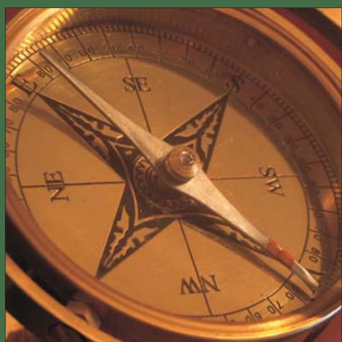
CHANDLER ASSET MANAGEMENT

May 2008

Bond Market Review

A monthly review of fixed income markets



What's Inside

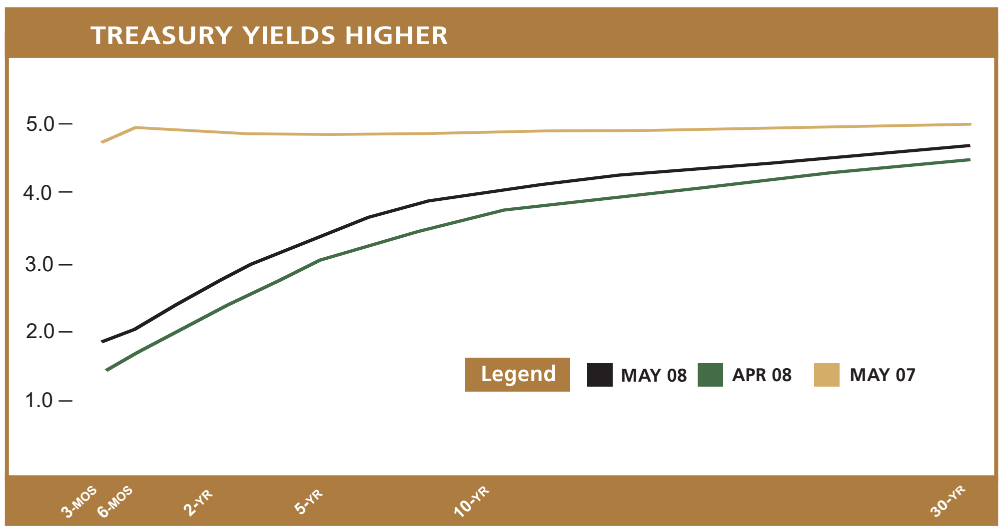
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

Market Summary

Bond yields were much higher in May. The market's recent activity stems from some easing of fear among financial market participants. Nevertheless, there is still concern that difficulties in the housing and mortgage market have resulted in slower economic growth. The global market volatility has lessened, but market participants remain extremely sensitive to signs of housing, mortgage, and credit weakness.

The economy displayed slower growth in May. The Non-Farm Payroll number showed a decrease of 49,000 jobs, and the unemployment rate rose to 5.5%. This was the fifth straight report that demonstrated negative job growth and increased fears that the economy will continue to perform poorly. Housing data remains weak. Inflation readings remain elevated, raising concerns that the Federal Reserve will eventually have to raise interest rates to combat inflation. Going forward, market participants will continue to look for signs as to whether or not weakness in the housing, mortgage and credit markets is reflected in the broader economy.

The FOMC lowered the federal funds rate and the discount rate 25 basis points at their meeting on April 30. The federal funds rate currently stands at 2.00%. The next scheduled FOMC meeting is on June 25th.



Treasury yields were much higher in May 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	5/30/08	4/30/08	Change
3 Month	1.88	1.37	0.51
2 Year	2.63	2.26	0.37
5 Year	3.40	3.03	0.37
10 Year	4.04	3.76	0.28
30 Year	4.70	4.50	0.20

YIELD SPREADS	5/30/08	4/30/08	Change
5yr - 2yr T-Note	0.77	0.77	0.00
10yr - 2yr T-Note	1.41	1.50	(0.09)

Source: Bloomberg

Note: Inflation is a key measure of the state of the economy and arguably the most important determinant of returns in a fixed income portfolio. In this multipart series, we will examine inflation in detail. In Part 1, we look at why containing inflation is so important. Next month, we look at the ways in which policy maker's measure and attempt to contain inflation. In the third and final installment of this series, we will take a closer look at the state of inflation today and the outlook for your investment portfolio.

Everyone reading this article has probably experienced the effects of inflation within the past week. With gas prices averaging $4 a gallon across the nation (and higher still in California), much higher food prices at grocery stores and restaurants, and ever rising medical costs, inflation is quickly becoming one of the primary concerns among American consumers. It may come as little consolation that America is not alone in this worry; nations around the world from Germany and Russia to China, India and the Middle East, to Argentina and Venezuela are all experiencing sharply higher inflation. What dangers do rising inflation levels present to the economy, and why is it so important that policy makers contain inflation as soon as it begins to appear? Those are the questions we will examine in Part I of this series. We'll start by taking a quick look at a famous example of a time when policy makers did not contain inflation.

"In 1923, a student at Freiburg University in Germany ordered a cup of coffee at a cafe. The price on the menu was 5,000 Marks. He had two cups. When the bill came, it was for 14,000 Marks. "If you want to save money," he was told, "and you want two cups of coffee, you should order them both at the same time." "*

This anecdote comes from a period when prices in Germany were doubling every two days, and the exchange rate of the German Mark to the US Dollar stood at 4 trillion to one. In fact, as the picture to the right demonstrates, paper money lost so much of its value that it was cheaper to burn money than wood for fuel.

