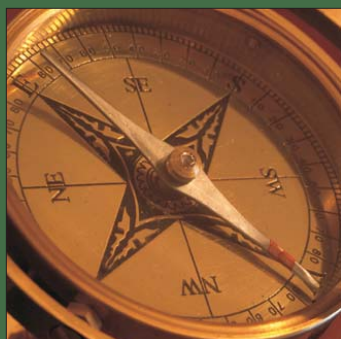


# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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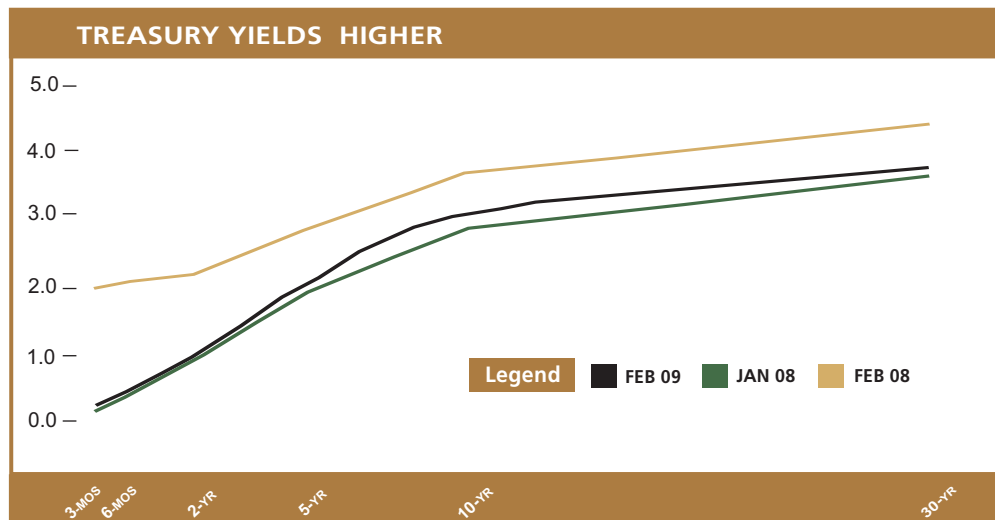
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

## MARKET SUMMARY

The US economy has been in recession since December 2007 and the economic decline has accelerated following the financial market turmoil that began in September 2008. The economy has now lost 4.4 million jobs since the start of the recession. The February Non-Farm Payroll number showed a decrease of 651,000 jobs and the unemployment rate increased to 8.1%. Consumer spending and the housing market remained very weak, and manufacturing activity continued to decline. Fourth quarter GDP was revised lower; the new -6.2% reading was the worst since the early 1980s. Forecasts call for continued declines in economic activity.

Treasury bond yields were higher in February as investors debated the impact of a severe global recession and much higher levels of Treasury issuance. Credit availability remained impaired and companies and individuals had difficulty accessing credit. Global stock markets continued their decline.

The next scheduled FOMC meeting is on March 17th.



Treasury yields were higher in February as market participants debated the impact of increased levels of Treasury bond issuance. The yield curve retained its normal shape as long-term interest rates are higher than short-term rates.

YIELDS	2/28/09	1/31/09	Change
3 Month	0.25	0.23	0.02
2 Year	1.01	0.95	0.06
5 Year	2.02	1.87	0.15
10 Year	3.04	2.84	0.20
30 Year	3.72	3.59	0.13

YIELD SPREADS	1/31/09	12/31/08	Change
5yr - 2yr T-Note	1.01	0.92	0.09
10yr - 2yr T-Note	2.03	1.89	0.14

Source: Bloomberg

## EVALUATING THE U.S. TREASURY MARKET

Some market participants are concerned that as global financial markets normalize investors will abandon low yielding Treasuries in favor of more attractive options. Because most bond market portfolios hold Treasuries, these concerns have presented a dilemma. Should investors continue to purchase Treasuries? Or should they reduce their holdings in the expectation of higher rates in the future?

### Current Low Yields

There are fundamental reasons why Treasury yields have reached very low levels. As the global financial crisis prompted a flight to safety, investors abandoned risky asset classes in favor of ultra-safe U.S. Treasuries. The Federal Reserve also contributed to the Treasury rally by aggressively lowering short-term interest rates. Finally, if current economic weakness persists or worsens, some investors believe that yields on Treasury securities will remain extremely low for years to come.

While it is plausible that Treasury yields will remain low, there are equally good reasons why rates may rise sharply. The decline in yields leaves little room for further improvement. For instance, the two-year Treasury yield has fallen from 5.25% to less than 1% since the credit crisis began. Furthermore, in order to fund increased government spending, the issuance of Treasury securities has increased dramatically. In a traditional supply and demand relationship, this increased issuance should lead to lower prices and higher yields. The actions of US and international policymakers are also designed to stoke inflation and prevent a deflationary spiral. Higher inflation could lead to much higher interest rates in the future.

Regardless of their market outlook though, investors should carefully consider their ability to predict the future course of interest rates before altering their portfolio structure based upon interest rate forecasts.

### The Difficulty of Predicting Interest Rates

A significant body of academic research has demonstrated that correctly predicting interest rates is virtually impossible to accomplish over an extended period of time. Studies indicate that most professional interest rate forecasters fail to outperform a random walk approach. Despite years of experience and access to the most sophisticated tools available, the professional economists' forecasts are less accurate than those obtained by flipping a coin. In fact, even the forecaster with the best previous track record failed to consistently outperform a coin flip when attempting to predict interest rate changes.

