

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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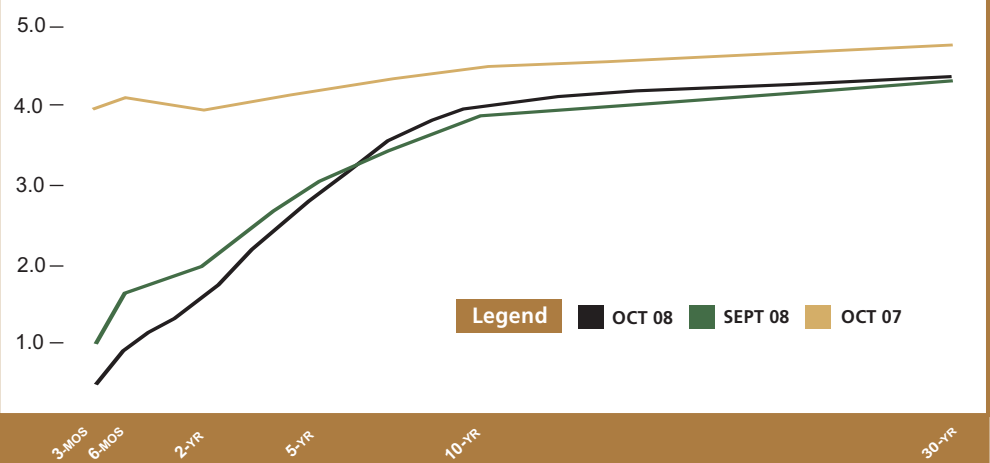
MARKET SUMMARY

Treasury bond yields were mixed in October, as short-term rates fell sharply while longer-term rates rose. Market volatility and the credit crisis continued. Credit availability remained impaired and companies and banks had difficulty accessing credit. Stocks plummeted worldwide, with the S&P 500 falling nearly 17% in the month.

Economic data was much weaker, as the economy lost jobs for the tenth straight month. The October Non-Farm Payroll number showed a decrease of 240,000 jobs and the unemployment rate increased to 6.5%. Retail sales declined as consumers sharply cut back their spending. Housing continued to decline, with housing starts falling by 12.9%. The initial reading for 3rd quarter 2008 gross domestic product (GDP) showed that the economy contracted by -0.3%. Recent economic releases are beginning to reflect the impact of September/October's financial market turmoil, and it is possible that growth could slow even further in the months ahead.

The FOMC cut the federal funds rate twice during the month; by 50 basis points at an inter-meeting move on October 8th, and by another 50 basis points at their regularly scheduled meeting on October 29th to 1%. That is the lowest rate since May 2004. The next scheduled FOMC meeting is on December 16th.

SHORT-TERM TREASURY YIELDS MUCH LOWER



Treasury yields were sharply lower in September as market participants sought safety in Treasuries due to global market volatility. The yield curve became steeper as short-term rates declined more than longer-term rates.

YIELDS	10/31/08	9/30/08	Change
3 Month	0.44	0.92	(0.48)
2 Year	1.56	1.98	(0.42)
5 Year	2.82	2.98	(0.16)
10 Year	3.97	3.83	0.14
30 Year	4.37	4.31	0.06

YIELD SPREADS	10/31/08	9/30/08	Change
5yr - 2yr T-Note	1.26	1.00	0.26
10yr - 2yr T-Note	2.41	1.85	0.56

