

# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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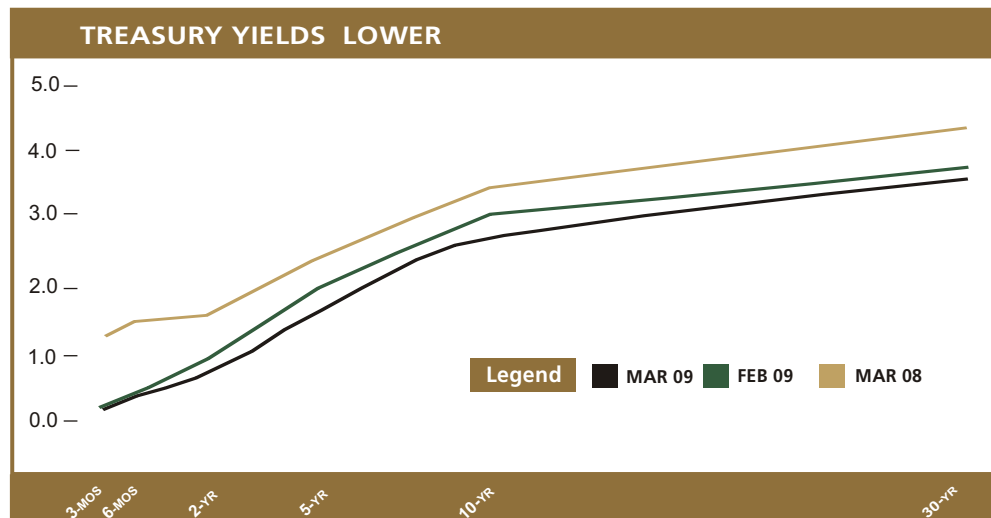
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

## 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 5 million jobs since the start of the recession. The March Non-Farm Payroll number showed a decrease of 663,000 jobs and the unemployment rate increased to 8.5%. There were tentative signs of stabilization in consumer spending, housing, and manufacturing, although any stabilization is occurring at very low levels. Fourth quarter GDP was revised lower; the new -6.3% reading was the worst since the early 1980s. Forecasts call for continued declines in economic activity, although there is hope that the first quarter of 2009 will ultimately represent the low point of the economic cycle.

Treasury bond yields were lower in March as investors reacted to the Federal Reserve's announcement that it would begin purchasing US Treasuries in the open market. These purchases are part of the Fed's ongoing efforts at mitigating the financial crisis and global recession. While credit markets remain impaired, in March global stock markets enjoyed their largest monthly gains since the 1930s.

The next scheduled FOMC meeting is on April 29th.



Treasury yields were lower in March as market participants debated the impact of increased levels of Treasury bond issuance and the ongoing global recession. Treasury prices were supported by the Fed's decision to begin purchasing Treasuries in the open market. The yield curve retained its normal shape as long-term interest rates are higher than short-term rates.

YIELDS	3/31/09	2/28/09	Change
3 Month	0.20	0.25	(0.05)
2 Year	0.80	1.01	(0.21)
5 Year	1.68	2.02	(0.34)
10 Year	2.69	3.04	(0.35)
30 Year	3.56	3.72	(0.16)

YIELD SPREADS	2/28/09	3/31/09	Change
5yr - 2yr T-Note	0.88	1.01	(0.13)
10yr - 2yr T-Note	1.89	2.03	(0.14)

Source: Bloomberg

## LEADING AND LAGGING ECONOMIC MEASURES

With the nation in the midst of a severe recession, this month's article will take a look at some of the economic indicators that market participants will be watching for signs of a recovery. We'll also examine one well-known economic indicator that while important, does not necessarily forecast the future direction of the economy.

### Economic Indicators that Lead the Broader Economy

**Leading Economic Indicators** - is a composite index comprised of 10 different economic measures that have historically shown tendencies to reverse course prior to changes in the trend of the broader economy. Therefore, this index is often used in order to foreshadow the future course of economic activity. Readings on the leading economic indicators have been volatile, but have not declined precipitously over the last several months.

**Housing Starts** - sharp declines in the housing market were an early indicator of the financial and economic crisis we have experienced. A stabilization and/or rebound in housing activity is likely a prerequisite for an eventual economic recovery. Housing starts, or the number of new dwellings on which construction has begun in a given month, represent an early indicator of future housing activity. The very sharp decline in housing starts readings has moderated recently, but this moderation has occurred at levels of activity that are only a fraction of what they were several years ago. Nevertheless, stabilization, even at low levels, is preferable to the precipitous declines this indicator experienced over the course of the past several years.

**Credit Spreads** - represent the increased compensation investors demand for investing in risky assets as opposed to ultra-safe U.S. Treasury's. Historically, the level and direction of credit spreads has served as a good indicator of future economic activity. Tighter spreads often foreshadow an improving US economy; spreads often widen prior to an economic decline. Credit spreads are currently relatively stable, but they are at historically high levels. This may be indicative of an economy that is slowing its downward decline, but remains at depressed levels.