In order to be successful, portfolio managers must predict not only the direction of future interest rate moves, but also the magnitude and the timing of the move. This is difficult to do correctly even once, and virtually impossible to accomplish consistently over a long period of time. This problem is further compounded by the fact that predicting interest rate changes becomes more difficult as the time horizon increases.

The risk in trying to time interest rates is that once a forecaster makes a mistake, it becomes extremely difficult to recapture that lost performance. Therefore, investors should carefully consider whether they truly have a competitive advantage in forecasting interest rates before making a decision to alter their Treasury holdings based upon their market forecast. This is especially true considering the benefits that Treasury securities provide to a diversified fixed income portfolio.

### The Role of Treasuries in a Fixed Income Portfolio

Regardless of their interest rate outlook, diversified fixed income investors almost always hold some Treasury securities. In fact, it would be accurate to say that Treasury securities form the foundation of fixed income portfolios because they uniquely satisfy the investment goals of safety, liquidity, and return.

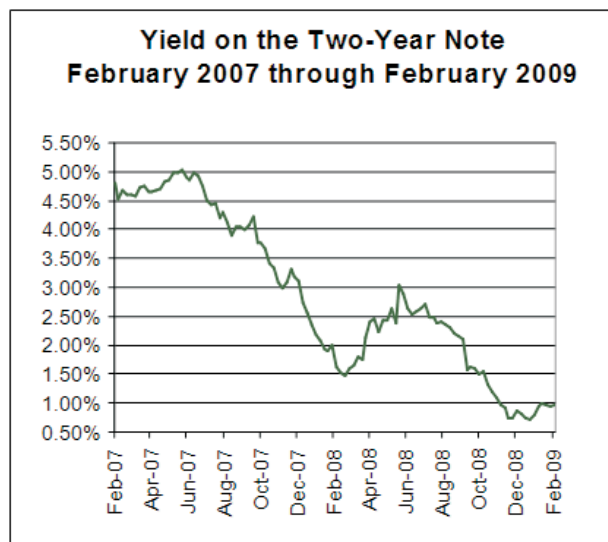
Because they are considered to be free from default risk, Treasuries add a safety component to fixed income portfolios. Since safety is an important consideration for fixed income investors, this benefit should not be minimized. The market for U.S. Treasuries is also among the most liquid in the world. During the fall of 2008, liquidity evaporated from most other asset classes leaving investors searching for securities that could be sold at a reasonable price. During that tumultuous period, Treasuries provided much-needed liquidity. Finally, although Treasury

returns are often lower than those for other fixed income sectors, this is not always the case. In fact, during 2008 Treasuries were the best performing asset class in the world, with a total return of nearly 14%.

### Conclusion

While economic fundamentals have contributed to recent strong performance for Treasury securities, there is concern that current levels are unsustainable. Historically low yields, increasing supply, and potentially inflationary monetary policy have prompted concern that the Treasury yields will rise sharply in the future. However, research shows that market participants should carefully consider their ability to successfully forecast future interest rate moves. The challenging nature of successful interest rate forecasting, combined with Treasury securities' safety and liquidity components, present a strong argument for maintaining a position in Treasuries as part of a diversified fixed income portfolio.

Brian Perry, Vice President, Investment Strategist



### CONSUMER PRICES

In January, the CPI showed that consumer prices were unchanged on a year over year basis. The year-over-year Core CPI (CPI less food and energy) rose at a 1.7% y-o-y rate. Inflation has significantly moderated in recent months as lower energy prices and slowing economic growth have resulted in a slower pace of price increases.

### RETAIL SALES

In January, Retail Sales declined at a year-over-year rate of -9.7%, slightly better than December's -10.5% annual rate of decline. Recently, consumers have broadly slowed their spending in reaction to financial market turmoil, a general tightening of credit standards, job loss worries, and the housing market contraction. Retail spending is expected to remain weak in the months ahead.

### LABOR MARKETS

The February non-farm payroll employment report showed a decrease of 651,000 jobs and the unemployment rate increased to 8.1%. The payroll data reflected the fourteenth consecutive month of negative job growth. Since the start of the recession, the economy has lost more than 4 million jobs. February's employment reports showed continuing deterioration in the labor markets.

### HOUSING STARTS

Single-family housing starts declined by 12.2% in January, to a 347,000 annual pace. This was the lowest level since data collection began in 1959. This follows December's reading of 395,000. The fall in housing starts is supporting the financial market concern that the decline in the housing market has not yet run its course.

## CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.55	0.68	(0.13)
2-year AA corporate note	1.75	1.97	(0.22)
5-year AA corporate note	1.92	1.98	(0.06)
5-year Agency note	0.77	0.85	(0.08)

Source: Bloomberg

Data as of 1/31/09

## MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(39.93) \$Bln DEC 08	(41.58) \$Bln NOV 08	(57.58) \$Bln DEC 07
GDP	(6.20%) DEC 08	(0.50%) SEP 08	(0.20%) DEC 07
Unemployment Rate	8.10% FEB 09	7.60% JAN 09	4.80% FEB 08
Prime Rate	3.25% FEB 09	3.25% JAN 09	6.00% FEB 09
CRB Index	211.57 FEB 09	220.37 JAN 09	412.69 FEB 09
Oil (West Texas Int.)	\$44.76 FEB 09	\$41.68 JAN 09	\$101.84 FEB 08
Consumer Price Index (y/o/y)	0.0% JAN 09	0.1% DEC 08	4.3% JAN 08
Producer Price Index (y/o/y)	(1.0%) JAN 09	(0.9%) DEC 08	7.4% JAN 08
Dollar / EURO	1.27 FEB 09	1.28 JAN 08	1.52 FEB 08

Source: Bloomberg

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