

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.

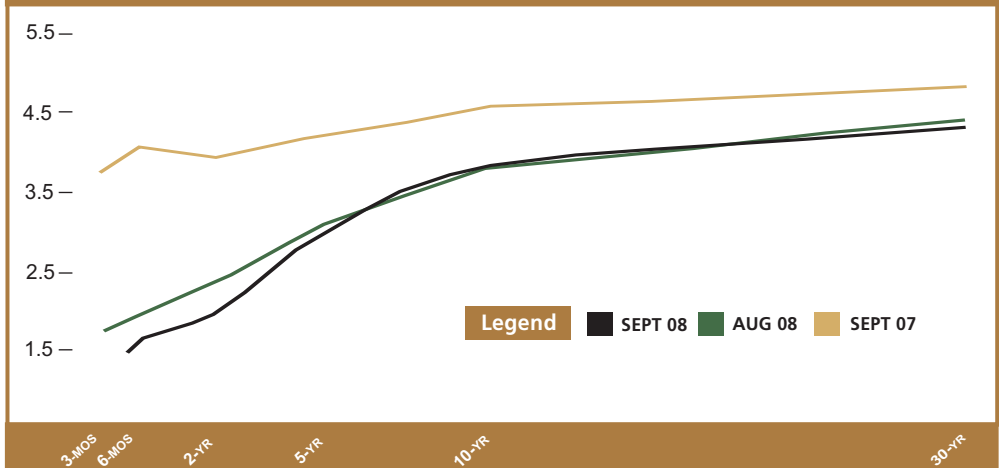
MARKET SUMMARY

Treasury bond yields were much lower in September as market participants sought safety due to market volatility. Economic data were weaker, as the economy lost jobs for the ninth straight month and the September Non-Farm Payroll number showed a decrease of 159,000 jobs. Housing and retail sales reports also showed much slower growth. Since recent economic releases do not yet reflect the impact of September's financial market turmoil, it is possible that growth could slow even further in the months ahead.

On September 7 the government placed Fannie Mae and Freddie Mac under federal conservatorship. The agencies are now being managed by their federal regulator and the Treasury has promised to provide very significant financial support for the agencies if they need it. During the month of September, AIG, Lehman Brothers, Merrill Lynch, Washington Mutual, and Wachovia were also either rescued by the government or agreed to be purchased by stronger partners.

The FOMC held the federal funds rate at 2.00% at their meeting on September 16th. The next scheduled FOMC meeting is on October 29th. Going forward, market participants will continue to look for signs of an economic slowdown or an end to market volatility as well as anticipating the direction and timing of the next Federal Reserve move.

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	9/30/08	8/31/08	Change
3 Month	0.92	1.72	(0.80)
2 Year	1.98	2.35	(0.37)
5 Year	2.98	3.09	(0.11)
10 Year	3.83	3.82	0.01
30 Year	4.31	4.42	(0.11)

YIELD SPREADS	9/30/08	8/31/08	Change
5yr - 2yr T-Note	1.00	0.74	0.26
10yr - 2yr T-Note	1.85	1.47	0.38

Source: Bloomberg

UPDATE ON SEPTEMBER'S MARKET VOLATILITY

In September, financial markets experienced unprecedented volatility. The government bailed out several large financial institutions, and other firms were forced to merge with stronger partners. At the same time, markets around the world gyrated wildly, as fear and lack of confidence engulfed the marketplace. This article presents a summary of the events leading up to September's market action, and a recap of the historic events of this month.

Credit Crisis Summary

- The current market crisis had its roots in the bursting of the housing bubble
 - Sub-prime borrowers are defaulting and going into foreclosure at high rates
 - Many sub-prime mortgages were securitized and sold to investors around the world
 - Trillions of dollars of these mortgages and securitized mortgages are held on the balance sheets of major global financial institutions
 - These mortgage securities and mortgages are difficult to value, resulting in uncertainty about the liquidity and capitalization of major financial institutions
 - Inaccessibility to liquidity and additional capital has forced some financial institutions into bankruptcy and others into takeovers forced by federal regulators
 - The federal government has taken many actions to provide the financial markets with liquidity and attempt to contain any systemic risk that recent events might pose
 - Congress approved the \$700 billion bailout package and the government will continue to seek additional solutions to mitigate the effects of this crisis

Unprecedented Market Volatility

On September 7, the Federal Housing Finance Agency, the new housing regulatory authority created to oversee Fannie Mae and Freddie Mac, in conjunction with the Treasury Department placed Fannie and Freddie under conservatorship as part of a four part plan to strengthen the housing agencies. In addition to conservatorship, the Treasury pledged to: inject up to \$100 billion in each agency if needed to maintain a positive net worth; provide unlimited short term liquidity if needed; and purchase mortgage backed securities in the open market.

