

# BOND MARKET REVIEW

A MONTHLY REVIEW OF  
FIXED INCOME MARKETS



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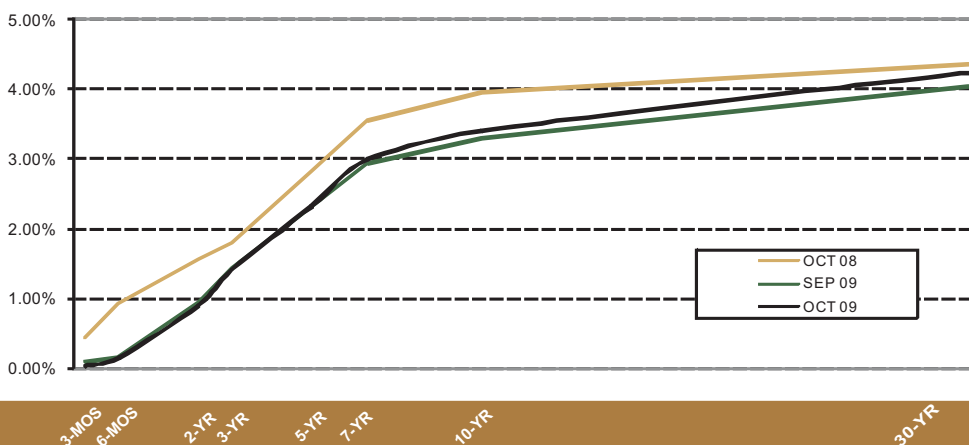
## MARKET SUMMARY

After contracting for four consecutive quarters, the economy finally expanded in the third quarter, in what appears now to be an end to the current recession. Backed mostly by government spending, gross domestic product expanded 3.5% with many forecasters predicting continued growth through the end of 2009. However, critics note that there are few signs that the economy will be able to sustain that growth once the government stimulus pulls back as unemployment remains high and consumers' faith shaky. To the average American, this technical end to the recession is unlikely to "feel" good until steady job growth becomes widespread and we can finally see unemployment recede.

Treasury bond yields fluctuated during October before ending the month relatively unchanged. While investors remain concerned about the very large volume of Treasury bonds being issued, as well as potential inflation, uncertainty about the strength of the economic recovery has so far limited increases in Treasury yields.

The Federal Reserve stated, "economic activity has continued to pick up" at their November 4 meeting. Debate has begun on the timing of eventual interest rate increases, but the FOMC stated that conditions are "likely to warrant exceptionally low levels of the federal funds rate for an extended period." The next scheduled FOMC meeting is on December 16.

### TREASURY YIELDS MIXED IN OCTOBER



Short-term Treasury yields declined slightly in October while longer-term rates rose slightly as market participants debated the impact of increased levels of Treasury bond issuance and the strength and durability of the expected economic recovery. The yield curve remains steep as long-term interest rates are much higher than short-term rates.

YIELDS	10/30/09	9/30/09	Change
3 Month	0.03	0.10	(0.07)
2 Year	0.90	0.95	(0.05)
3 Year	1.41	1.43	(0.02)
5 Year	2.32	2.32	0.00
7 Year	2.98	2.93	0.05
10 Year	3.39	3.31	0.08
30 Year	4.23	4.04	0.19
YIELD SPREADS	10/30/09	9/30/09	Change
5yr - 2yr T-Note	1.42	1.37	0.05
10yr - 2yr T-Note	2.49	2.36	0.13

Source: Bloomberg

# CHALLENGES IN THE CURRENT MARKET ENVIRONMENT

Now that the worst part of the financial crisis seems to have passed, we are at an opportune time to examine the current investment environment and how investors might deal with some of the challenges they are currently facing.

## Challenge #1: Low Interest Rates

The first important challenge facing fixed income investors is the current environment of ultra-low interest rates. With yields currently at record low levels, what can investors do to maximize returns in their portfolio?

One effective approach is to purchase “spread” products such as corporate bonds and government agency bonds. Because they carry additional credit risk, as compared to risk-free US Treasuries, spread products provide higher returns than Treasury securities. Furthermore, if interest rates begin to rise, the “spread” of these bonds is likely to compress, leading to higher returns than Treasury securities.

Another approach is to hold securities across the maturity spectrum. Although investors face a natural temptation to invest only in the shortest securities when concerned about rising interest rates, this is usually not a wise decision. Financial markets have experienced periods in the past when rates stayed low for years on end; investors that stayed in short-term fixed income during these periods suffered a very high opportunity cost for doing so. On the other hand, it would also be unwise to concentrate solely on long-term securities in this low-yield environment.

