

# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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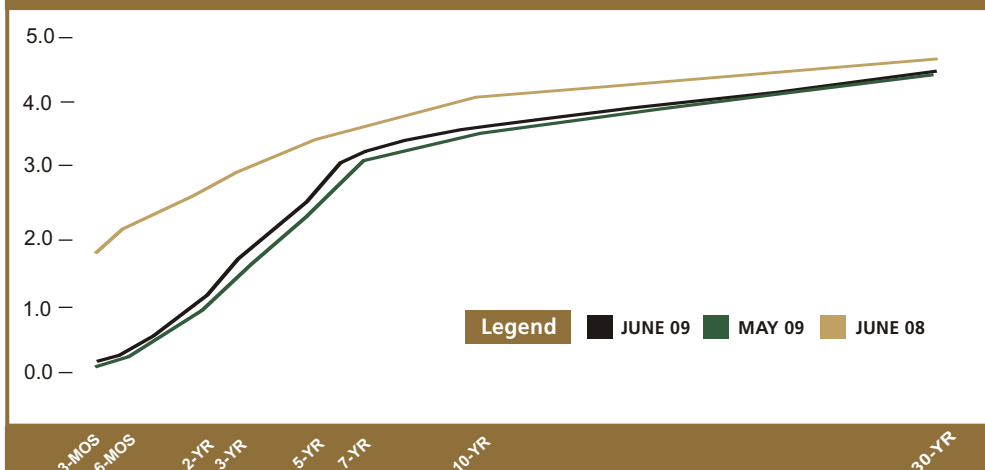
## MARKET SUMMARY

Recent indicators have provided tentative signs that the pace of economic decline is moderating and some forecasters have begun to predict an end to the recession. Consumer spending, housing, and manufacturing continue to stabilize, and the ISM Manufacturing Index increased for the sixth straight month. Unfortunately, many of these indicators remain at very low levels. The decline in GDP is expected to moderate in the second quarter, and positive GDP growth is now forecast for Q3. However, it remains likely that the economic recovery will be weak and the unemployment rate (currently 9.5%) is likely to continue to rise.

Treasury bond yields rose slightly in June as investors debated the impact of upcoming Treasury issuance and the Federal Government's budget deficits. However, many market participants continue to believe that inflation is unlikely in the near-term, limiting the decline in Treasury prices.

The Federal Reserve announced that they remain more concerned with reinvigorating the economy than with short-term inflationary pressures, and they intend to keep the fed funds rate at exceptionally low levels for the foreseeable future. The next scheduled FOMC meeting is on August 12th.

### TREASURY YIELDS SLIGHTLY HIGHER



Treasury yields rose slightly in June as market participants debated the impact of increased levels of Treasury bond issuance and the ongoing global recession. The yield curve has steepened as long-term interest rates are much higher than short-term rates.

YIELDS	6/30/09	5/31/09	Change
3 Month	0.18	0.13	0.05
2 Year	1.11	0.92	0.19
3 Year	1.61	1.40	0.21
5 Year	2.56	2.35	0.21
7 Year	3.20	3.07	0.13
10 Year	3.52	3.47	0.05
30 Year	4.31	4.33	-0.02

YIELD SPREADS	6/30/09	5/31/09	Change
5yr - 2yr T-Note	1.45	1.43	0.02
10yr - 2yr T-Note	2.41	2.55	-0.14

Source: Bloomberg

## NEW ASSET CLASSES

As part of its efforts to mitigate the effects of the financial crisis, the federal government has taken actions that have resulted in the creation of several new asset classes. These new asset classes may have important implications for investors. This article will examine the Temporary Liquidity Guarantee Program as well as the Build America Bonds program. Readers may find that these new asset classes offer attractive investment characteristics and may wish to consider them as complementary pieces of their current investment programs.

### Temporary Liquidity Guarantee Program

One of the most successful programs that the federal government has introduced in the past year is the Temporary Liquidity Guarantee Program (TLGP). The TLGP program provides insurance from the Federal Deposit Insurance Corporation (FDIC) for certain debt issued by holding companies of US corporations. Issuance of TLGP bonds is limited to banks and bank holding companies; however, in addition to firms such as J.P. Morgan and Goldman Sachs, companies such as General Electric and many insurance companies also own small banks that are able to issue bonds under the program. Like FDIC insurance on bank deposits, the FDIC's TLGP notes guarantee full and timely payment of principal and interest on corporate notes issued under the program. This FDIC insurance guarantee is backed by the full faith and credit of the United States. While FDIC insurance on bank deposits is limited to a maximum amount, there is no limit on the TLGP guarantee.

At the time of the program's creation, financial markets were under severe stress and financial companies had virtually no access to the traditional capital markets. The TLGP program allowed financial firms to access the capital markets to roll over existing debt. The program also provided financial institutions with additional capital to make new loans. The TLGP was initially due to expire in June 2009, but was extended through October 2009. All bonds issued under the program must have a final stated maturity of no longer than December 2012. As financial market conditions have improved, firms have found themselves better able to issue non-FDIC insured debt. Therefore, TLGP issuance has begun to slow dramatically, and some healthier financial companies have stated that they do not intend to utilize the program again. Nevertheless, many secondary issues are still available in the marketplace.