It was hoped that these government actions would restore confidence to the marketplace and help mitigate recent volatility. Unfortunately, while the credit profile of Fannie Mae and Freddie Mac improved, the broader markets moved from bad to worse. In fact, the remainder of the month of September witnessed an incredible reshaping of the financial landscape and some of the highest levels of financial market volatility on record.

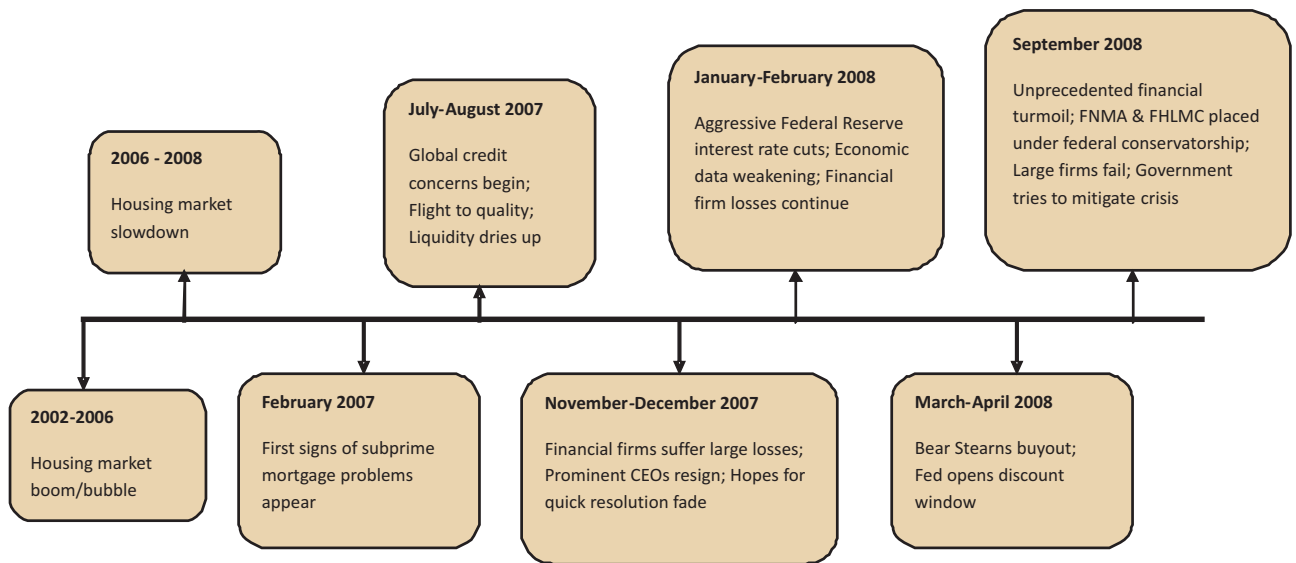
Shortly after the housing agencies' situation was presumably resolved, confidence in a number of venerable financial institutions began to evaporate. On September 14, Lehman Brothers (the 4th largest Wall Street investment bank) declared bankruptcy following 158 years of business and Merrill Lynch (the 3rd largest Wall Street firm) agreed to be purchased by Bank of America. On September 16, American International Group (AIG), once the largest insurance company in the United States, received an \$85 billion emergency loan from the federal government in order to prevent the company's bankruptcy and the chaos that might have ensued in the financial system.



Over the course of the next several days fear of bankruptcy continued to swirl among a wide variety of financial firms. These concerns caused Goldman Sachs and Morgan Stanley, the two largest and most prestigious investment banks on Wall Street, to change their regulatory status in order to become bank holding companies. Although this change may result in lower profitability for Goldman and Morgan, both firms saw the ability to access relatively stable customer deposits as essential to their survival.

On September 25, Washington Mutual was seized by the Federal Deposit Insurance Corporation (FDIC) and its assets were sold to JP Morgan in what is officially the nation's largest bank failure. On September 29, the banking operations of Wachovia (at one point the nation's 4th largest bank) were purchased by Citigroup in a deal that included the backing of the FDIC. Wells Fargo has also seen value in Wachovia's assets, and Citigroup and Wells are currently fighting for control of the bank.

