

# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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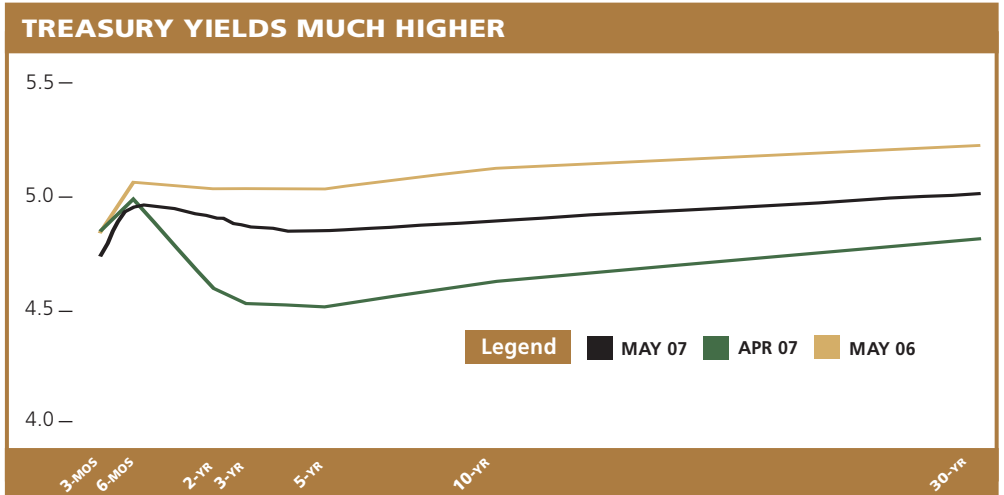
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## MARKET SUMMARY

Very short term rates declined in May, while yields on most other maturities showed large increases. The market's recent activity indicates that participants may be losing hope for a near-term interest rate cut by the Federal Reserve. As a result of last month's market movements, the yield curve has moved closer to a normal shape, with the highest rates found in the thirty year sector.

The economy continued to display mixed signals in April. The Non-Farm Payroll number was slightly stronger than expected, showing an increase of 157,000 new jobs, and the unemployment rate remained at 4.5 percent. Both figures indicated that the job market continues its moderate growth. Inflation readings moderated but remain higher than the FOMC would prefer. Housing data were mixed during the month, along with most other measures of consumer activity. Going forward, market participants will continue to look for signs as to whether or not economic activity is poised to rebound in the second half of the year.

The FOMC took no action at its May 9th meeting, leaving the fed funds target at 5.25%. The next FOMC meeting is on June 28th, and most market participants anticipate no action on interest rates.



YIELDS	5/31/07	4/30/07	Change
3 Month	4.73	4.84	(0.11)
2 Year	4.91	4.59	0.32
3 Year	4.87	4.53	0.34
5 Year	4.85	4.51	0.34
10 Year	4.89	4.62	0.27
30 Year	5.01	4.81	0.20

YIELD SPREADS	5/31/07	4/30/07	Change
5yr - 2yr T-Note	(0.06)	(0.08)	0.02
10yr - 2yr T-Note	(0.02)	0.03	(0.05)

Source: Bloomberg

## THE FEDERAL RESERVE: PART II OF A SERIES

In last month's newsletter article we discussed the history of the Federal Reserve, its structure, and its mandate to facilitate economic growth and promote price stability. This month we'll explore in greater detail some of the most important measures of short term interest rates, as well as the tools the Federal Reserve (Fed) uses to implement monetary policy.

### Key Interest Rates

#### The Federal Funds Rate (fed funds)

The fed funds rate is the rate at which banks and financial institutions lend money amongst themselves on a short-term basis. It is the most important short term rate the Fed uses in implementing its monetary policy. The Fed targets a fed funds rate through its open market operations (explained later).

#### The Discount Rate

The discount rate is the rate that the Federal Reserve charges banks to borrow directly from it. This rate is less important than the fed funds rate in implementing monetary policy.

#### The Prime Rate

The Federal Reserve has no direct impact on the prime rate, which is set individually by various banks and other financial institutions. In practice though, most banks set their prime rate at a level three hundred basis points above the fed funds rate. Therefore, when the Fed raises rates, the prime rate usually increases, and when the Fed cuts rates, the prime rate decreases. The prime rate is used in pricing a wide range of consumer and commercial loans such as credit cards, construction loans, and small business loans. Therefore, when the prime rate fluctuates in response to Fed actions, it serves to further promote or discourage economic growth

### Tools of the Fed

The Fed attempts to manage short term interest rates and the money supply in order to facilitate economic growth and promote price stability. It has several tools that it employs in order to accomplish its goals. These tools include open market operations, discount window lending, and managing bank reserve requirements.

#### Open Market Operations

The Federal Open Market Committee (FOMC) meets eight times a year to discuss economic conditions and set a target for the federal funds rate. The "cheaper" the cost of these funds, the more willing customers are to borrow. Therefore, when the Federal Reserve wishes to tighten credit throughout the financial system, they raise the federal funds

rate. When they want to promote economic activity, they lower the rate. Adjusting the fed funds rate is the primary tool that the Federal Reserve uses to combat inflation and promote economic growth.

