

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



WHAT'S INSIDE

Market Summary 1

Yield Curve

Current Yields

Treasury Yield Spreads

Sticking with a Long-Term
Investment Plan 2

Economic Round-Up 3

Credit Spreads

Economic Indicators

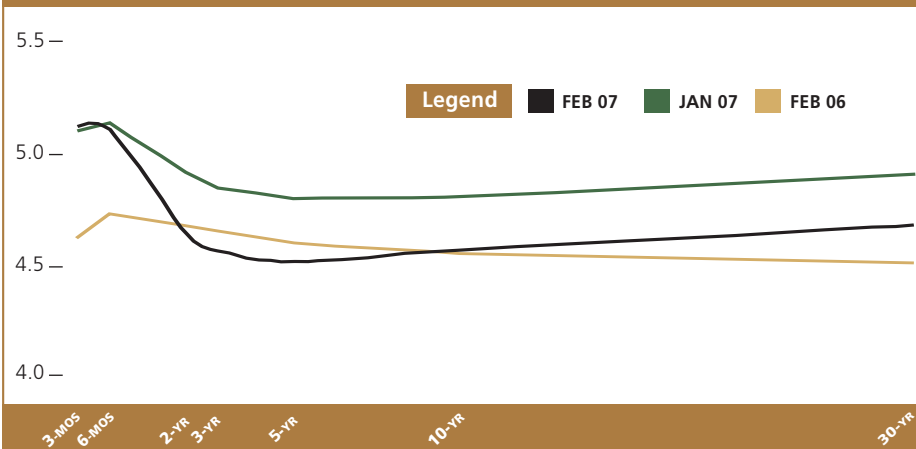
MARKET SUMMARY

Bond yields declined sharply during February, closing the month 20 to 30 basis points lower across the treasury curve. This market movement occurred in part due to unexpectedly volatile equity markets late in the month. Also contributing to the bond market rally were several weaker than expected economic releases.

The economy continued to display mixed signals in February. The Non-Farm Payroll number showed an increase of 97,000 new jobs. Data from the housing market was weaker than expected, but the manufacturing sector rebounded somewhat, as the ISM Manufacturing Index increased to 52.3 from 49.3 in January. Inflation data was also mixed last month, with the overall CPI reading moderating, while Core CPI increased. 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.

The FOMC took no action at its January 31st meeting, leaving its target for the fed funds rate at 5.25%. While there was no FOMC meeting scheduled during February, Chairman Ben Bernanke did testify before Congress on several occasions. During his testimony, Bernanke stated that "there are some indications that inflation pressures are beginning to diminish." However, he went on to stress that the FOMC remained ready to raise interest rates should inflation not decline as anticipated. The next FOMC meeting is on March 21st, and most market participants anticipate no action on interest rates.

TREASURY YIELDS MUCH LOWER



The treasury curve shifted downward in February, as yields declined by 20 to 30 basis points during the month.

YIELDS	2/28/07	1/31/07	Change
3 Month	5.12	5.10	0.02
2 Year	4.64	4.92	(0.28)
3 Year	4.56	4.85	(0.29)
5 Year	4.52	4.80	(0.28)
10 Year	4.57	4.81	(0.24)
30 Year	4.68	4.91	(0.23)

YIELD SPREADS	2/28/07	1/31/07	Change
5yr - 2yr T-Note	(0.12)	(0.12)	0.00
10yr - 2yr T-Note	(0.08)	(0.11)	0.03

Source: Bloomberg

STICKING WITH A LONG-TERM INVESTMENT PLAN

Selecting a long term investment plan and maintaining it over time is the key to investment success. However, market conditions that are constantly changing can make this difficult to do. The current bond market environment, where the yield curve is inverted and shorter term securities provide greater yield than longer term ones, can tempt investors to deviate from their established investment plan by purchasing securities shorter than those that they would typically consider. These investors are engaging in market timing, although they may not even realize they are doing so.

At first glance, market timing can appear to be a viable investment strategy. In fact, accurate market timers could generate returns in excess of those available to adherents of a more consistent investment strategy. Furthermore, the benefits of successful market timing go beyond financial rewards. There is a tremendous amount of emotional and psychological satisfaction that comes from correctly predicting market movements. The feeling that "I'm smarter than the market" is quite tempting and very appealing. Often times, these non-monetary rewards are so great that they cause a market timer to remember fondly those occasions when they have correctly predicted market moves. These instances are then used to justify further attempts at market timing. Unfortunately, this often leads the investor to avoid a realistic and rational measurement of the portfolio's long term performance.

