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MONTHLY

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BOND MARKET UPDATE

Introduction

We last reviewed the bond markets in our March 2006 *Monthly* titled, "Update - Bonds Aren't that Bad". It was in this piece that we concluded that high quality bonds were somewhat overpriced in the longer maturities but not the disaster that many analysts predicted.

In our assessment at that time, short-term interest rates had risen to a level consistent with their risk and inflation expectations, which had been trading within a narrow band, remained consistent with our long-term views. We did however believe that longer-term US Treasury rates needed to move up modestly and that credit spreads should widen. In addition, we reviewed the role of bonds in a balanced portfolio.

Perspective

In general, although it hasn't been a smooth ride, the trend has followed our expectations. Figure 1 shows that, since the end February 2006, the interest rate on cash (Fed funds rate) rose while the yield on shorter-term Treasury notes - the 2 year note for example - moved modestly lower. In the longer maturities, e.g. 10-year note and 30-year bond, rates increased. This leaves a yield curve that is inverted in the very short end but is closer to a normal upward slope from 2-year Treasury notes on out.

Figure 1 also shows Stairway Partners' assessment of fair-value for interest rates. As you can see in the difference column, we believe that Treasury rates are still a bit below the level that we think is fair compensation for risk. This remains the case even though interest rates for the longer-term maturities have moved higher.

It is interesting to note that as recently as mid June, rates had moved to levels we believed were above fair value and attractive. For example the yield on the 10-year Treasury note closed at 5.30% on June 12th. Since that time, credit concerns in the mortgage and high yield market prompted a flight-to-quality which has pushed the yield on the 10-year Treasury back down to 4.74%.

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Figure 1: Yield Curve in Perspective

	2/28/06	7/31/07	Change	Stairway Fair Value	Difference*
Fed Funds	4.50	5.25	0.75	4.30	0.95
2-Yr Tsy	4.68	4.52	-0.16	4.57	-0.05
5-Yr Tsy	4.60	4.56	-0.04	4.75	-0.19
10-Yr Tsy	4.55	4.74	0.19	5.00	-0.26
30-Yr Tsy	4.51	4.90	0.39	5.18	-0.28

*Stairway Fair Value minus 7/31/2007 market yields

Source: Bloomberg, Stairway Partners

CURRENT TOPIC

Bond market update

STRATEGY

- *We believe US equities offer better value than their overseas counterparts, particularly emerging markets*
- *We remain underweight equity risk across portfolios*
- *Although the high yield market has been moving closer to fair value, we still maintain minimum exposure to this sector*

"THE YIELD CURVE IS INVERTED IN THE VERY SHORT END BUT IS CLOSER TO A NORMAL UPWARD SLOPE FROM 2 YEAR TREASURY NOTES ON OUT"

Bond Market Update - Cont'd

(Continued from page 1)

Valuation

As described in the January 2005 *Monthly*, interest rates are a combination of 3 components: the real short-term interest rate (cash yield less inflation), inflation expectations, and a risk premium (compensation for the risk of holding longer maturity bonds). Two of the components, the real cash rate and inflation expectations, can be derived from market yields and compared with our long-term assumptions.

Figure 2 illustrates the real cash rate over time. Since the Fed started raising rates in June 2004, the real cash rate has moved higher and now is above our long-term assumption. This is in sharp contrast to 2001-2004 when the real cash rate was negative and too low.

Inflation expectations have remained reasonably well contained and are similar to their level of a year ago (see Figure 3). The market's inflation expectations remain very close to ours.

The last component of bond valuation, which is not as easily observed, is the amount of compensation investors require for risk. This compensation is normally greater for longer-dated maturities because their returns are more volatile due to their greater sensitivity to changes in interest rates. As a result, in a normal environment long rates are higher than short rates and the yield curve is positively sloped. With the 2-year Treasury note yielding 4.57% and the 30-year Treasury bond yielding 4.95%, the yield curve has steepened and is closer to a shape and level that we consider to be normal.

