CHANDLER ASSET MANAGEMENT

January 2008

Bond Market Review

A monthly review of fixed income markets

What's Inside

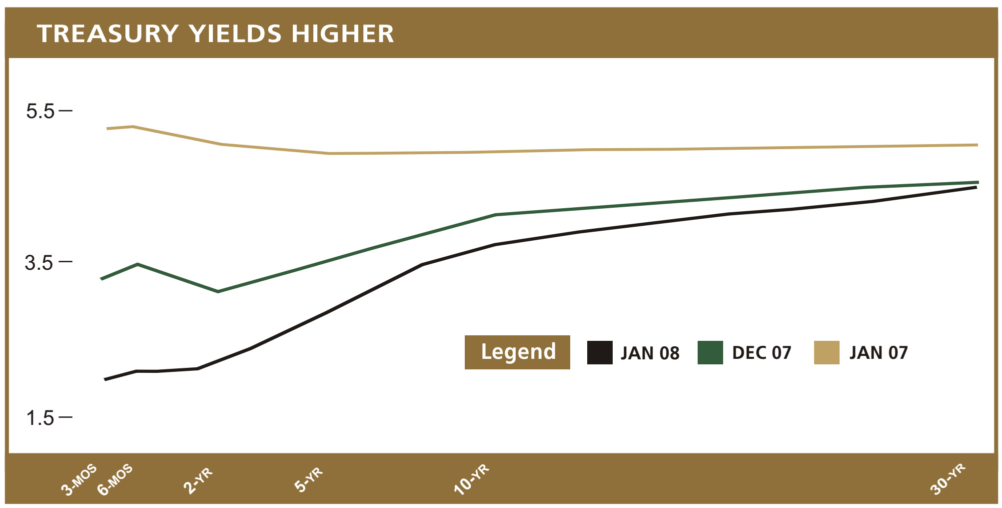
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

Market Summary

Bond yields were lower in January. The market's recent activity stems from concerns that difficulties in the housing and mortgage market will result in slower economic growth going forward. The global market volatility has continued, and market participants remain extremely sensitive to signs of housing, mortgage, and credit weakness.

The economy displayed slower growth in January. The Non-Farm Payroll number was weaker than expected, showing a decrease of 17,000 jobs. This was the first time since 2003 that the economy failed to add jobs. Housing data has continued to weaken. Inflation readings have moved slightly higher, raising concerns that the recent decline in inflation may be ending. Going forward, market participants will continue to look for signs as to whether or not weakness in the housing and mortgage markets is reflected in the broader economy.

The FOMC lowered the federal funds rate and the discount rate 75 basis points at an unscheduled meeting on January 22nd. It followed this move by lowering interest rates an additional 50 basis points at the regularly scheduled meeting on January 30th. The next scheduled FOMC meeting is on March 18th.



Treasury yields were lower in January as market participants attempted to ascertain the consequences of financial market volatility, a housing-led economic slowdown and Federal Reserve interest rate cuts. Shorter term interest rates declined much more than longer term ones, so that the yield curve retained its normal shape and the slope of the curve became much steeper.

YIELDS	1/31/08	12/31/07	Change
3 Month	1.95	3.22	(1.27)
2 Year	2.17	3.06	(0.89)
5 Year	2.82	3.45	(0.63)
10 Year	3.64	4.03	(0.39)
30 Year	4.35	4.45	(0.10)

YIELD SPREADS	1/31/08	12/31/07	Change
5yr - 2yr T-Note	0.65	0.39	0.26
10yr - 2yr T-Note	1.47	0.97	0.50

Source: Bloomberg

Firms that insure bond issues have been in the headlines recently. This article will provide an overview of the news surrounding these companies, commonly known as "monoline insurers." Before we discuss recent events though, it might be helpful to provide some background on what role the monoline insurers actually play in the financial markets.

The term monoline insurer refers to companies that are in the business of insuring bonds. The largest and most well known of these companies include MBIA, AMBAC, FSA, and FGIC. The main business of the monoline insurers is insuring bond issues of local agencies. When a local agency with a bond rating below AAA wants to lower the cost of their debt issuance, they often secure a ratings enhancement by purchasing insurance from one of the monoline companies. This allows the bond issue to be rated AAA, when the local agency itself carries a lower rating. This AAA rating lowers the interest rate the local agency must pay on the debt, while also making the securities more attractive to some investors.

The key to the municipal insurance business is the AAA rating that the local agency bond issues receive when they insure their bonds. This occurs because the monoline insurers carry an AAA rating themselves. Therefore, the bonds they insure are also rated AAA. Historically, very few municipal bond issuers have defaulted, and the insurance has rarely been needed. This fact, combined with the lucrative premiums that the monoline insurers collect, has made insuring municipal bonds a very profitable business.

Problems for the monoline insurers arose when they saw an opportunity to make money in the market for collateralized debt obligations, or CDOs as they are commonly known. CDOs have been one of the fastest growing and most profitable segments of the financial markets over the past decade. They have also been in the news quite a bit recently as one of the main causes of the financial market volatility. That is because many CDOs have been backed by subprime mortgages that are now declining sharply in value. Even worse, CDOs are so complex that even issuers and insurers have had difficulty determining exactly how risky these securities are and what they are worth. Over the past several months though, one clear fact has emerged: whatever their value, many CDO investors are facing very large losses from these securities.

