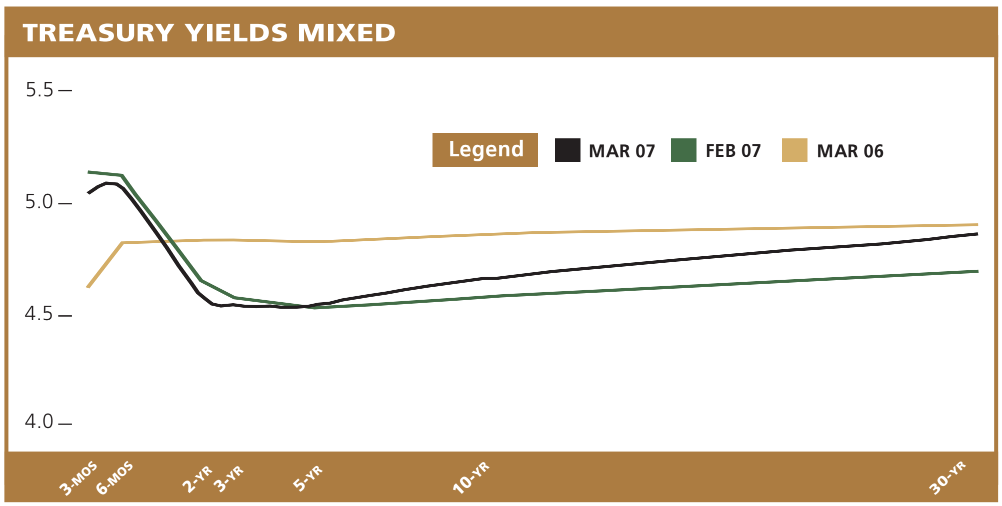
WHAT'S INSIDE

MARKET SUMMARY

Bond yields were mixed during March, with yields on shorter maturities declining slightly while those on longer maturities rose. The bond market's recent fluctuations indicate that market participants remain uncertain about the future course of economic growth. Accordingly, each new economic release or FOMC pronouncement is being scrutinized even more closely than usual.

The economy continued to display mixed signals in March. The Non-Farm Payroll number was unexpectedly strong, showing an increase of 180,000 new jobs, and the unemployment rate decreased to 4.4 percent. Both figures indicated that the job market remains relatively tight. Inflation readings also remained higher than the FOMC would prefer. On the other hand, housing data were mixed during the month, and there were fears that difficulties occurring in the subprime mortgage market might spread to traditional mortgages, thereby further depressing the housing sector.

The FOMC took no action at its March 21st meeting, leaving its target for the fed funds rate at 5.25%. The accompanying statement was highlighted by language that indicated somewhat slower economic growth and slightly higher inflation. The next FOMC meeting is on May 9th, and most market participants anticipate no action on interest rates.



The treasury curve was mixed in March, as yields declined for shorter maturities and rose for longer ones.

YIELDS	3/31/07	2/28/07	Change
3 Month	5.03	5.12	(0.09)
2 Year	4.57	4.64	(0.07)
3 Year	4.53	4.56	(0.03)
5 Year	4.53	4.52	0.01
10 Year	4.64	4.57	0.07
30 Year	4.84	4.68	0.16

YIELD SPREADS	3/31/07	2/28/07	Change
5yr - 2yr T-Note	(0.04)	(0.12)	0.08
10yr - 2yr T-Note	0.07	(0.07)	0.14

Source: Bloomberg

Subprime Mortgages, Housing, and the Broader Economy

The subprime mortgage market has been experiencing difficulties recently, and some investors fear that this will result in broader economic weakness. With that in mind, we wanted to look at what the impact of the subprime market might be on US economic growth.

The subprime mortgage market is part of the broader housing sector of the economy. In aggregate, housing makes up approximately 5% of the US economy, as measured by Gross Domestic Product (GDP). When related expenditures such as home refurbishments and furniture are taken into account, housing constitutes approximately 15% of the economy. While not an insignificant amount by any measure, housing is not the most significant component of economic growth. The largest determinant of economic growth is consumer spending, which constitutes roughly 70% of GDP. It is a truism that "as goes the consumer, so goes the economy." So the question becomes: will the subprime mortgage trouble lead to further weakness in the broader housing market and if so, will housing sector weakness lead to reduced consumer spending, and ultimately a weaker economy?

The Subprime Story

Subprime mortgages are issued to households with below average credit or income histories and are generally considered more risky than traditional "prime" mortgages. Although they constitute a minority of the overall mortgage market, they have become increasingly important in recent years. The proportion of subprime to prime mortgages varies widely by region, with some areas of the industrial midwest having as much as 50% of all mortgages subprime, while other areas have very few subprime mortgages.

Recently, many subprime lenders have been forced to declare bankruptcy, and others have tightened lending standards significantly. Observers wonder if this means that buyers with marginal credit will have greater difficulty in purchasing a home. If so, demand and prices in some markets might fall. Furthermore, there is a possibility that credit standards will be tightened not only in the subprime mortgage market, but also in the traditional mortgage market. This could be problematic, particularly since activity in the housing sector has already come off its highs.

