

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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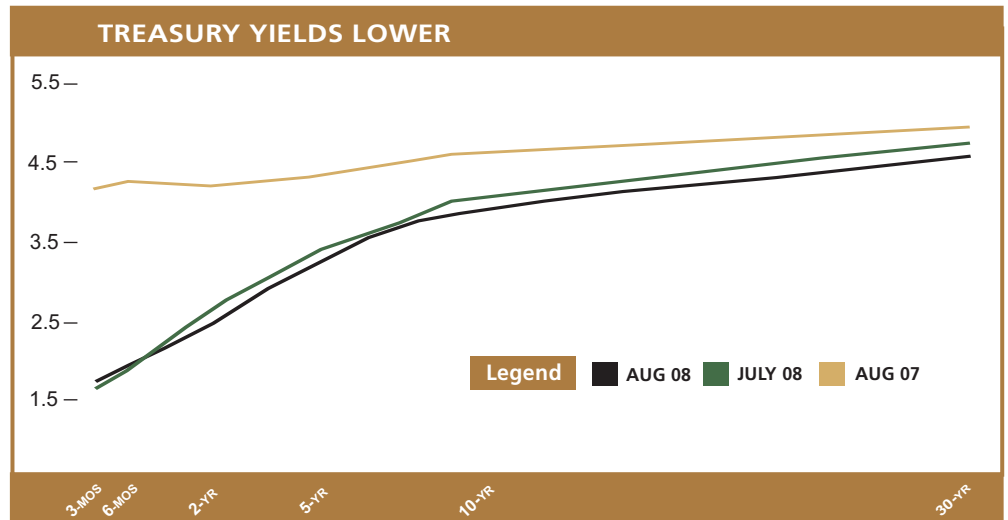
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

MARKET SUMMARY

Bond yields were mostly lower in August and economic data was mixed. The preliminary reading for Gross Domestic Product showed that the economy grew at a stronger than expected 3.3% annual rate during the second quarter. However, the economy lost jobs for the eighth straight month as the August Non-Farm Payroll number showed a decrease of 84,000 jobs, and the unemployment rate rose to 6.1%. While many inflation readings remain at twenty year highs, the Federal Reserve believes that slowing economic growth and lower energy prices will eventually reduce inflation levels.

On September 7 the government placed Fannie Mae and Freddie Mac under federal conservatorship. The agencies are now being managed by their federal regulator and the Treasury has promised to provide very significant financial support for the agencies if they need it. In addition to providing assurance as to the safety of the agencies' bonds, the government's actions are intended to provide liquidity to the mortgage market and help the housing sector to recover (see this month's article for much more information on the agencies.)

The FOMC held the federal funds rate at 2.00% at their meeting on September 16th. The next scheduled FOMC meeting is on October 29th. Going forward, market participants will continue to look for signs of an economic slowdown as well as anticipating the direction and timing of the next Federal Reserve move.



Treasury yields were mostly lower in August as market participants attempted to ascertain the consequences of financial market volatility, a housing-led economic slowdown and an end to Federal Reserve interest rate cuts. The yield curve retained its normal shape.

YIELDS	8/29/08	7/31/08	Change
3 Month	1.72	1.66	0.06
2 Year	2.35	2.52	(0.17)
5 Year	3.09	3.27	(0.18)
10 Year	3.82	3.98	(0.16)
30 Year	4.42	4.60	(0.18)

YIELD SPREADS	8/29/08	7/31/08	Change
5yr - 2yr T-Note	0.74	0.75	0.01
10yr - 2yr T-Note	1.47	1.46	0.01

Source: Bloomberg

UPDATE ON FANNIE MAE AND FREDDIE MAC

The Federal Housing Finance Agency (FHFA,) in conjunction with the U.S. Treasury Department placed Fannie Mae and Freddie Mac under conservatorship as part of a four part plan to strengthen the housing agencies. In addition to conservatorship, the other three parts of the plan include:

- A) pledging to inject up to \$100 billion in each if needed to maintain a positive net worth
- B) offering to provide unlimited short term liquidity if needed
- C) planning to purchase mortgage backed securities in the open market to improve the availability of mortgage credit to homeowners

The government took these actions in order to provide stability to the financial markets, support the availability of mortgage finance, and protect taxpayers from excessive losses.

What conservatorship entails:

The government placed the housing agencies under federal conservatorship in order to stabilize them with the objective of returning them to normal business operations. Management control of the two companies has been given to the agencies' regulator, the FHFA (the FHFA is a new government regulator formed by combining the Federal Housing Finance Board (FHFB) and the Office of Federal Housing Enterprise Oversight (OFHEO) and provided with expanded powers to regulate Fannie and Freddie.) The companies' chief executives have been replaced, but most of the management teams will remain in place to facilitate the continuity of the firms' operations. Although common and preferred stock issues will remain outstanding, dividends will be eliminated and common and preferred holders will be the first to suffer any future losses that the companies may experience.

Details of the Treasury's financial support

The Treasury is providing very substantial and explicit financial support to Fannie Mae and Freddie Mac. In return, the Treasury has received \$1 billion in preferred stock upfront from each of the agencies, as well as warrants representing nearly 80% of each company. Effectively, the Treasury can become the majority owner of Fannie and Freddie. Importantly for bondholders, although the preferred stock that the Treasury is receiving is senior to existing common and preferred stock holdings, it is junior to subordinated and senior debt issues. That means that bondholders maintain priority of payment ahead of the government.