In addition to these failures and takeovers of very large financial institutions, the markets demonstrated extreme turmoil. At one point demand for Treasury securities was so great that the thirty-day Treasury bill was actually paying negative interest as investors fled to the world's safest asset. The importance of the negative interest rate is that in this crisis environment, investors essentially preferred to pay the treasury to hold their cash, instead of accepting interest earnings from any other borrower. Credit spreads (the additional compensation required for investing in risky assets) reached all-time highs and many fixed income and short-term money markets essentially ceased to function.



The Treasury's Bailout Plan

Faced with the possibility of a systemic collapse of the financial system, the Treasury Department and the Federal Reserve used every tool at their disposal in order to manage the crisis. In addition to essentially nationalizing several large firms and facilitating the takeovers of others, the Federal Reserve provided unprecedented levels of liquidity to the marketplace. The Treasury also formulated a \$700 billion plan that will involve the government's purchase of impaired assets from the balance sheets of banks and investment firms. It is hoped that by purchasing these assets the government can restore liquidity to the banks, repair their credit standing, and reinvigorate their willingness to lend to businesses and consumers. The Treasury would hold the impaired assets until their market value improves and then resell them, perhaps even earning a profit.

The Treasury's plan received final congressional approval on October 3rd and implementation will begin shortly. While it is unknown how effective the plan will be, many market observers feel that at this point the Treasury's plan provides the best chance for a financial sector recovery and a limit to future damage caused to the broader economy.

From Main Street to Wall Street and Back Again

The difficulty on Wall Street began with housing weakness on Main Street. This process has now come full circle as financial market volatility has contributed to a slowdown on Main Street. National economic reports reflect this, and the slowdown is even more evident in certain regions of the country such as the industrial Midwest, Florida, Arizona, Nevada and California. Housing market weakness has been exacerbated by high energy and food prices, a weakening job market, and a difficult credit environment.

Forecasts for the remainder of the year call for much slower economic growth, and consumer confidence remains very poor. Since recent economic indicators do not yet reflect the impact of September's financial market events, the potential exists for growth to slow even more than previously predicted.

Conclusion

The ongoing financial market volatility and economic slowdown have justifiably worried investors, who have never experienced such market volatility and may be unsure how best to proceed in these difficult times. In this climate, it is important to put safety first. Please do not hesitate to contact us if you have any questions regarding this challenging market environment.

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

CONSUMER PRICES

In August, the CPI increased by 5.4% on a year-over-year basis, compared to July's 5.6% 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 help inflation to moderate in the months ahead.

HOUSING STARTS

Single-family housing starts declined by 1.9% in August, to a 0.63 million annual pace, the lowest since March 1991. This follows July's reading of 0.64 million. 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 August, Retail Sales rose at a year-over-year rate of 1.6%. Recently, consumers have slowed their spending in reaction to higher energy prices, the housing market contraction, and a general tightening of credit standards. The arrival of tax rebate checks helped mitigate this weakness somewhat, but the benefits of this one time stimulus are diminishing.

LABOR MARKETS

The September non-farm payroll employment report showed a decrease of 159,000 jobs and the unemployment rate remained at 6.1%. The payroll data reflected the ninth consecutive month of negative job growth. September's employment report reinforces the recent financial market concern about a slowing economy impacting the labor markets.

CREDIT SPREADS MUCH WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	2.64	1.01	1.63
2-year AA corporate note	1.50	1.14	0.36
5-year AA corporate note	1.67	1.41	0.26
5-year Agency note	1.12	0.92	0.20

Source: Bloomberg

Data as of 9/30/08

ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(62.2) \$Bln JUL 08	(58.3) \$Bln JUNE 08	(59.1) \$Bln JUN 07
GDP	2.8% JUN 08	0.9% MAR 08	4.8% JUN 07
Unemployment Rate	6.10% SEPT 08	6.10% AUG 08	4.70% SEPT 07
Prime Rate	5.00% SEPT 08	5.00% AUG 08	7.75% SEPT 07
CRB Index	345.5 SEPT 08	391.7 AUG 08	333.7 SEPT 07
Oil (West Texas Int.)	\$100.64 SEPT 08	\$115.46 AUG 08	\$81.66 SEPT 07
Consumer Price Index (y/o/y)	5.4% AUG 08	5.6% JUL 08	2.% AUG 07
Producer Price Index (y/o/y)	9.6% AUG 08	9.8% JUL 08	2.3% AUG 07
Dollar / EURO	1.41 SEPT 08	1.47 AUG 08	1.43 SEPT 07

Source: Bloomberg

Data as of 9/30/08

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