Source: Bloomberg

RECESSIONS AND DEPRESSIONS

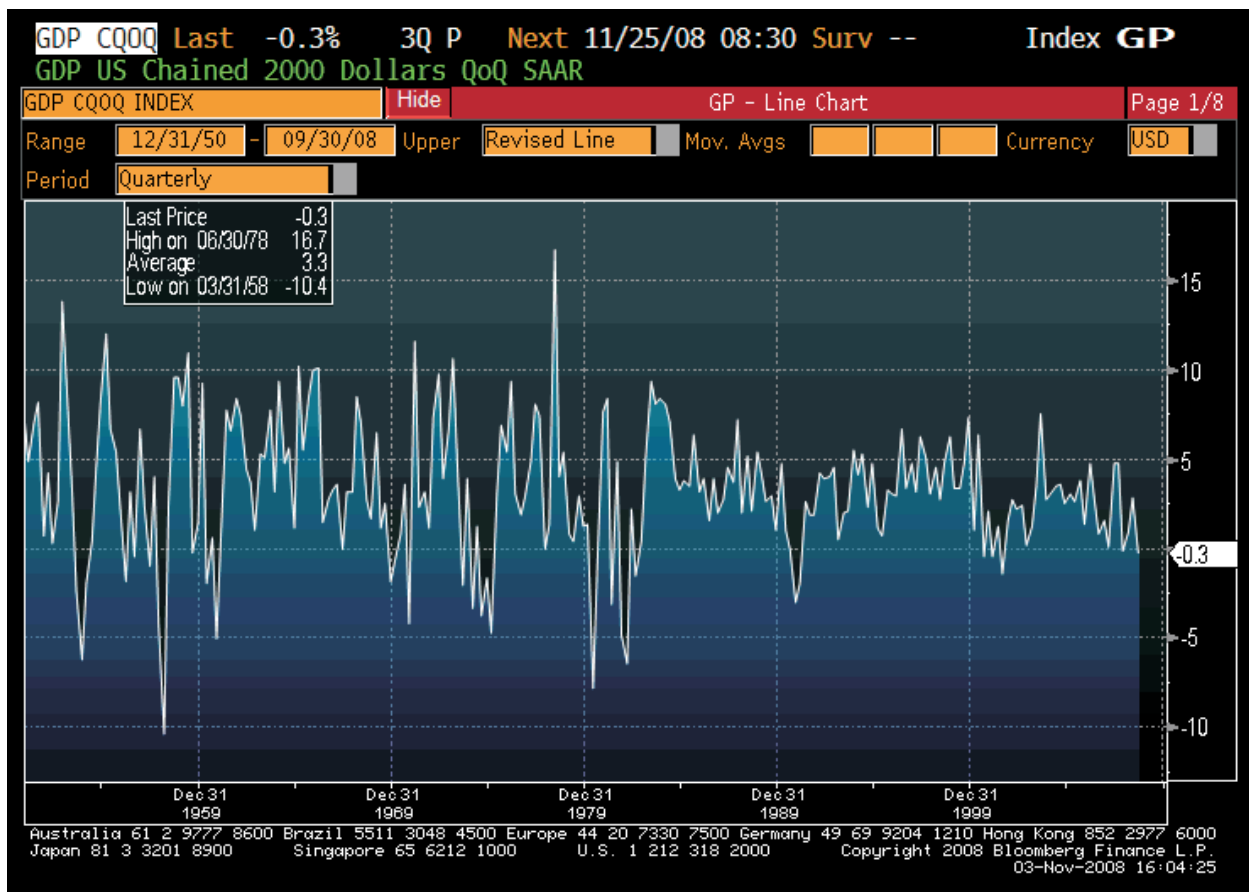
One of the defining characteristics of capitalism is large fluctuations in the level of economic output. When activity is robust, these fluctuations are taken in stride. However, when fluctuations occur to the downside and output contracts, the economy can cause widespread suffering.

According to the National Bureau of Economic Research (NBER) a recession is "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales." Since 1900, there have been 21 periods during which the US economy has officially been in a recession. There is no official definition for a depression, but traditionally a recession that is unusually long and deep is called a depression. While recessions are fairly common, the economic decline of the 1930s is the only period in the last 100 years which is commonly referred to as a depression.

Given recent negative headlines, this is an opportune time to examine the characteristics of an economic slowdown as well as the differences between recessions and depressions.

Fluctuations in economic output

The broadest measure of economic output in the economy is gross domestic product (GDP.) As the chart below demonstrates, GDP has fluctuated widely since 1950. Growth has been as strong as a 16.7% annualized pace and as weak as a (-10.4%) annualized pace. The third quarter of 2008's GDP reading of (-0.3%) falls well within this range. The pace of economic activity seems likely to slow further in the months ahead and forecasts for fourth quarter 2008 GDP call for the economy to contract again; perhaps by as much as (-4.5%). A reading of this magnitude would be the lowest since the early 1980s and would indicate an extremely weak economy. However, the chart indicates that even a very weak reading of (-4.5%) would be within the historical range.



Source Bloomberg

Negative GDP readings are consistent with an economy that is in a recessionary period. However, despite the fact that the word "depression" is often used when discussing economic forecasts, it is important to reiterate that there is a large difference between an economy that is in a recession and an economy that is in a depression. A look at additional economic indicators will demonstrate just how disastrous economic performance was during the 1930s and how much further the current economy would have to contract before it would begin to replicate that period.

RECESSIONS AND DEPRESSIONS CONT...

Economic data then and now

Popular newspaper and magazine headlines recently featured numerous photos and captions in which the current economic cycle was compared to the Great Depression of the 1930s. As demonstrated above, overall economic output (GDP), while weak, currently falls within the historical range and is forecast to continue to do so. The table below displays additional economic indicators and compares their readings during the Great Depression and the current economic slowdown.

Comparison of Great Depression and current economic conditions		
	Great Depression	Current conditions
Gross Domestic Product	-50%	Q4 2008 -4.5% weakest forecast
Unemployment Rate	25%	8% highest forecast
Bank Failures	Approximately 9000	19 banks from 7/31/07 - 10/31/08
Industrial Production	-45%	-2.8% 9/30/08
Dow Jones Industrial Average	-89% peak to trough	-42% peak to trough

Comparisons to the Great Depression are not meant as a forecast of future economic activity. Rather, the comparisons are made in order to provide perspective on the current economic environment to readers that may never have experienced a significant economic downturn. Current circumstances, although challenging, would have to deteriorate exponentially in order to begin to approximate conditions during the Great Depression. This deterioration is unlikely to occur due in part to the progress that has been made in economic policymaking during the past 75 years.