The Treasury has offered to provide up to \$100 billion in capital to each firm as necessary in order to restore the firms to financial health. These capital infusions will occur any time the net worth of one of the agencies turns negative and are designed to ensure that they maintain a positive net worth. The Treasury has also offered to provide unlimited short-term funding to Fannie, Freddie and the 12 Federal Home Loan Banks if they need it. Finally, the Treasury is planning to purchase mortgage-backed securities in the open market. Initially they will

purchase \$5 billion, and that figure may increase. These purchases are designed to stimulate the market for mortgage-backed securities in order to lower mortgage rates and support the housing market.

What recent events mean for senior debt holders

The government's four step plan affirms our confidence in the safety of Fannie Mae and Freddie Mac bonds and minimizes any lingering uncertainty as to the timely payment of principal and interest on the agencies' senior debt. In the words of government officials, the plan to guarantee that Fannie and Freddie maintain a positive net worth will provide "additional security" to the owners of Fannie and Freddie bonds and "additional confidence" for the holders of their mortgage-backed securities.

The agencies remain AAA rated by Moody's, S&P, and Fitch. In fact, S&P recently affirmed Fannie Mae and Freddie Mac's long-term AAA ratings. "S&P attributed its affirmation of the AAA senior unsecured rating to the explicit government support under the terms of the conservatorship and the Treasury's establishment of a preferred stock purchase agreement."¹

The Future of Fannie & Freddie

In conjunction with the government's actions, Fannie and Freddie have agreed to limit the size of their company's mortgage portfolios to a maximum of \$850 billion each as of the end of 2009. The Treasury then intends for the mortgage portfolios to shrink about 10% a year until they reach about \$250 billion; this part of the plan is controversial and is already encountering Congressional opposition.

The ultimate corporate structure of Fannie and Freddie still remains to be determined. The companies' shares continue to be listed on the New York Stock Exchange, but the federal regulator has management control until the two companies are deemed financially healthy. Ultimately, Congress will decide if Fannie and Freddie remain government-sponsored public companies, are nationalized, or are privatized without any government charter. As these events unfold, we will continue to keep you abreast of the latest developments; however, we do not believe that any future changes to the ownership status of Fannie and Freddie will impact the status of the senior debt they have already issued or will issue in the near future.

Conclusion

Recent government actions have strengthened our consistently firm conviction as to the safety of Fannie Mae and Freddie Mac debt. Within the scope of the high grade fixed income universe, we believe that agency senior debt displays an attractive combination of safety of principal, liquidity, and yield. As a result, we continue to view agency bonds as a core holding for high quality fixed income portfolios.

Brian Perry, Vice President, Investment Strategist

1 - Credit Sights: GSEs: Conservatorship Comes Early Senior and Sub Supported, Common and PfD Punished; September 7, 2008

ECONOMIC ROUNDUP

CONSUMER PRICES

In July, the CPI increased by 5.6% on a year-over-year basis, compared to June's 5.0% indication. The year-over-year Core CPI (CPI less food and energy) rose at a 2.5% y-o-y rate. Although inflation readings remain elevated, the Fed expects inflation to moderate as growth slows in the months ahead.

HOUSING STARTS

Single-family housing starts declined by 2.9% in July, to a 0.64 million annual pace, the lowest since March 1991. This follows June's reading of 0.66 million. The fall in housing starts is supporting the financial market concern that the decline in the housing market has not yet run its course.

RETAIL SALES

In July, Retail Sales rose at a year-over-year rate of 2.6%. Recently, consumers have slowed their spending in reaction to higher energy prices, the housing market contraction, and a general tightening of credit standards. The arrival of tax rebate checks helped mitigate this weakness somewhat, although not to the extent previously hoped for.

LABOR MARKETS

The August non-farm payroll employment report showed a decrease of 84,000 jobs and the unemployment rate rose to 6.1%. The payroll data reflected the eighth consecutive month of negative job growth. August's employment report validates the recent financial market concern about a slowing economy impacting the labor markets.

CREDIT SPREADS MIXED

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	1.01	1.07	(0.06)
2-year AA corporate note	1.14	1.05	0.09
5-year AA corporate note	1.41	1.48	(0.07)
5-year Agency note	0.92	0.84	0.08

Source: Bloomberg

Data as of 8/29/08

ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(56.8) \$Bln JUN 08	(59.2) \$Bln MAY 08	(59.1) \$Bln JUN 07
GDP	3.3% JUN 08	0.9% MAR 08	4.8% JUN 07
Unemployment Rate	6.10% AUG 08	5.70% JUL 08	4.70% AUG 07
Prime Rate	5.00% AUG 08	5.00% JUL 08	8.25% AUG 07
CRB Index	391.7 AUG 08	416.4 JUL 08	308.7 AUG 07
Oil (West Texas Int.)	\$115.46 AUG 08	\$124.08 JUL 08	\$74.04 AUG 07
Consumer Price Index (y/o/y)	5.6% JUL 08	5.0% JUN 08	2.4% JUL 07
Producer Price Index (y/o/y)	9.8% JUL 08	9.2% JUN 08	4.2% JUL 07
Dollar / EURO	1.47 AUG 08	1.56 JUL 08	1.36 AUG 07

Source: Bloomberg

Data as of 8/29/08

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