CHANDLER ASSET MANAGEMENT

May 2009

Bond Market Review

A monthly review of fixed income markets

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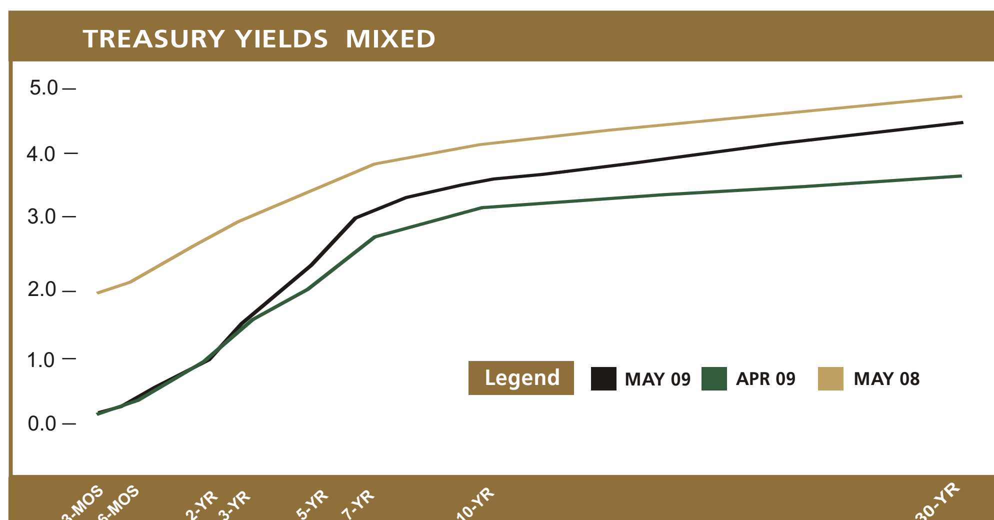
Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

Market Summary

Recent indicators have provided tentative signs that the pace of economic decline is moderating. Although the economy lost 345,000 jobs in May, the decline was less than forecast. There were continued signs of stabilization in consumer spending, housing, and manufacturing. The ISM Manufacturing Index increased for the fifth straight month, although readings remain at contractionary levels. First Quarter 2009 GDP declined at an annualized pace of -5.7%, and there are hopes that this will represent the trough of the recession. However, it remains likely that the economy will stay weak for the foreseeable future, and the unemployment rate is likely to continue to rise.

Longer-term Treasury bond yields were higher in May as investors grew increasingly concerned over the volume of upcoming Treasury issuance and the Federal Government's budget deficits. Investors also sold Treasuries in reaction to signs of economic stabilization, reduced financial market volatility, and increasing confidence in the health of the banking system.

The next scheduled FOMC meeting is on June 24th.



Short-term Treasury yields were unchanged in May but longer rates rose sharply 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	5/31/09	4/30/09	Change
3 Month	0.13	0.12	0.01
2 Year	0.92	0.92	0.00
3 Year	1.40	1.36	0.04
5 Year	2.35	2.02	0.33
7 Year	3.07	2.69	0.38
10 Year	3.47	3.12	0.35
30 Year	4.33	4.04	0.29

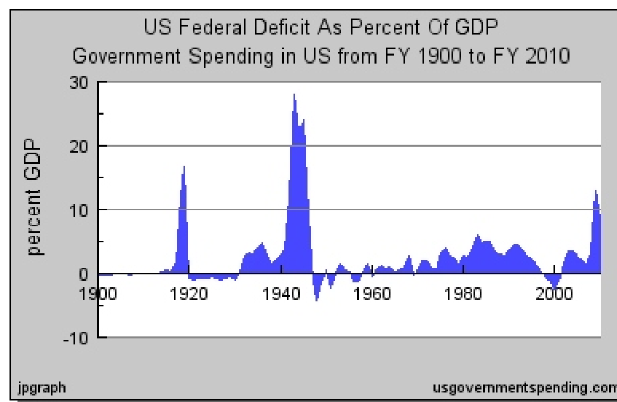
YIELD SPREADS	5/31/09	4/30/09	Change
5yr - 2yr T-Note	1.43	1.10	0.33
10yr - 2yr T-Note	2.55	2.20	0.35

Source: Bloomberg

In order to counteract the effects of the worst global recession since the 1930s, governments have run increasingly large budget deficits. These deficits are a manifestation of the principles of Keynesian economics which postulate that governments should employ deficit spending during economic slowdowns in order to make up for reduced demand from the business and consumer sectors. It is generally believed that following such policies is an effective means of mitigating economic downturns; however, the longer-term effects of these budget deficits can be extremely damaging to economic growth.

Keynesian economics

Keynesian economics is a field of economics named after the famous 20th century economist John Maynard Keynes. In response to the Great Depression, Keynes postulated that economic slowdowns intensify because aggregate demand in the economy declines once growth begins to slow. Since demand from the business and consumer sectors falls, Keynes theorized that governments should increase their spending in order to bring the overall level of aggregate demand in the economy more in line with supply.



