Bond Market Review

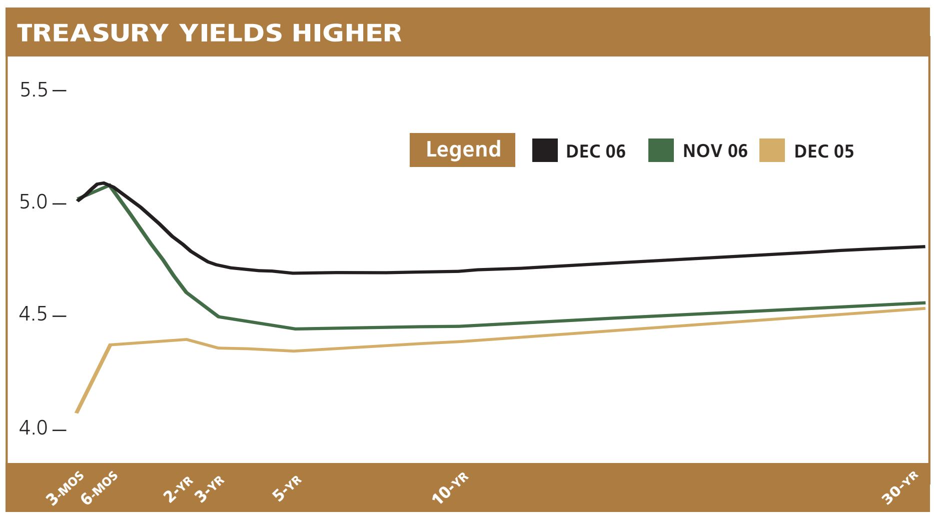
A monthly review of fixed income markets

What's Inside

Market Summary

The FOMC took no action at its December 12th meeting, leaving its target for the fed funds rate at 5.25%. In its accompanying statement, the FOMC noted that "economic growth has slowed over the course of the year," and that the housing market had experienced "substantial cooling." The FOMC went on to say that "going forward, the economy seems likely to expand at a moderate pace." The next FOMC meeting is on January 31st, and most market participants anticipate no action on interest rates.

The economy continued to display moderate growth in December. The Non-Farm Payroll number was stronger than expected, with the economy adding 167,000 new jobs. There were some tentative signs that the housing decline may have begun to moderate, and the manufacturing sector also rebounded, as the ISM Manufacturing Index rose to 51.4 from 49.5 in November. 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, but Core CPI did moderate. 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.



Bond yields rose throughout December, closing the month more than 20 basis points higher across most of the treasury curve.

YIELDS	12/31/06	11/30/06	Change
3 Month	5.01	5.02	(0.01)
2 Year	4.81	4.61	0.20
3 Year	4.73	4.50	0.23
5 Year	4.69	4.44	0.25
10 Year	4.70	4.46	0.24
30 Year	4.81	4.56	0.25

YIELD SPREADS	12/31/06	11/30/06	Change
5yr - 2yr T-Note	(0.12)	(0.17)	0.05
10yr - 2yr T-Note	(0.11)	(0.15)	0.04

Source: Bloomberg

What moved markets in 2006...

This past year witnessed a number of significant developments in the financial markets. While some of these were unexpected, many others were eagerly anticipated. Once again though, the financial markets proved that even when investors anticipate a development, accurately predicting its timing, magnitude, and impact can be extremely difficult. Some of the most notable developments in 2006 included:

- The Federal Open Market Committee (FOMC) raised the Fed Funds Target Rate four times in 2006, from 4.25% to 5.25%. The last interest rate increase occurred at the June 29th meeting and for the remainder of the year the FOMC refrained from taking further action. While the FOMC has maintained a neutral stance, there has been significant disagreement in the financial markets as to the future course of monetary policy and economic growth. While some market participants believe that the FOMC has merely paused in its tightening campaign and that there are more interest rate increases to come, others believe that the economy will be influenced by the housing slowdown and that the next move on interest rates will be lower. This situation has led to an inverted yield curve, as the yields on short term treasuries have been higher than those for longer dated securities. In the past this relationship has often forecast the onset of a recession, but as with many forward-looking economic indicators its accuracy can only be measured in hindsight.

- Following Alan Greenspan's long and successful tenure as Chairman of the Federal Reserve, Ben Bernanke assumed the top spot following the January 31st meeting. Although the transition was relatively seamless, it took market participants some time to adjust to the new Chairman's communication style. Going forward, the FOMC may adopt a more open and transparent management style. Also, Chairman Bernanke may support an explicit inflation target, which would be an important development if it were to occur.

- By many measures, volatility and spreads on risky assets are at record lows. While this contributed to strong performance for a wide range of financial assets in 2006, a number of investors are concerned that market returns no longer reflect the potential downside risk of certain securities. In the past this situation has occasionally led to large market movements as investors suddenly decide to demand higher premiums for accepting risk.

