CHANDLER ASSET MANAGEMENT

July 2008

Bond Market Review

A monthly review of fixed income markets

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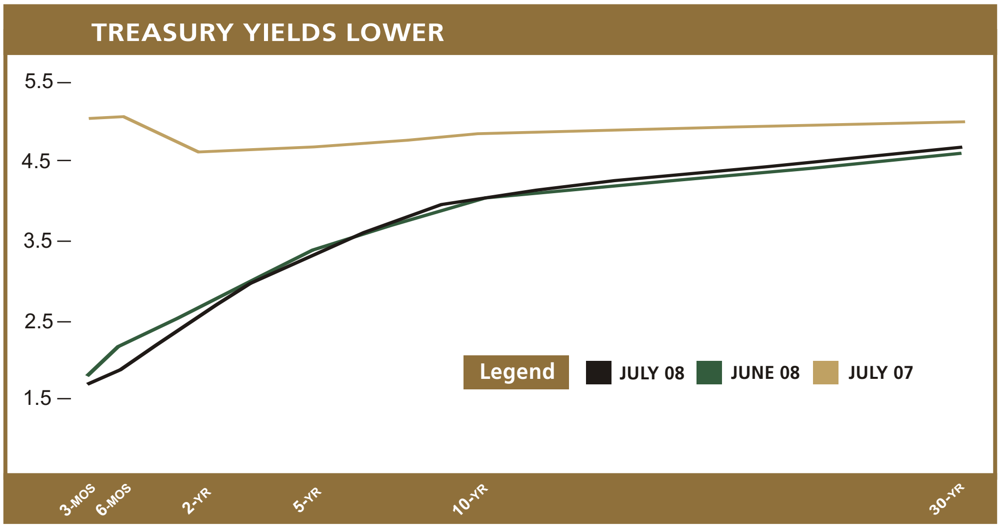
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

Market Summary

Bond yields were slightly lower in July. The market's recent activity stems from concerns over a slowing economy and continued financial market volatility, as well as rising inflation expectations. There is still concern that the economic slowdown will turn into a recession, but the advance reading for second quarter Gross Domestic Product showed that the economy grew at a 1.9% annual rate the past three months.

The June Non-Farm Payroll number showed a decrease of 51,000 jobs, and the unemployment rate rose to 5.7%. This was the seventh straight report that demonstrated negative job growth and increased fears that the economy will continue to perform poorly. Many inflation readings remain at twenty year highs, raising concerns that the Federal Reserve will eventually have to raise interest rates to combat inflation.

The FOMC held the federal funds rate at 2.00% at their meeting on June 25th. The next scheduled FOMC meeting is on August 5th. 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 LOWER

Treasury yields were slightly lower in July 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	7/31/08	6/30/08	Change
3 Month	1.66	1.73	(0.07)
2 Year	2.52	2.62	(0.10)
5 Year	3.27	3.34	(0.08)
10 Year	3.98	3.98	0.00
30 Year	4.60	4.53	0.07

YIELD SPREADS	7/31/08	6/30/08	Change
5yr - 2yr T-Note	0.75	0.72	(0.03)
10yr - 2yr T-Note	1.46	1.36	(0.109)

Source: Bloomberg

Economic Roundup

Consumer Prices

During June, the economy's headline inflation reading showed a 5.0% year-over-year rate, an increase from May's 4.2% indication. The year-over-year Core CPI (CPI less food and energy) rose to a 2.4% rate. Although inflation readings remain elevated, the Fed continues to expect inflation to moderate as growth slows in the months ahead.

Housing starts

Single-family housing starts declined by 5.3% in June, to a 0.65 million annual pace. This follows May's reading of 0.68 million. The latest reading was the lowest level since January 1991. Housing starts have now declined 11 of the past 12 months, supporting the financial market concern that the decline in the housing market has not yet run its course.

Retail Sales

During June, Retail Sales were weaker than expected, but the year-over-year growth rose to a 3.0% annual rate. Recently, consumers have slowed their spending in reaction to higher energy prices, the housing market contraction, and a general tightening of credit standards. The recent arrival of tax rebate checks has helped mitigate this weakness somewhat, although not to the extent previously hoped for.

Labor Markets

The July non-farm payroll employment report showed a decrease of 51,000 jobs and the unemployment rate rose to 5.7%. The payroll data reflected the seventh consecutive month of negative job growth. July'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	1.07	1.00	0.07
2-year AA corporate note	1.05	0.90	0.15
5-year AA corporate note	1.48	1.47	0.01
5-year Agency note	0.84	0.85	(0.01)

Source: Bloomberg *Data as of 7/31/08*

Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(59.8) $Bln MAY 08	(60.5) $Bln APR 08	(59.4) $Bln MAY 07
GDP	1.9% JUN 08	0.9% MAR 07	4.8% JUN 07
Unemployment Rate	5.70% JUL 08	5.50% JUN 08	4.70% JUL 07
Prime Rate	5.00% JUL 08	5.00% JUN 08	8.25% JUL 07
CRB Index	416.4 JUL 08	462.7 JUN 08	324.1 JUL 07
Oil (West Texas Int.)	$124.08 JUL 08	$140.00 JUN 08	$78.21 JUL 07
Consumer Price Index (y/o/y)	5.0% JUN 08	4.2% MAY 08	2.7% JUN 07
Producer Price Index (y/o/y)	9.2% JUN 08	7.2% MAY 08	3.3% JUN 07
Dollar / EURO	1.56 JUL 08	1.58 JUN 08	1.37 JUL 07