Since the government is spending more at a time when tax receipts are declining, Keynesian economics sometimes requires a government to run a larger budget deficit during an economic slowdown. If they are effective in mitigating the effects of an economic downturn, these budget deficits can serve as a valuable tool of government economic policy. However, it is important that once business and consumer demand picks up and economic growth resumes, governments reduce their budget deficit and resume a more conservative fiscal position.

Why budget deficits are bad

The US budget deficit for the fiscal year 2009 is forecast to be more than 12% of gross domestic product, the largest percentage deficit since World War II. Large government budget deficits can be problematic for several reasons. The most potentially catastrophic problem occurs if the government is unable to fund its deficit. If this occurs, a currency devaluation or even a default might ensue. Although this occasionally occurs in developing markets, it is exceptionally unlikely that this worst case scenario would occur in a large, economically advanced nation. The US is further insulated from a currency devaluation or debt default due to the country's status as the world's largest economy and the dollar's role as the world's reserve currency.

Unfortunately, even if they can be easily funded, large budget deficits hurt long term economic growth. Deficits can produce what's known as the "crowding out effect." When this occurs, the government's need to raise capital draws resources away from private enterprise and makes it more difficult and more expensive for companies and individuals to borrow money. This has the effect of raising the overall level of interest rates in the economy, which lowers economic growth. In fact, the International Monetary Fund (IMF) has forecast that, all else being equal, by 2014 the projected US budget deficits will raise the overall level of interest rates in the economy by more than 100 basis points. The impact of this interest rate increase will reduce gross domestic product (GDP) by 4%.

What might happen?

There are several possible outcomes that can result from very large budget deficits. The first is that the level of interest rates on US Treasuries will increase as investors demand higher yields in order to purchase the increasing supply of Treasuries. The second possibility is that the US dollar will weaken as foreign holders of Treasuries moderate future purchases. The US may also choose to allow the dollar to weaken in order to reduce the value of the obligation that it owes to foreign investors. Doing so would ease the burden on Uncle Sam.

A third possibility, which has recently been mentioned in the press, is that the United States could lose its AAA credit rating. This could occur because as the US debt-to-GDP ratio increases, the country's creditworthiness decreases commensurately. If the deterioration is sufficiently large, the credit rating agencies may choose to downgrade the United States. Although this scenario is certainly a possibility, a US credit downgrade is unlikely to occur in the near term. Furthermore, even if the US eventually loses its AAA rating, it will still remain one of the more economically stable countries in the world.

Conclusion

The presence of large government budget deficits in a time of economic crisis is an unfortunate but perhaps necessary reality. To the extent that these deficits have mitigated the ongoing crisis and prevented worst-case scenarios from occurring, deficit spending has been effective. However, future forecasts of continued large deficits are extremely troubling, particularly given the looming presence of an entitlement crunch due to the aging of the baby boomer generation.

Unless brought under control, these budget deficits have the potential to severely harm economic growth in the United States and with it the well-being of many millions of Americans. Once the current economic slowdown has been reversed, bringing budget deficits back under control will require some combination of higher tax revenue and/or reduced spending. Either solution requires difficult political choices, but the sooner that these choices are made the easier they will be to implement. With each year that goes by, the necessary size of future government spending cuts or tax increases rises significantly.

Brian Perry, Vice President, Investment Strategist

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Consumer Prices

In April, the CPI showed that consumer prices decreased 0.7% on a year-over- year basis. The year-over-year Core CPI (CPI less food and energy) increased 0.1% to a 1.9% 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.

Labor Markets

The May non-farm payroll employment report showed a decrease of 345,000 jobs and the unemployment rate increased to 9.4%. The payroll data reflected the eighteenth consecutive month of negative job growth. Since the start of the recession, the economy has lost more than 6.0 million jobs. May's employment report was much better than expected and showed that the rate of deterioration in the labor markets is slowing, although the labor markets remain weak.

Retail Sales

In April, Retail Sales declined at a year-over-year rate of -10.1%, worse than March's -9.6% 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.

Housing starts

Single-family housing starts increased slightly in April to a 368,000 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	0.25	0.41	(0.16)
2-year AA corporate note	1.45	1.33	0.12
5-year AA corporate note	1.67	1.54	0.13
5-year Agency note	0.73	0.60	0.13

Source: Bloomberg *Data as of 5/31/09*

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(27.58) $Bln MAR 09	(26.13) $Bln FEB 09	(57.41) $Bln MAR 08
GDP	(5.70%) MAR 09	(6.3%) DEC 08	0.90% MAR 08
Unemployment Rate	9.40% MAY 09	8.90% APR 09	5.50% MAY 08
Prime Rate	3.25% MAY 09	3.25% APR 09	5.00% MAY 08
CRB Index	253.05 MAY 09	222.39 APR 09	422.17 MAY 08
Oil (West Texas Int.)	$66.31 MAY 09	$51.12 APR 09	$127.35 MAY 08
Consumer Price Index (y/o/y)	(0.70%) APR 09	(0.40%) MAR 09	3.90% APR 08
Producer Price Index (y/o/y)	(3.70%) APR 09	(3.50%) MAR 09	6.40% APR 08
Dollar / EURO	1.42 MAY 09	1.32 APR 09	1.56 MAY 08

Source: Bloomberg

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