By holding securities across the maturity spectrum an investor can take advantage of the steep yield curve (long-term bonds currently yield much more than short-term bonds) and avoid an over-concentration in ultra-low yielding money market instruments. At the same time, this approach also assures that if interest rates begin to rise, maturities within the portfolio will be available for reinvestment at higher yields.

Finally, investors frustrated about low interest rates might do well to focus upon the difference between real returns and nominal returns. While nominal rates are certainly very low at this time, inflation is also extremely low—even negative by some measures. As a result, the real return on many fixed income investments is actually above the long-term average. Focusing on the increasing purchasing power of their account, rather than the low nominal yields, might help to put a smile on the face of unhappy investors.

## Challenge #2: Credit Research

The financial crisis reinforced the importance of rigorous credit research and ongoing monitoring of credit positions. An increased emphasis on credit research presents a challenge for investors lacking the resources to properly evaluate and monitor credit. At the same time though, credit positions enhance portfolio returns over time, while also offering some protection against rising interest rates. So what is the average investor to do?

One obvious solution is to add the necessary resources to analyze credit, whether through internal hiring, utilizing third-party research, or employing an outside investment adviser with the resources and expertise to properly evaluate credit. A second approach is to purchase only the highest rated securities or to focus upon a select number of securities. While this approach will reduce the odds that a portfolio suffers a negative credit event, it is not a failsafe approach. Therefore, investors unwilling or unable to evaluate credit with their current resources or add additional resources may choose to forgo holding credit in their account. Although this approach will likely result in lower returns over time, it will avoid the possibility of a negative credit event resulting from a lack of proper credit research.

## Challenge #3: The Emotions of Investing

During times of market crisis, it can be particularly difficult to overcome one's emotions and adhere to a disciplined, long-term investment approach. However, difficult market environments are when it is most crucial to stick with a chosen strategy. Behavioral finance deals with the challenges investors face in overcoming their emotions and sticking with an investment strategy. A rigorous discussion of behavioral finance is beyond the scope of this article, but investors can benefit simply by attempting to increase their awareness of the role emotions play in their investment program. Investment policies and investment strategies are put in place for a reason; although deviations are sometimes called for, investors should carefully consider whether there are rational reasons for these deviations, or whether they are simply reacting to their emotions in the face of volatile market fluctuations.

## Conclusion

This article has briefly examined several challenges currently facing fixed income investors. By sticking with their long-term investment strategy and employing best practices in portfolio management, investors can move closer to meeting their financial goals regardless of the external market environment.

Brian Perry, Vice President, Investment Strategist

### CONSUMER PRICES

In September, 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 1.5% y-o-y rate. Despite hopes for an economic recovery and an increased money supply, many economists believe that inflation will remain moderate over the next 12 months.

### RETAIL SALES

In September, Retail Sales declined 5.7% on a year-over-year basis, an improvement over the previous several months' readings. Consumers have increased their savings rate and slowed their spending in reaction to a general tightening of credit standards, job losses, and the housing market contraction.

### LABOR MARKETS

The October non-farm payroll employment report showed a larger-than-expected decrease of 190,000 jobs while the unemployment rate increased to 10.2%. The unemployment rate was the highest since 1983 and there have now been 7.3 million jobs lost since the start of the recession. Although the pace of job losses has slowed, it appears unlikely that the unemployment rate will meaningfully decline in the near future. High unemployment calls into question the strength and durability of the economic recovery.

### HOUSING STARTS

Single-family housing starts increased 3.9% in September to 501,000, reversing August's decline. Recent data seems to confirm that the housing sector is stabilizing following the sharp decline of the past several years.

## CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.18	0.17	0.01
2-year AA corporate note	0.75	0.64	0.11
5-year AA corporate note	0.95	0.83	0.12
5-year Agency note	0.34	0.41	(0.07)

Source: Bloomberg

Data as of 10/30/09

## MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(30.71) \$Bln AUG 09	(31.85) \$Bln JUL 09	(60.91) \$Bln AUG 08
GDP	(3.5%) SEP 09	(0.7%) JUN 09	(2.70%) SEP 08
Unemployment Rate	10.20% OCT 09	9.80% SEP 09	6.60% OCT 08
Prime Rate	3.25% OCT 09	3.25% SEP 09	4.00% OCT 08
CRB Index	270.38 OCT 09	259.39 SEP 09	268.39 OCT 08
Oil (West Texas Int.)	\$77.00 OCT 09	\$70.61 SEP 09	\$67.81 OCT 08
Consumer Price Index (y/o/y)	(1.30%) SEP 09	(1.50%) AUG 09	4.90% SEP 08
Producer Price Index (y/o/y)	(4.80%) SEP 09	(4.30%) AUG 09	8.80% SEP 08
Dollar / EURO	1.47 OCT 09	1.46 SEP 09	1.27 OCT 08

Source: Bloomberg

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