- Housing market indicators began to weaken in 2006. In fact, home prices in some parts of the United States began to decline for the first time in many years. We also saw a reduction in new construction for residential units, as well as increases in inventories of unsold homes. From their peak in January and February 2006, single family housing starts have fallen 35%, while existing home sales have fallen 13% since June 2005. Housing market weakness has been the topic of much debate in financial market circles. In fact, market participants that believe the U.S. economy is slowing often point to this as the crucial factor that will prompt a broader economic slowdown. The continuation of this argument is that the slowdown will then lead to FOMC interest rate cuts and lower bond yields.

- Market participants that believe the economy is still strong and that the FOMC will resume interest rate increases often point to inflationary statistics. Although it has begun to moderate during the past several months, Core CPI has persistently remained above the FOMC's comfort level throughout 2006. Meanwhile, since reaching a high for the year of 4.3% in June, the Overall Consumer Price Index (CPI) has declined to 2.0%. This divergence between the two indicators has led to uncertainty among market participants as to whether or not inflation is indeed moderating.

- The labor markets continued to enjoy moderate growth in 2006. For the year, the economy added an average of 153,000 jobs each month, comparable to 2005's 165,000 jobs per month.

What to watch for in 2007...

As is always the case, the year ahead promises to be filled with unexpected surprises. Nevertheless, there are several themes that promise to impact the course of financial markets both in 2007 and beyond. Some of these include:

- Is the FOMC finished raising rates? Will the next action on interest rates be a tightening or will the FOMC choose to lower rates? Market participants disagree greatly as to the future course of FOMC monetary policy. How and when this issue is resolved is perhaps the most important factor influencing the fixed income markets in the coming year.

- Is US economic growth accelerating, or have we already reached the peak of the current economic cycle? We appear to have reached an inflection point in the economic and interest rate cycles. Which way the economy and interest rates turn remains to be seen.

- What effect will the new Congress have on the financial markets? Most prognosticators foresee little change for the overall economy, but the new Congress could have a large impact on certain industries or sectors.

- Will the slowing housing market depress the rest of the U.S. economy? Whether housing continues its decline or rebounds in 2007 will go a long way towards determining the strength of the overall economy and the future course of interest rates.

- Will risk premiums remain low, or will they begin to rise in 2007? With premiums on risky assets at historic lows, it appears that risk premiums must increase *at some point in the future*. When and how this will occur is the subject of great uncertainty.

-Brian Perry, Research Analyst

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Consumer and Producer Prices

During November, the economy's headline inflation reading rose slightly as the year-over-year CPI increased to 2.0% from 1.3% in October. Despite this increase, the overall CPI level recorded its second lowest reading since March 2004. The year-over-year Core CPI (CPI less food and energy) eased to 2.6%. While the trends in both Overall and Core CPI have improved recently, Core CPI remains above the FOMC's comfort level. Going forward, market observers will watch carefully to see if the past two months' decline in the Core CPI marks the beginning of a trend towards lower inflation.

Oil Prices

Oil prices for West Texas Intermediate decreased in December. The price per barrel closed the month at $61.05 down from $64.62 per barrel. Price levels decreased due to unusually warm winter weather across much of the United States.

Labor Markets

The December non-farm payroll employment report showed an increase of 167,000 jobs, higher than the consensus forecast for a gain of 100,000. One of the main causes for this increase was unseasonably warm and dry weather, which contributed to stronger than expected construction payrolls. The six-month average for non-farm payroll employment is now 161,000 jobs. December's employment report indicates continued moderate growth in the labor market.

Housing Starts

Single-family housing starts rose by 8.1% in November, to a 1.28 million annual pace. This follows October's reading of 1.18 million, which was the lowest in six years. Single family housing permits and new home sales indicators were little changed. Although November's data was more positive than the previous periods, several more months of data will be required to ascertain if the housing decline is reaching a bottom or if further weakness can be expected.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.21	0.19	0.02
2-year AA corporate note	0.33	0.34	(0.01)
5-year AA corporate note	0.59	0.59	0.00
5-year Agency note	0.27	0.27	0.00

Source: Bloomberg *Data as of 12/31/06*

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(58.9) $Bln OCT 06	(64.3) $Bln SEP 06	(66.6) $Bln OCT 05
GDP	2.0% SEP 06	2.6% JUN 06	4.2% SEP 05
Unemployment Rate	4.5% DEC 06	4.5% NOV 06	4.9% DEC 05
Prime Rate	8.25% DEC 06	8.25% NOV 06	7.25% DEC 05
CRB Index	307.26 DEC 06	321.53 NOV 06	331.83 DEC 05
Oil (West Texas Int.)	$61.05 DEC 06	$63.13 NOV 06	$61.04 DEC 05
Consumer Price Index (y/o/y)	2.0% NOV 06	1.3% OCT 06	3.5% NOV 05
Producer Price Index (y/o/y)	0.9% NOV 06	(1.6)% OCT 06	4.4% NOV 05
Dollar / EURO	1.32 DEC 06	1.32 NOV 06	1.18 DEC 05

Source: Bloomberg

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CHANDLER ASSET MANAGEMENT ■ 9255 Towne Centre Drive, Ste 350 ■ San Diego, CA 92121 ■ 800 317 4747 ■ chandlerasset.com