

# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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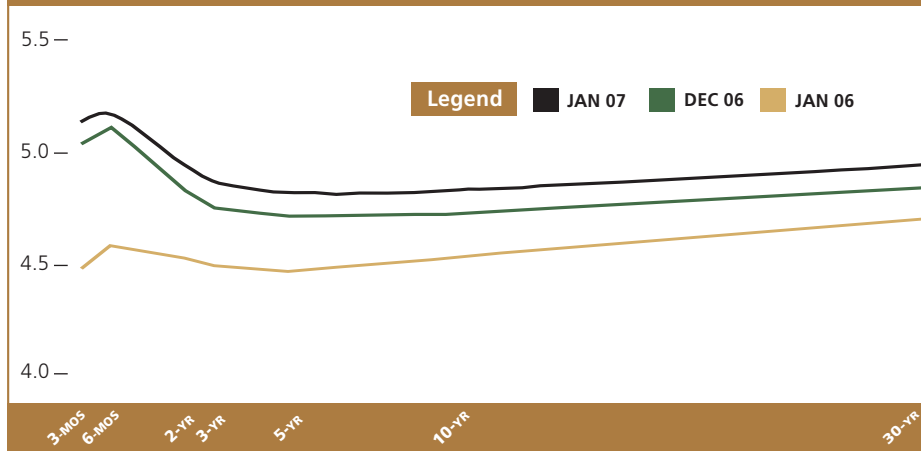
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## MARKET SUMMARY

The FOMC took no action at its January 31st meeting, leaving its target for the fed funds rate at 5.25%. In its accompanying statement, the FOMC noted that "recent indicators have suggested somewhat firmer economic growth," and that "some tentative signs of stabilization have appeared in the housing market." The FOMC went on to say that "readings on core inflation have improved modestly in recent months." This combination of stronger growth and lower inflation led some market pundits to describe the current economic environment as "nirvana." The next FOMC meeting is on March 21st, and most market participants anticipate no action on interest rates.

The economy continued to display moderate growth in January. The Non-Farm Payroll number showed an increase of 111,000 new jobs. There were some tentative signs that the housing decline may have begun to moderate, but the manufacturing sector weakened, as the ISM Manufacturing Index declined to 49.3 from 51.4 in December. ISM readings above 50 indicate that the manufacturing sector of the economy is in an expansionary phase; readings below 50 indicate that the manufacturing sector is contracting. Inflation data was mixed last month, with Core CPI showing a 2.6% year over year rise. Going forward, market participants will continue to focus upon inflation readings, while also searching for signs as to whether or not the economy is indeed growing at a moderate pace.

## TREASURY YIELDS HIGHER



The treasury curve shifted upward in January, as yields increased across most of the curve. Yields on bonds with more than two years remaining to maturity increased by more than ten basis points during the month.

YIELDS	1/31/07	12/31/06	Change
3 Month	5.10	5.01	0.09
2 Year	4.92	4.81	0.11
3 Year	4.85	4.73	0.12
5 Year	4.80	4.69	0.11
10 Year	4.81	4.70	0.11
30 Year	4.91	4.81	0.10

YIELD SPREADS	1/31/07	12/31/06	Change
5yr - 2yr T-Note	(0.12)	(0.12)	0.00
10yr - 2yr T-Note	(0.11)	(0.11)	0.00

Source: Bloomberg

## TOTAL RETURN VS. YIELD MEASURES

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There are two measures that investors commonly employ in order to track portfolio performance. These two measures are portfolio yield and total return. While yield might seem simpler and is easier to understand, in most circumstances total return is a more accurate measure of a portfolio's performance.

Generally speaking, portfolio yield measurement attempts to project the cash flow that a given portfolio will generate during a specific period of time, usually one year. For instance, imagine that an investor holds a portfolio of bonds that they have purchased for ten million dollars. If this portfolio generates five hundred thousand dollars of revenue each year, it can be said that the portfolio's yield is five percent. If an investor is attempting to generate budget projections, yield is a useful measure of portfolio return. By focusing upon the income that will be generated by the portfolio, the investor can ascertain whether or not the portfolio will generate sufficient revenue to satisfy any liabilities that are coming due.

Total return includes the portfolio's yield but goes further. In addition to yield, total return measures the gains or losses in the value of the portfolio over a given time period. Total return incorporates all cash flows from investment activities and asks the question: what was the value of the portfolio at the beginning of the measurement period and what is the value of the account at the end of the period? The difference between these two measures is the portfolio performance or total return for the period. In order to normalize these figures, portfolio return is often converted into a percentage and then annualized.

There are several reasons why total return is often a superior measure of portfolio performance than portfolio yield. The prices of most securities do not remain constant at the investor's purchase price but instead fluctuate on an ongoing basis. Yield measurement does not take these price fluctuations into account in its return calculations. If the investor needs to liquidate some or all of the portfolio, whether for reasons expected or unforeseen, the market may no longer value those securities at the same price that the investor paid for them. The price may have increased, but it just as easily could have decreased, leaving the investor with an unexpected loss.