The monoline insurers that guaranteed CDOs will be responsible for making up the losses that investors would otherwise suffer. This is extremely problematic, because the forecasted losses from CDOs represent a significant percentage of the capital base of the monoline insurers. Because of these potentially damaging losses, the credit ratings agencies have been closely monitoring the monoline insurers' credit ratings, and several downgrades have already occurred. The monolines' business is dependent upon their AAA credit rating and a downgrade below this level calls into question the viability of the monolines' business model going forward.

In order to preserve their AAA rating, the insurers have been taking steps to raise additional capital. The problems at the insurers have also caused outsiders to look more closely at their business. Because the core municipal insurance business is still attractive, companies such as AAA rated Berkshire Hathaway have recently entered the municipal insurance business.

Effect on Investors

If the monoline insurers are downgraded, the value of the insurance they provide on bonds will decline. This could cause the price of some municipal bonds and CDOs to fall. However, the value of many of these securities has already dropped, so any additional declines are difficult to forecast at this point. Given the uncertainty surrounding the monoline insurers, many municipal bonds are likely to be issued without insurance. This will require investors to evaluate the bond issues on the strength of the underlying entity rather than relying on an AAA insurance rating. In all likelihood, this will probably result in a more segmented market going forward. Instead of the vast majority of municipal issues trading with a similar AAA insured rating, there will be more of a stratified market with the "strong" credits and the "weak" credits. This should allow investors to select the appropriate level of risk and reward that they want in their portfolio, while also requiring them to perform additional credit research.

Effect on Issuers

Bond issuers will probably find that insurance is more expensive in the future. The reason is that many of the main suppliers of insurance have been weakened by the recent financial turmoil. This means that they will either have to increase the price they charge for insurance, or become more selective in the local agencies that they choose to insure. Many highly rated local agencies may decide to forego insurance and issue bonds directly to the public on the strength of their underlying credit rating. Lower rated agencies may continue to insure their bond issues, but at a slightly higher cost than in the past. The affect of Berkshire Hathaway's entrance into the marketplace is difficult to forecast at this point, but given the size of the company and the strength of its reputation, it could have a significant impact.

Stay Tuned

Because events surrounding the monoline insurers are still developing, it is unclear what the precise impact on the financial markets will be. However, it is apparent that this is an important story whose outcome will play a vital role in the municipal finance market. Therefore, as this story continues to unfold we will bring you the latest developments.

Brian Perry, Vice President, Portfolio Specialist

Consumer Prices

During December, the economy's headline inflation reading measured a 4.1% year-over-year rate. This elevated inflation level is mostly the result of high energy prices. The year-over-year Core CPI (CPI less food and energy) rose at a 2.4% rate, higher than October's 2.3%. Core CPI has now risen for the past four months. Although inflation readings remain somewhat elevated, the Fed expects inflation to moderate in the months ahead, and their primary concern is the pace of economic growth.

Retail Sales

During December, Retail Sales declined as the year-over-year growth slowed to 4.1% from a revised growth rate of 5.9% in November. Over the last several months, Retail Sales trends are reflecting moderate consumer spending despite higher energy prices, the effects of the slowdown in the housing market, and the uncertainty in the financial markets.

Housing starts

Single-family housing starts declined by 2.9% in December, to a 0.79 million annual pace. This follows November's reading of 0.82 million. Building permits also declined, reaching the lowest level since March 1993. Recent data has supported the financial market concern that the decline in the housing market has not yet run its course.

Labor Markets

The January non-farm payroll employment report showed a much weaker than expected decrease of 17,000 jobs, this was the first negative jobs report since August 2003. The six-month average for non-farm payroll employment has now slowed to an average monthly increase of 70,000 jobs. January's employment report seems to validate the recent financial market concern about a weakening economy.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.99	1.23	(0.24)
2-year AA corporate note	1.24	0.99	0.25
5-year AA corporate note	1.30	1.08	0.22
5-year Agency note	0.60	0.55	0.05

Source: Bloomberg *Data as of 1/31/08*

Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(63.1) $Bln NOV 07	(57.8) $Bln OCT 07	(58.5) $Bln NOV 06
GDP	0.6% DEC 07	4.9% SEP 07	2.1% DEC 06
Unemployment Rate	4.9% JAN 08	5.0% DEC 07	4.6% JAN 07
Prime Rate	6.00% JAN 08	7.25% DEC 07	8.25% JAN 07
CRB Index	369.46 JAN 08	358.71 DEC 07	301.22 JAN 07
Oil (West Texas Int.)	$91.75 JAN 08	$96.00 DEC 07	$58.14 JAN 07
Consumer Price Index (y/o/y)	4.1% DEC 07	4.3% NOV 07	2.5% DEC 06
Producer Price Index (y/o/y)	6.3% DEC 07	7.2% NOV 07	1.1% DEC 06
Dollar / EURO	1.49 JAN 08	1.46 DEC 07	1.30 JAN 07

Source: Bloomberg