Policy decisions during economic downturns

It is generally believed that policy decisions made at the onset of the Great Depression turned what could have been a normal slowdown into the worst economic disaster of the 20th century. While government actions exacerbated events in the 1930s, policy makers have learned from these mistakes and during the current economic crisis the government has been proactive in stabilizing the financial system and cushioning the economic decline.

There are three key areas in which policy makers appear to have improved their response when compared to the Great Depression. The first important area involves the safety of customer bank deposits. During the 1930s, thousands of banks failed and customers often lost the money that they had on deposit at the bank. In order to protect customer deposits, the government established the Federal Deposit Insurance Corporation (FDIC.) The FDIC now insures most customer bank deposits. The presence of FDIC insurance greatly enhances consumer confidence in the US banking system.

During the early years of the Great Depression, the Federal Reserve tightened monetary policy, which exacerbated the economic downturn. Policymakers have learned from this mistake and their first response now during times of financial difficulty is to provide as much liquidity as necessary to the financial system. Since the onset of the credit crisis in July 2007, the Federal Reserve (Fed) has lowered the key federal funds rate

from 5.25% to 1%. The Fed has also taken many other innovative and extraordinary steps in order to ensure that financial firms, businesses, and consumers continue to have access to credit. These steps have not prevented credit market conditions from deteriorating, but they have helped limit the damage to the financial system and the economy.

During economic downturns, businesses and consumers spend less which reduces aggregate economic output. One way to offset this decline in economic activity is for the government to increase its spending. However, during an economic downturn government tax receipts decline and in the 1930s governments generally did not run budget deficits. This meant that when tax receipts declined, so too did government spending. This decline in government spending contributed to the extraordinarily weak economic environment.

Most economists now believe that when the economy slows the government should not restrict spending, even if it means temporarily increasing the budget deficit. In fact, during a severe slowdown governments should actually increase their spending in order to provide a stimulus to the economy and make up for the reduced activity in the consumer and business sectors. During the current economic slowdown, the government has been increasing its spending, which should help mitigate the overall decline in economic output.

Poor policy decisions greatly exacerbated the economic slowdown of the 1930s. During the past 18 months, the government has employed every tool at their disposal in seeking creative and aggressive solutions to stabilize the financial system and minimize the severity of the present economic downturn. While it is impossible to know how effective these policy decisions will ultimately be, it seems likely that the economy will be able to avoid a return to a Great Depression-like environment.

Conclusion

Economic slowdowns are painful, and this one threatens to be more severe than other recent recessions. This article has not attempted to forecast the future direction of the economy; rather it has provided perspective on the current situation. This perspective should make it clear that the economy, while performing poorly, is not currently in a depression. Furthermore, an analysis of policy mistakes made at the onset of the Great Depression compared to policy decisions made over the course of the past 18 months, shows that government actions are likely to be more successful in the current environment than they were in the 1930s. This does not mean that the economy will not suffer a deep or lengthy recession, but it does make it appear unlikely that the economy will see a return to the dark days of the Great Depression.

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

CONSUMER PRICES

In September, the CPI increased by 4.9% on a year-over-year basis, compared to August's 5.4% reading. 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, lower energy prices and slowing economic growth should continue to help inflation moderate in the months ahead.

HOUSING STARTS

Single-family housing starts declined by 12.9% in September, to a 544,000 annual pace, the lowest since January 1991. This follows August's reading of 618,000. 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 September, Retail Sales declined at a year-over-year rate of -1.0%. Recently, consumers have sharply slowed their spending in reaction to financial market turmoil, a general tightening of credit standards, higher energy prices, and the housing market contraction. Retail spending is expected to remain weak in the months ahead.

LABOR MARKETS

The October non-farm payroll employment report showed a decrease of 240,000 jobs and the unemployment rate increased to 6.5%. The payroll data reflected the tenth consecutive month of negative job growth. October's employment report indicates that the slowing economy and financial crisis are significantly impacting the labor markets.

CREDIT SPREADS

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	2.29	2.64	(0.35)
2-year AA corporate note	2.17	1.50	0.67
5-year AA corporate note	2.33	1.67	0.66
5-year Agency note	1.67	1.12	0.55

Source: Bloomberg

Data as of 10/31/08

ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(59.1) \$Bln AUG 08	(61.3) \$Bln JUL 08	(55.3) \$Bln AUG 07
GDP	(0.3%) SEPT 08	2.8% JUN 08	4.8% SEPT 07
Unemployment Rate	6.5% OCT 08	6.1% SEPT 08	4.8% OCT 07
Prime Rate	4.00% OCT 08	5.00% SEPT 08	7.50% OCT 07
CRB Index	268.4 OCT 08	345.5 SEPT 08	351.0 OCT 07
Oil (West Texas Int.)	\$67.81 OCT 08	\$100.64 SEPT 08	\$94.53 OCT 07
Consumer Price Index (y/o/y)	4.9% SEPT 08	5.4% AUG 08	2.8% SEPT 07
Producer Price Index (y/o/y)	8.7% SEPT 08	9.6% AUG 08	4.4% SEPT 07
Dollar / EURO	1.27 OCT 08	1.41 SEPT 08	1.45 OCT 07

Source: Bloomberg

Data as of 10/31/08

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