

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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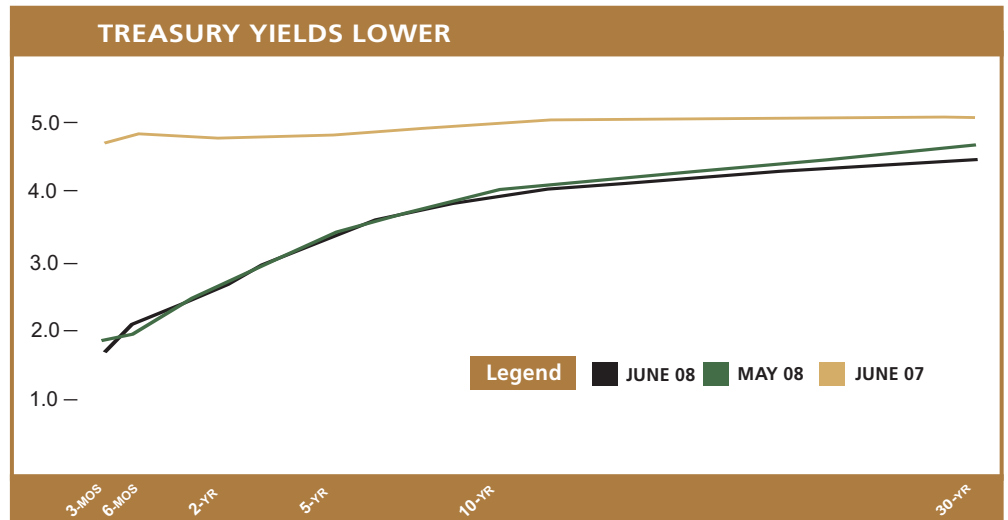
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

MARKET SUMMARY

Bond yields were slightly lower in June. 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 final reading for first quarter Gross Domestic Product was revised higher to reflect that the economy grew 1.0%.

The June Non-Farm Payroll number showed a decrease of 62,000 jobs, and the unemployment rate remained at 5.5%. This was the sixth straight report that demonstrated negative job growth and increased fears that the economy will continue to perform poorly. Inflation readings remain elevated and commodity prices high, 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 were slightly lower in June 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	6/30/08	5/30/08	Change
3 Month	1.73	1.88	(0.15)
2 Year	2.62	2.63	(0.01)
5 Year	3.34	3.40	(0.06)
10 Year	3.98	4.04	(0.06)
30 Year	4.53	4.70	(0.17)

YIELD SPREADS	6/30/08	5/30/08	Change
5yr - 2yr T-Note	0.73	0.77	(0.04)
10yr - 2yr T-Note	1.36	1.41	(0.05)

Source: Bloomberg



Source: Wikipedia

Last month's article on inflation included a picture of German citizens burning money in order to heat their homes. Even the extremely remote possibility that money could lose so much of its value that it would be used as tinder should be enough to demonstrate just how damaging the effects of inflation can be. Couple this with the fact that inflation, once present, is

extremely difficult to reverse, and it should come as no surprise that the primary goal of most central banks is to achieve price stability. With that in mind, we'll now take a closer look at how inflation can be measured, before examining the tools that the Federal Reserve (Fed) uses to achieve price stability.

Inflation Measures

Before inflation can be controlled, it must be accurately measured. There are several different measures of inflation commonly used in the United States, and it appears that something as complex as the absolute level of inflation is difficult to pinpoint. Instead, investors would be wise to consider a variety of measures when forming an opinion as to the relative level of inflation in the economy, and then use their experience and wisdom to convert this information into an investment outlook.

What are some commonly used measures of inflation?

Inflation can be measured at either the consumer level or the producer level. There are two primary measures of consumer inflation used in the United States: the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) Deflator. The most common measure of producer inflation is the producer price index (PPI.)

What is the "best" measure of inflation?