Additionally, yields in the market place move up and down on a regular basis due to a variety of factors such as supply and demand or economic growth. An investor measuring their portfolio return based solely upon yield may find that when their securities mature, market yields may have declined, forcing them to reinvest at lower yields. In a worst case scenario, the new yield may not be sufficient to meet future obligations.

Another benefit of using total return measurement is that it provides for a better method of evaluating a portfolio's performance. When measuring yield it is often difficult to determine whether or not portfolio performance was "good." Is a 4% yield "good?" What about 8%? What should these yields be compared to in order to determine relative performance?

In contrast to yield, total return is generally measured against a benchmark. A benchmark represents an index whose risk characteristics match the investor's risk tolerance and return requirements. On a regular basis, the performance of the portfolio can be compared to the performance of the benchmark thereby providing a reasonable manner in which to evaluate the portfolio's overall performance. Since this benchmark fits the investor's risk tolerance profile, performance versus a benchmark also provides a good measure of how a portfolio is performing on a risk adjusted basis. Total return provides a useful quantitative evaluation of how well the investment program is meeting the investor's objectives, and serves as a basis for understanding steps that could be taken to improve investment decision-making.

One final problem with using yield measurements is that many investors that do so tend to neglect capital appreciation possibilities. In other words, by focusing upon yield, an investor may neglect to conduct portfolio transactions that could benefit the overall portfolio and increase its total value.

This opportunity cost can be confusing to many people. They might respond that yield is "real" and that they "can't spend total return." While it is true that paper profits in a portfolio can not be spent in the same way that portfolio income can, that does not mean that price appreciation can not be harvested. Generating a greater total rate of return will either facilitate greater income by harvesting portfolio gains or allow for the same level of income while increasing the size of the overall portfolio.

When considering portfolio returns, an investor should ask themselves how many retirees' pensions could the portfolio fund, how many police cars could the portfolio buy, how many wonderful vacations could an investor take with the portfolio's proceeds? Thinking about the tangible benefits that portfolio growth can confer should help an investor to move beyond an abstract view of total return and instead begin to consider the added benefits that they can receive if they are able to increase the compound rate of growth on their account.

*-Brian Perry, Research Analyst*

**INFLATION MEASURES**

During December, the economy's headline inflation reading rose as the year-over-year CPI increased to 2.5% from 2.0% in November. The year-over-year Core CPI (CPI less food and energy) remained at 2.6%. While the trends in both Overall and Core CPI have moderated recently, Core CPI remains above the FOMC's comfort level. Going forward, market observers will watch carefully to see if there is a trend towards lower inflation.

**HOUSING STARTS**

Single-family housing starts fell by 3.9% in December, to a 1.23 million annual pace. This follows November's reading of 1.28 million. Single family housing permits, new home sales and existing home sales all rose slightly. Overall, the most recent housing data has been somewhat more positive than that of previous periods, but several more months of readings will be required to ascertain if the housing market is moderating or if further weakness can be expected.

**LABOR MARKETS**

The January non-farm payroll employment report showed an increase of 111,000 jobs, which was below consensus expectations. However, the previous two months' reports were revised higher. One of the main sources of strength in the report was unseasonably warm weather, which contributed to stronger than expected construction payrolls. The six-month average for non-farm payroll employment is now 167,000 jobs. January's employment report indicates continued moderate growth in the labor market.

**OIL PRICES**

Oil prices for West Texas Intermediate decreased in January. The price per barrel closed the month at \$58.14 down from \$62.38 per barrel. Price levels decreased due to unusually warm winter weather across much of the United States, as well as statements from OPEC that they did not intend to curtail supplies.

**CREDIT SPREADS MIXED**

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.11	0.21	(0.10)
2-year AA corporate note	0.28	0.33	(0.05)
5-year AA corporate note	0.52	0.59	(0.07)
5-year Agency note	0.28	0.27	0.01

Source: Bloomberg

Data as of 1/31/07

**MIXED ECONOMIC DATA**

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(58.2) \$Bln NOV 06	(58.8) \$Bln OCT 06	(64.0) \$Bln NOV 05
GDP	3.5% DEC 06	2.0% SEP 06	1.8% DEC 05
Unemployment Rate	4.6% JAN 07	4.5% DEC 06	4.7% JAN 06
Prime Rate	8.25% JAN 07	8.25% DEC 06	7.50% JAN 06
CRB Index	301.22 JAN 07	307.26 DEC 06	348.66 JAN 06
Oil (West Texas Int.)	\$58.14 JAN 07	\$61.05 DEC 06	\$67.92 JAN 06
Consumer Price Index (y/o/y)	2.5% DEC 06	2.0% NOV 06	3.4% DEC 05
Producer Price Index (y/o/y)	1.1% DEC 06	0.9% NOV 06	5.4% DEC 05
Dollar / EURO	1.30 JAN 07	1.32 DEC 06	1.22 JAN 06

Source: Bloomberg

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