If the investor did measure their portfolio performance against a market benchmark, they would probably find that over time their portfolio had performed relatively poorly. That is because, while market timing is a concept that sounds good in theory, it is nearly impossible to execute in the real world. "Trying to predict (the market's) direction over the near term is an exercise in futility." These words were spoken by the legendary mutual fund manager Peter Lynch, one of the most successful investors of all time.

When it comes to investing in the bond market, successfully forecasting future interest rate movements should result in superior long term investment returns. However, in order to be successful, the prognosticator must not only correctly determine the direction of interest rate movements, but also their magnitude and timing. The majority of academic studies, as well as many market participants, agree that doing this on a consistent basis is virtually impossible.

To make matters even worse, successful market timing requires the prognosticator to correctly forecast the market, not once, *but twice*. A market timer must successfully predict a market movement, which prompts them to deviate from their established investment strategy in an attempt to capture additional returns. Then, the market timer must make another correct prediction in order to decide when to return to their chosen long term investment strategy.

If the odds of correctly timing a market movement are 50/50, then the chances of correctly entering and reversing a market timing trade are 25%. The chances of correctly executing two market timing trades are 6 in 100, and the odds are only 1 in 1000 that a market prognosticator will be able to correctly time their entry and exit from the market on five separate occasions (this is a *failure rate of 99.9%*). While some market timers might argue that their odds on any given trade are greater than 50/50, many studies indicate that this is unlikely to be the case. In fact, academic surveys that measure the predictions of many of Wall Street's leading economists and market strategists indicate that their actual success rate at predicting interest rate movements is less than 50%. In other words, some of the world's most successful economists are less accurate than a coin flip.

In order to enjoy long term success, an investor must have a process that works and that is *repeatable*. While correctly predicting one, or even two, or perhaps even ten market movements may be possible, an honest investor must ask themselves whether or not these predictions are truly and consistently repeatable. For most, the answer will be a resounding no.

One of the ways in which an investment manager can add value to a client's portfolio is by providing the discipline necessary to stick with a long term investment strategy. A good investment manager will have a track record based upon an easily explained, repeatable, consistent process. At those times when the client feels most tempted to search out the hottest new investment trend the manager can remind the client of why a particular investment strategy was implemented in the first place. In today's inverted yield curve environment, long term investment discipline is more important than ever.

-Brian Perry, Research Analyst

CONSUMER AND PRODUCER PRICES

During January, the economy's headline inflation reading declined as the year-over-year CPI decreased to 2.1% from 2.5% in December. The year-over-year Core CPI (CPI less food and energy) increased to 2.7%, partly due to an increase in tobacco prices. 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.

LABOR MARKETS

The February non-farm payroll employment report showed an increase of 97,000 jobs, which was equal to consensus expectations. The previous two months' reports were revised higher. The February unemployment rate unexpectedly declined to 4.5%. Relatively severe weather in February negatively influenced the payroll report by causing construction payrolls to fall. The six-month average for non-farm payroll employment is now 162,000 jobs. February's employment report indicates continued moderate growth in the labor market.

HOUSING STARTS

Single-family housing starts fell by 11.2% in January, to a 1.11 million annual pace. This follows December's reading of 1.25 million. Single family housing permits also declined. Both housing starts and housing permits declined sharply in most areas of the country. January's numbers have caused some concern that perhaps the decline in the housing market has not yet run its course.

MANUFACTURING

During February the ISM Manufacturing Index increased to 52.3, rebounding from January's reading of 49.3. 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 months 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	0.07	0.11	(0.04)
2-year AA corporate note	0.35	0.28	0.07
5-year AA corporate note	0.52	0.52	0.00
5-year Agency note	0.28	0.28	0.00

Source: Bloomberg

Data as of 2/28/07

MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(61.2) \$Bln DEC 06	(58.1) \$Bln NOV 06	(64.2) \$Bln DEC 05
GDP	2.2% DEC 06	2.0% SEP 06	1.8% DEC 05
Unemployment Rate	4.5% FEB 07	4.6% JAN 07	4.80 FEB 06
Prime Rate	8.25% FEB 07	8.25% JAN 07	7.50% FEB 06
CRB Index	312.39 FEB 07	301.22 JAN 07	324.36 FEB 06
Oil (West Texas Int.)	\$61.79 FEB 07	\$58.14 JAN 07	\$61.41 FEB 06
Consumer Price Index (y/o/y)	2.1% JAN 07	2.5% DEC 06	4.0% JAN 06
Producer Price Index (y/o/y)	0.2% JAN 07	1.1% DEC 06	5.6% JAN 06
Dollar / EURO	1.32 FEB 07	1.30 JAN 07	1.19 FEB 06

Source: Bloomberg

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