The point of this historical tidbit isn't to suggest that the US is about to succumb to a period of hyperinflation, but rather to demonstrate just how destructive inflation can be if it gets out of control. That is why the mandate of almost every central bank in the world is to control the rate of inflation. Some central banks, such as the US Federal Reserve (Fed), have a dual mandate that also includes promoting economic growth; others, such as the European Central Bank, are tasked solely with keeping inflation contained. If inflation is controlled, the theory goes; economic growth will take care of itself.

Over time, prices for a wide variety of goods and services tend to increase. That is why the Big Mac we purchased for a dollar when we were kids now costs $6 or why we can't go to the movies for $5 anymore. This normal, gradual increase in prices represents an acceptable, normal level of inflation, and is far preferable to a period of decreasing prices, or deflation, which is usually associated with a severe economic slowdown. While gradual inflation increases the prices we have to pay to lead our lives, wages generally increase gradually as well to offset this increase. In fact, inflation doesn't really become a problem until consumers begin to expect much higher levels of inflation in the future. These inflation expectations lead to changing behavior patterns among consumers, with often severe consequences for the overall economy.


Source: Wikipedia

When consumers fear that prices will be higher tomorrow than they are today, they rush to the store to buy as much as possible as soon as possible. This rapid demand increase causes supplies to drop and prices to rise, which further increases inflation expectations, which causes more of a rush to buy, and so on and so forth in a vicious cycle. For this reason, the Fed and other central banks keep a sharp eye on inflation expectations; and tend to act rapidly to contain inflation.

Inflation can generate a number of negative consequences. Inflation harms those on a fixed income; this is a particular concern in countries with rising populations of retirees such as the US or Europe. Another negative effect of inflation is that it increases the price of exports, making a country less competitive in international trade, an important consideration in today's increasingly globalized world.

Inflation can be good news for debtors, who get to repay principal and interest with dollars worth less than those they borrowed. However, the opposite is also true; creditors are negatively impacted by high rates of inflation, thereby reducing their incentive to lend. Inflation also increases the uncertainty surrounding capital investments and other long-term corporate investments. An unwillingness to lend or commit to capital investments can lead to an increase in consumption over investment, to the detriment of an economy's long run prosperity.

These negative consequences of high inflation can be extremely difficult to reverse once they get started. Fortunately, policy makers are aware of this, and are therefore exceedingly vigilant in combating inflation. Next month, we'll take a closer look at some of the ways that inflation can be measured, as well as some of the tools policy makers use to slay the inflation dragon.

Brian Perry, Vice President, Portfolio Specialist

* The German Hyperinflation, 1923 Excerpt from Paper Money by "Adam Smith," (George J.W. Goodman), pp. 57-62.
http://www.pbs.org/wgbh/commandingheights/shared/minitext/ess_germanhyperinflation.html

Economic Roundup

Consumer Prices

During April, the economy's headline inflation reading showed a 3.9% year-over-year rate, a slight improvement from March's 4.0% indication. The year-over-year Core CPI (CPI less food and energy) decreased at a 2.3% rate, lower than March's 2.4%. 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 1.7% in April, to a 0.69 million annual pace. This follows March's reading of 0.70 million. The latest decline was the lowest level since February 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 April, Retail Sales were unchanged as the year-over-year growth remained at 2.0%. Over the last several months, consumers have slowed their spending in reaction to higher energy prices, the housing market contraction, and a general tightening of credit standards.

Labor Markets

The May non-farm payroll employment report showed a decrease of 49,000 jobs and the unemployment rate jumped to 5.5% from 5.0%. This rise in the unemployment rate was the largest since 1986 and the payroll data reflected the fifth consecutive month of negative job growth. May'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	0.68	1.39	(0.71)
2-year AA corporate note	0.87	1.19	(0.32)
5-year AA corporate note	1.50	1.55	(0.05)
5-year Agency note	0.73	0.59	0.14

Source: Bloomberg *Data as of 5/31/08*

Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(58.2) $Bln MAR 08	(61.7) $Bln FEB 08	(63.0) $Bln MAR 07
GDP	0.9% MAR 08	0.6% DEC 07	0.6% MAR 07
Unemployment Rate	5.50% MAY 08	5.00% APR 08	4.50% MAY 07
Prime Rate	5.00% MAY 08	5.00% APR 08	8.25% MAY 07
CRB Index	422.17 MAY 08	409.27 APR 08	311.46 MAY 07
Oil (West Texas Int.)	$127.35 MAY 08	$113.46 APR 08	$64.01 MAY 07
Consumer Price Index (y/o/y)	3.9% APR 08	4.0% MAR 08	2.6% APR 07
Producer Price Index (y/o/y)	6.5% APR 08	6.9% MAR 08	3.2% APR 07
Dollar / EURO	1.55 MAY 08	1.56 APR 08	1.34 MAY 07

Source: Bloomberg *Data as of 5/31/08*

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