The Housing Story

Most readers are probably aware that the housing market has been slowing for the past year or so. Home prices have declined in some areas, and new construction and sales of existing homes have declined. It is important to note that these declines have come from near record levels; housing activity remains well within the long term historical range.

Concern over housing comes in two forms. The first is that economic activity related to home building and construction will decline further, directly impacting economic growth. The second concern is less direct, but could potentially have a bigger impact on the economy. Economic growth in the past several years was driven in part by consumer spending that was fueled by rising home prices. These rising prices allowed owners to extract wealth from their homes via second mortgages or home equity loans. This additional "income" was often spent on discretionary purchases. Rising home prices also contributed to a "wealth effect" similar to that experienced during the late 1990s stock market boom. This "wealth effect" results in consumers that have greater confidence in their overall financial position, which causes them to increase their discretionary spending. If a weaker housing market causes consumers to reassess their spending plans, economic growth will slow.

The Consumer Spending Story

Consumer spending represents roughly 70% of GDP. As such, any slowdown in consumer spending is likely to negatively impact the economy, particularly since the past three quarters have already witnessed below trend growth. While developments in the job market tend to be the biggest determinant of consumer spending, if housing sector weakness leads to even a slight decline in consumer spending, an economic slowdown could follow. That is because consumer spending tends to be a self-fulfilling prophecy. If consumers hear news reports of a weak economy, or believe that the economy is weakening, they are likely to reign in their spending and cut back unnecessary expenses. This leads to a cycle of bad news, reduced spending, and economic weakness.

Where Do We Go From Here?

Economists and market participants disagree over whether subprime mortgage troubles or housing sector weakness will lead to a broader economic slowdown. At this point it seems likely that if consumer spending remains unaffected by developments in the housing sector the effect on the economy will be relatively small. On the other hand, if consumers curtail or delay spending due to concerns over falling home prices or the reversal of the wealth effect, broader economic growth could be seriously impacted. How this situation is resolved will be one of the most significant factors in determining whether the FOMC institutes further rate increases, remains on hold, or loosens monetary policy. FOMC policy will in turn prove vital in determining the path of interest rates and the bond market.

-Brian Perry, Research Analyst

Consumer and Producer Prices

During February, the economy's headline inflation reading rose as the year-over-year CPI increased to 2.4% from 2.1% in January, partly due to an increase in food and beverage prices. The year-over-year Core CPI (CPI less food and energy) remained unchanged at 2.7%. Core CPI remains above the FOMC's comfort level. Going forward, market observers will watch carefully to see if there is a trend towards higher or lower inflation.

Labor Markets

The March non-farm payroll employment report showed an increase of 180,000 jobs, which was much higher than consensus expectations. The unemployment rate declined to 4.4%. One of the leading factors in the strength of the employment report was a rebound in construction payrolls. The six-month average for non-farm payroll employment is now 164,000 jobs. March's employment report indicates continued moderate growth in the labor market.

Housing Starts

Single-family housing starts rose by 10.3% in February, to a 1.22 million annual pace. This follows January's reading of 1.11 million. Single family housing permits declined. The combination of unusually warm weather in December followed by extremely cold temperatures in January and February has led to greater than usual volatility in housing data. Going forward, market participants will watch closely to see whether or not the decline in the housing market has run its course.

Manufacturing

During March the ISM Manufacturing Index declined to 50.9 from February's reading of 52.3. ISM readings below 50 indicate that the manufacturing sector of the economy is contracting; readings above 50 indicate that the manufacturing sector is in an expansionary phase. For the past several month's ISM readings have been fluctuating on either side of 50, leaving market participants unsure as to whether the manufacturing sector is expanding or contracting.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.07	0.10
2-year AA corporate note	0.36	0.35	0.01
5-year AA corporate note	0.51	0.52	(0.01)
5-year Agency note	0.31	0.28	0.03

Source: Bloomberg

Data as of 3/31/07

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(59.1) $Bln JAN 07	(61.5) $Bln DEC 06	(66.5) $Bln JAN 06
GDP	2.5% DEC 06	2.0% SEP 06	1.8% DEC 05
Unemployment Rate	4.4% MAR 07	4.5% FEB 07	4.7% MAR 06
Prime Rate	8.25% MAR 07	8.25% FEB 07	7.75% MAR 06
CRB Index	316.88 MAR 07	312.39 FEB 07	333.18 MAR 06
Oil (West Texas Int.)	$65.87 MAR 07	$61.79 FEB 07	$66.63 MAR 06
Consumer Price Index (y/o/y)	2.4% FEB 07	2.1% JAN 07	3.6% FEB 06
Producer Price Index (y/o/y)	2.5% FEB 07	0.2% JAN 07	3.9% FEB 06
Dollar / EURO	1.34 MAR 07	1.32 FEB 07	1.21 MAR 06

Source: Bloomberg

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