Despite carrying the full faith and credit of the US government, yields on TLGP bonds remain above those available on U.S. Treasury securities making them attractive additions to a fixed income portfolio. Benefits of TLGP bonds include the FDIC insurance, additional compensation over Treasury securities, and the ability to provide further diversification to a portfolio. On the downside, TLGP bonds are only available with relatively short maturities (less than 3.5 years) and the bonds are somewhat less liquid than Treasury securities. Additionally, investors should remember that the asset class is designed to be temporary in nature and bonds may not be available in the future.

### Build America Bonds

Municipalities have traditionally raised funds through the issuance of tax exempt bonds, with the main purchasers of these bonds being individuals seeking relief from high tax burdens. Because of the tax exemptions that traditional municipal bonds offer, local agencies have been able to issue them at attractive absolute yields. However, these low absolute yield levels have not appealed to institutional investors that are not subject to taxes. During the financial crisis, investor demand for traditional tax exempt municipal securities fell substantially, making it difficult for municipalities to raise funds. Since local construction projects are intended to be one of the centerpieces of the federal government's economic recovery plan, a solution was needed that would allow local agencies to raise the funds necessary to break ground on new construction projects.

The solution was the Build America Bonds program. Issued by municipalities, these bonds are fully taxable, which means that their absolute yields are higher than those of traditional tax exempt municipal securities. These higher yields are designed to appeal to institutional investors, thereby broadening the investor base for municipal debt and making it easier to raise funds for new projects. To compensate the municipality for the higher absolute level of yield it must pay, the federal government is providing a rebate of 35% of the total coupon payment to the municipality. This structure has created what is essentially a win-win situation: local agencies can issue at a lower overall cost of capital and have access to a wider investor base while institutional investors gain access to an attractive asset class.

The program has gotten off to a strong start, with entities such as the State of California and the New Jersey Turnpike Authority issuing large deals. So far, nearly \$15 billion bonds have been issued under this new program, and Barclay's Capital has estimated that this amount will grow tenfold over the next 18 months - eventually constituting a \$150 billion market by the end of 2010. The Build America Bonds program was initially designed to expire at the end of 2010, but due to its early success there is already talk of extending it beyond that date, with a decision expected near the end of 2009.

### Conclusion

This article has briefly analyzed two attractive new investment alternatives: the Temporary Liquidity Guarantee Program and the Build America Bonds program. Both of these new asset classes possess characteristics which may make them an attractive addition to some investment programs. As market conditions continue to evolve, investors may want to consider including these asset classes in their investment program.

Brian Perry, Vice President, Investment Strategist

### CONSUMER PRICES

In May, the CPI showed that consumer prices decreased 1.3% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.8% y-o-y rate. Inflation has significantly moderated in recent months as lower energy prices and the weak economy have resulted in a slower pace of price increases. Market participants continue to debate whether higher inflation or deflation is a more likely scenario for the near-term future.

### RETAIL SALES

In May, Retail Sales declined at a year-over-year rate of -9.6%, slightly better than April's -10.0% annual rate of decline. Recently, consumers have broadly slowed their spending in reaction to 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 June non-farm payroll employment report showed a decrease of 467,000 jobs and the unemployment rate increased to 9.5%. The payroll data reflected the nineteenth consecutive month of negative job growth. Since the start of the recession, the economy has lost more than 6.0 million jobs. June's employment report was worse than expected and labor markets are expected to remain weak for some time to come.

### HOUSING STARTS

Single-family housing starts increased in May to a 401,000 annual pace. Single-family housing starts appear to have stopped their most recent decline over the last few months.

## CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.26	0.25	0.01
2-year AA corporate note	1.12	1.45	(0.33)
5-year AA corporate note	1.30	1.67	(0.37)
5-year Agency note	0.44	0.73	(0.29)

Source: Bloomberg

Data as of 6/30/09

## MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(29.16) \$Bln APR 09	(28.53) \$Bln MAR 09	(62.14) \$Bln APR 08
GDP	(5.50%) MAR 09	(6.3%) DEC 08	0.90% MAR 08
Unemployment Rate	9.50% JUN 09	9.40% MAY 09	5.60% JUN 08
Prime Rate	3.25% JUN 09	3.25% MAY 09	5.00% JUN 08
CRB Index	249.96 JUN 09	253.05 MAY 09	462.74 JUN 08
Oil (West Texas Int.)	\$69.89 JUN 09	\$66.31 MAY 09	\$140.00 JUN 08
Consumer Price Index (y/o/y)	(1.30%) MAY 09	(0.70%) APR 09	4.20% MAY 08
Producer Price Index (y/o/y)	(5.00%) MAY 09	(3.70%) APR 09	7.30% MAY 08
Dollar / EURO	1.40 JUN 09	1.42 MAY 09	1.58 JUN 08

Source: Bloomberg

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