The "best" measure of inflation depends on what it is being used for. PPI is an important measure of inflation at the producer level, but producer inflation tends to be extremely volatile which limits the value of these readings. Additionally, an inflationary spiral only occurs if producer price increases can be passed along to consumers. Therefore, measures of consumer price inflation are probably more important indicators of the "true" inflation level than measures of producer price inflation.

Among consumer price inflation measures, the Federal Reserve and many of its members are on record that they regard the PCE Deflator to be the most accurate measure of inflation and therefore the most important determinant of the direction of monetary policy. On the other hand, CPI works very well when it is used to index

payments (such as social security or wages) to consumers in order to allow them to maintain a continuous level of purchasing power for a basket of common goods.

Tools of the Federal Reserve

The Federal Reserve attempts to manage short term interest rates and the money supply in order to control inflation. It has two main tools that it employs in order to accomplish its goal: open market operations and discount window lending.

Open Market Operations

The Federal Open Market Committee (FOMC) of the Federal Reserve meets eight times a year to discuss economic conditions and set a target for the federal funds rate*. A "cheaper" cost of funds promotes greater levels of economic activity. Therefore, when the Federal Reserve wishes to tighten credit in order to reduce inflation, they raise the federal funds rate. When they want to promote economic activity and allow inflation to rise slightly, they lower the rate. Adjusting the federal 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 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 financial system, it buys securities. If it wants to remove money from the system, it sells securities. All else being equal, if there is more money in the financial system the inflation rate will be higher. 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, financial institutions will be less willing to borrow from the Fed, thereby curtailing economic activity and lowering inflation. However, the discount rate is less important as a tool of monetary policy than the federal funds rate because financial institutions usually prefer to borrow from one another at the federal funds rate rather than directly from the Fed.

Conclusion

The primary goal of the Federal Reserve and other central banks is to control inflation. In next month's article, we'll take a closer look at how successful central banks have been at achieving this goal and what the prospects are for inflation in the global economy.

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

ECONOMIC ROUNDUP

CONSUMER PRICES

During May, the economy's headline inflation reading showed a 4.2% year-over-year rate, an increase from April's 3.9% indication. The year-over-year Core CPI (CPI less food and energy) remained at a 2.3% rate. Although inflation readings remain somewhat elevated, the Fed continues to expect inflation to moderate as growth slows in the months ahead.

HOUSING STARTS

Single-family housing starts declined by 1.0% in May, to a 0.67 million annual pace. This follows April's reading of 0.68 million. The latest decline was the lowest level since March 1991. Recent data has supported the financial market concern that the decline in the housing market has not yet run its course.

RETAIL SALES

During May, Retail Sales were much stronger than expected, but the year-over-year growth declined to a 2.5% 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.

LABOR MARKETS

The June non-farm payroll employment report showed a decrease of 62,000 jobs and the unemployment rate remained at 5.5%. The payroll data reflected the sixth consecutive month of negative job growth. June'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	1.00	0.68	0.32
2-year AA corporate note	0.90	0.87	0.03
5-year AA corporate note	1.47	1.50	(0.03)
5-year Agency note	0.85	0.73	0.12

Source: Bloomberg

Data as of 6/30/08

ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(60.9) \$Bln APR 08	(56.5) \$Bln MAR 08	(60.3) \$Bln APR 07
GDP	1.0% MAR 08	0.6% DEC 07	0.6% MAR 07
Unemployment Rate	5.50% JUNE 08	5.50% MAY 08	4.60% JUNE 07
Prime Rate	5.00% JUNE 08	5.00% MAY 08	8.25% JUNE 07
CRB Index	462.74 JUNE 08	422.17 MAY 08	315.74 JUNE 07
Oil (West Texas Int.)	\$140.00 JUNE 08	\$127.35 MAY 08	\$70.68 JUNE 07
Consumer Price Index (y/o/y)	4.2% MAY 08	3.9% APR 08	2.7% MAY 07
Producer Price Index (y/o/y)	7.2% MAY 08	6.5% APR 08	3.9% MAY 07
Dollar / EURO	1.58 JUNE 08	1.56 MAY 08	1.35 JUNE 07

Source: Bloomberg

Data as of 6/30/08

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