Source: Bloomberg *Data as of 7/31/08*

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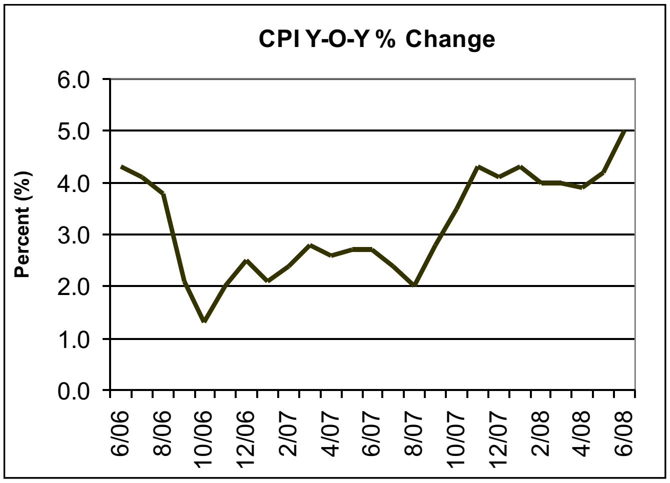
Inflation, Part 3

The last two issues of our newsletter have given us the opportunity to review the problems caused by high inflation, as well as the ways that the Federal Reserve and other central banks measure and contain inflation. The final installment of this series examines the current state of inflation in the global economy and the challenges facing central bank policy makers.

Since 1960, the rate of inflation in the United States (as measured by the Consumer Price Index (CPI)) has ranged between 0.7% and 13.3%. The most recent reading showed a year-over-year CPI rate of 5.0%, higher than the fifty year average of 4.1%. Since the end of the Cold War, the CPI has averaged only 2.7%, and the recent 5.0% reading is the highest during that period. Other measures of inflation, such as the Producer Price Index (PPI) have also reached multi-decade highs. Although these readings are still moderate when viewed over a longer time frame, given the difficulty of reversing high levels of inflation and inflationary expectations, market observers and policy makers are justifiably concerned with this recent inflationary spike.



So what is causing the recent increase in inflation readings? The main culprit is rising energy and commodity prices. Prices for oil, gas, and food have risen dramatically over the past several years. Strong economic growth in China and other emerging markets has increased the demand for a wide variety of commodities, and the basic dynamic of supply and demand has caused the price of these goods to rise. Some observers also feel that market speculators have contributed to the price increases.

Due to recent price increases, the Federal Reserve (Fed) and other central banks have become increasingly concerned about inflation. At the same time that prices are rising, global economic growth is also slowing. This places central bankers in a difficult predicament, because the steps that they would typically take to curb inflation also cause economic growth to slow. During times of robust economic growth, this is usually an acceptable tradeoff, but with growth already slowing, central bankers worry about taking any actions that could further curtail economic activity. In fact, some central bankers would prefer to be taking steps to reinvigorate economic growth, but the rising level of inflation is preventing them from moving as aggressively as they would like in that direction.

When faced with the dilemma of rising prices and slower economic growth, central bankers and other monetary policy makers have limited choices. They can:

A) take actions, such as lowering interest rates, that generally stimulate economic growth - this risks higher inflation
B) take actions, such as raising interest rates, that generally tend to curb inflation - this risks sharply slower economic growth
C) hold monetary policy steady and hope for the best

After an extended period of interest rate cuts to stimulate economic growth, the Federal Reserve is now holding monetary policy steady while closely monitoring economic growth and inflation readings. While they remain concerned about inflation, the Fed also expects slower economic growth to cause inflation to decline in the months ahead. If they are right, inflation will moderate, and the stage will be set for an economic recovery. The risk of this approach is that if inflation does not decline as expected, the Fed will eventually have to react more vigorously than they would like. This aggressive action towards inflation could have the possibility of causing considerable damage to economic growth.

High inflation levels are difficult to reverse once they take hold, so the primary concern of most central banks is to contain inflation, even at the cost of slower economic growth. Therefore, central banks in China, Brazil, Russia, Europe, and elsewhere are currently raising interest rates, increasing reserve requirements, or taking other anti-inflationary measures. As previously noted, these anti-inflationary actions also have the potential to weaken economic growth. That is a risk some central banks seem prepared to take, partly because the history of central banking shows that it is easier to promote growth in a weak economy than to contain inflation in an economy that is overheating. As is often the case with difficult policy choices, there is no single correct option. Time will tell whether the actions of the Fed or other central banks were appropriate. Regardless of the outcome, it is apparent that the officials of these institutions face difficult decisions with far ranging and important impacts. The success of the central banks in making these decisions is one of the keys to the continued prosperity of the global economy. With that in mind, I wish them good luck.

Brian Perry, Vice President, Portfolio Specialist

* Federal Funds Rate - the rate at which financial institutions borrow and lend among themselves on an overnight basis

*Discount Rate - the rate at which financial institutions can borrow funds directly from the Federal Reserve