The federal funds rate is a target rate that the FOMC sets at its meetings. The Fed then attempts to maintain the target overnight rate through the use of open market operations. With open market operations, the Federal Reserve buys and sells US Treasury and Agency securities on a regular basis in order to manage the money supply. If the Fed wants to add more money to the system, it buys securities. If it wants to remove liquidity from the system, it sells securities. All open market operations are conducted by the Federal Reserve's New York branch.

#### Discount Window Lending

At the same time that the FOMC sets the federal funds rate, it also sets the discount rate. In theory, if the discount rate is higher, banks will be less willing to borrow from the Fed, thereby curtailing economic activity. Banks usually prefer to borrow from one another rather than directly from the Fed. That is why the discount rate is less important as a tool of monetary policy than the fed funds rate.

#### Reserve Requirements

Banks and financial institutions must hold a portion of their assets on reserve at the Fed. These reserves are not available to be lent out. Therefore, by altering the reserve requirement, the Fed can influence money supply. Changing the reserve requirement is a very powerful tool of monetary policy which the Fed seldom invokes.

### The Fed in Action

Let's look at a couple of examples of the Fed in action.

#### 1998 & 2001

In both 1998 and 2001 the Federal Reserve responded to financial crises by cutting short term interest rates, thereby providing liquidity to the system and helping to minimize economic slowdowns.

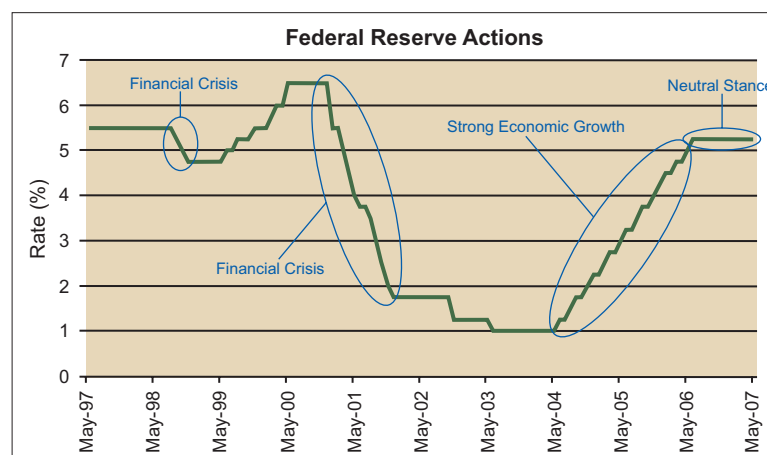
#### 2004 - 2006

In 2004 interest rates hit an historic low. As economic growth began to increase, the Fed raised rates 17 times in order to reach a "neutral stance."

#### 2006 - 2007

Since June 2006, the Fed has refrained from action, as it awaits clearer indications as to the future course of economic activity and inflation.

*Brian Perry, Research Analyst*



**CONSUMER PRICES**

During April, the economy's headline inflation reading fell as the year-over-year CPI declined to 2.6% from 2.8% in March. The year-over-year Core CPI (CPI less food and energy) declined to 2.3%. While Core CPI remains above the FOMC's comfort level, the trend has been relatively positive over the past six months. Going forward, market observers will watch carefully to see if there is a trend towards higher or lower inflation.

**LABOR MARKETS**

The May non-farm payroll employment report showed an increase of 157,000 jobs, which was slightly higher than consensus expectations. The unemployment rate remained at 4.5%. The six-month average for non-farm payroll employment is now 148,000 jobs. May's employment report indicates continued moderate growth in the labor market.

**HOUSING STARTS**

Single-family housing starts rose by 2.5% in April, to a 1.23 million annual pace. This follows March's reading of 1.21 million. Single family housing permits declined. While the increase in housing starts is positive, the decline in permits may indicate weakness in the future. Going forward, market participants will watch closely to see whether or not the decline in the housing market has run its course.

**MANUFACTURING**

During May the ISM Manufacturing Index increased to 55.0 from April's reading of 54.7. 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. The recent trend in ISM readings indicates that the manufacturing sector of the economy remains relatively healthy. Nevertheless, it is important to remember that manufacturing constitutes a smaller portion of the US economy than in the past.

**CREDIT SPREADS WIDER**

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.47	0.35	0.12
2-year AA corporate note	0.45	0.42	0.03
5-year AA corporate note	0.71	0.61	0.10
5-year Agency note	0.32	0.31	0.01

Source: Bloomberg

Data as of 5/31/07

**MIXED ECONOMIC DATA**

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(63.9) \$Bln MAR 07	(57.9) \$Bln FEB 07	(62.3) \$Bln MAR 06
GDP	0.6% MAR 07	2.5% DEC 06	5.6% MAR 06
Unemployment Rate	4.5% MAY 07	4.5% APR 07	4.6% MAY 06
Prime Rate	8.25% MAY 07	8.25% APR 07	8.00% MAY 06
CRB Index	311.46 MAY 07	312.71 APR 07	344.87 MAY 06
Oil (West Texas Int.)	\$64.01 MAY 07	\$65.71 APR 07	\$71.29 MAY 06
Consumer Price Index (y/o/y)	2.6% APR 07	2.8% MAR 07	3.5% APR 06
Producer Price Index (y/o/y)	3.2% APR 07	3.2% MAR 07	4.1% APR 06
Dollar / EURO	1.35 MAY 07	1.36 APR 07	1.28 MAY 06

Source: Bloomberg

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