**Stock Prices** - because stock prices represent investors' expectations of future corporate earnings, they often move upward or downward before economic activity follows. The past month's very strong stock price increases may be indicating that investors expect economic activity to recover in the future. However, investors must also consider the possibility that recent stock price increases only represent a short-term bounce in the midst of a longer-term decline.

**Bloomberg Financial Conditions Index** - this indicator is compiled by Bloomberg and attempts to convey current conditions in the money market, credit, and equity markets. Because economic weakness was precipitated by the financial crisis, it seems likely that financial markets must stabilize in order for the broader economy to recover. Therefore the Bloomberg financial conditions index may be particularly appropriate for forecasting an end to the current recession. After reaching a low of 11 standard deviations below normal during the fall, the index recovered somewhat and currently sits at approximately 5

standard deviations below normal. As with many other indicators, current ratings of the Bloomberg index forecast an economy that is beginning to stabilize but is doing so at extremely low levels.

### Economic Indicators that Lag the Broader Economy

In addition to these leading indicators, there are also a number of indicators that either coincide with the current economic cycle or lag the economic cycle. Among these indicators, the most prominent is the unemployment rate.

**Unemployment Rate** - the unemployment rate represents one of the most visual and painful symbols of a recessionary economy. However, the unemployment rate is not a good indicator of the future course of economic activity. Instead, unemployment is what is known as a lagging indicator, which means that it begins to deteriorate long after the economy has already turned down and does not begin to recover until well into an economic recovery. Indeed, the unemployment rate remained relatively stable for some time following the onset of the current recession. However, the rate has moved much higher in the past nine months and shows signs that this increase will continue. Investors should expect that the unemployment rate will continue to rise for at least the remainder of 2009; however this may not be an indication of the "true" direction of the economy.

### Conclusion

Investors and ordinary citizens are understandably eager to see signs of an eventual economic recovery. As they attempt to do this, they should make sure that they look to correct economic indicators; including those that have traditionally forecast changes in the course of economic activity. While the unemployment rate will likely continue to increase and will understandably affect consumer and investor confidence, it is important to remember that unemployment is a lagging economic indicator. Market participants should focus upon leading measures of economic activity, including the leading economic indicators, housing starts, credit spreads, stock prices, and the Bloomberg financial conditions index for signs that the economy is beginning to recover.

Any individual data series can be extremely volatile on a month-to-month basis and economic recovery is likely to occur in fits and starts. However taken in aggregate, the leading measures of economic activity discussed in this article show a pattern of an economy that has begun to enter the stabilization process. Unfortunately, this stabilization is occurring at very low levels of economic activity and any eventual recovery is likely to be slow and painful. However, stabilization is a necessary first step in an eventual economic recovery; investors should look to the indicators discussed in this article for further signs that the economy is moving in a positive direction.

Brian Perry, Vice President, Investment Strategist

### CONSUMER PRICES

In February, the CPI showed that consumer prices increased 0.2% on a year over year basis. The year-over-year Core CPI (CPI less food and energy) rose at a 1.8% 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 February, Retail Sales declined at a year-over-year rate of -8.6%, slightly better than January's -9.0% and December's -10.5% annual rates 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 March non-farm payroll employment report showed a decrease of 663,000 jobs and the unemployment rate increased to 8.5%. The payroll data reflected the sixteenth consecutive month of negative job growth. Since the start of the recession, the economy has lost more than 4 million jobs. March's employment reports showed continuing deterioration in the labor markets.

### HOUSING STARTS

Single-family housing starts increased by 1.1% in February, to a 357,000 annual pace. This follows January's reading of 353,000 which was the lowest reading on record. Despite February's increase, the low level of 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	0.54	0.55	(0.01)
2-year AA corporate note	1.74	1.75	(0.01)
5-year AA corporate note	1.91	1.92	(0.01)
5-year Agency note	0.85	0.77	0.08

Source: Bloomberg

Data as of 3/31/09

## MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(36.03) \$Bln JAN 09	(39.9) \$Bln DEC 08	(59.16) \$Bln JAN 08
GDP	(6.30%) DEC 08	(0.50%) SEP 08	(0.20%) DEC 07
Unemployment Rate	8.50% MAR 09	8.10% FEB 09	5.10% MAR 08
Prime Rate	3.25% MAR 09	3.25% FEB 09	5.25% MAR 08
CRB Index	220.40 MAR 09	211.57 FEB 09	386.89 MAR 08
Oil (West Texas Int.)	\$49.66 MAR 09	\$44.76 FEB 09	\$101.58 MAR 08
Consumer Price Index (y/o/y)	0.2% FEB 09	0.0% JAN 09	4.0% FEB 08
Producer Price Index (y/o/y)	(1.3%) FEB 09	(1.0%) JAN 09	6.5% FEB 08
Dollar / EURO	1.33 MAR 09	1.27 FEB 09	1.58 MAR 08

Source: Bloomberg

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