Prospective Returns

Figure 4 shows our forward looking return expectations across various sectors of the fixed income market. The blue bars provide our return expectations (given current pricing), while the purple bars depict the hurdle return that represents what we consider to be fair compensation for risk. The expected re-

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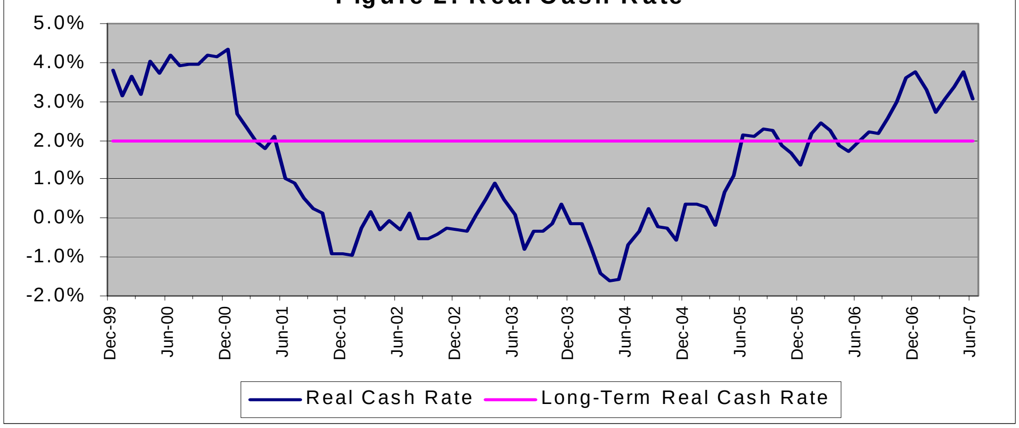

Figure 2: Real Cash Rate

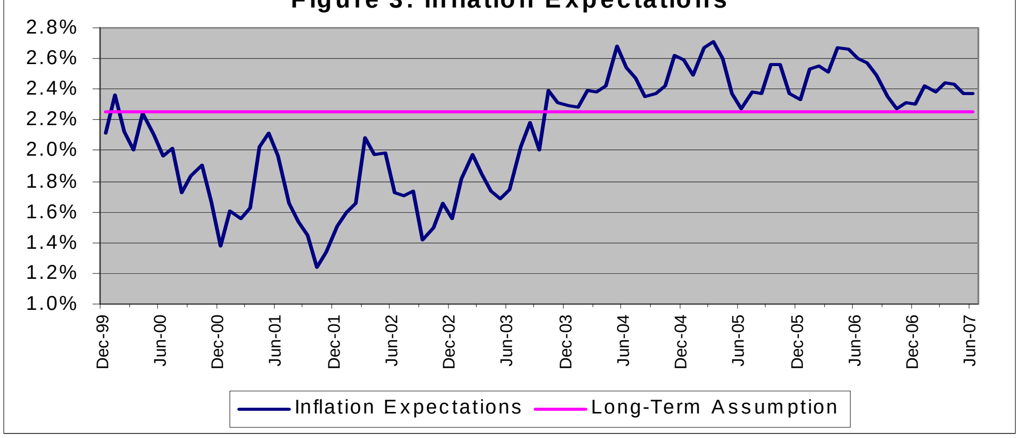

Figure 3: Inflation Expectations

"THE REAL CASH RATE HAS MOVED ABOVE OUR LONG-TERM ASSUMPTION"

*

"THE MARKET'S INFLATION EXPECTATIONS REMAIN VERY CLOSE TO OURS"

Sources: Bloomberg, Bureau of Labor Statistics, Stairway Partners

Notes: Real cash rate = 1-month Libor minus annualized 3-month change in Core CPI; Inflation Expectations = 10-year Treasury notes minus 10-year Treasury Inflation Protected Securities (TIPS)

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

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turns only match or exceed the hurdle returns in one sector: municipal bonds.

Note: For taxable investors, we have grossed-up the municipal bond returns to account for their status as exempt from Federal income tax.

High yield and emerging market bonds are also included in this analysis. As our regular readers know, we have viewed these sectors as considerably overpriced compared to their risk. Spreads, the incremental yield over less-risky Treasury bonds, have been too narrow, leaving little insufficient compensation for widening to more normal levels (Figure 5). In the last two months, spreads in the high yield market have widened considerably - just shy of 2%. As a result, high yield bonds have moved quite a bit closer to fair value.

Investment Implications

It is important to remember that bonds serve an important risk diversification role in a portfolio. With rates close to fair value we have maintained high-quality bond exposure close to benchmark in all portfolios.

Since late 2005, we have had no exposure to high yield and emerging debt due to their unfavorable risk and return prospects. We are closely monitoring the high yield market given the considerable widening of spreads and the resulting improvement in prospective returns.

"IN THE LAST TWO MONTHS, SPREADS IN THE HIGH YIELD MARKET HAVE WIDENED CONSIDERABLY. AS A RESULT, HIGH YIELD BONDS HAVE MOVED QUITE A BIT CLOSER TO FAIR VALUE."

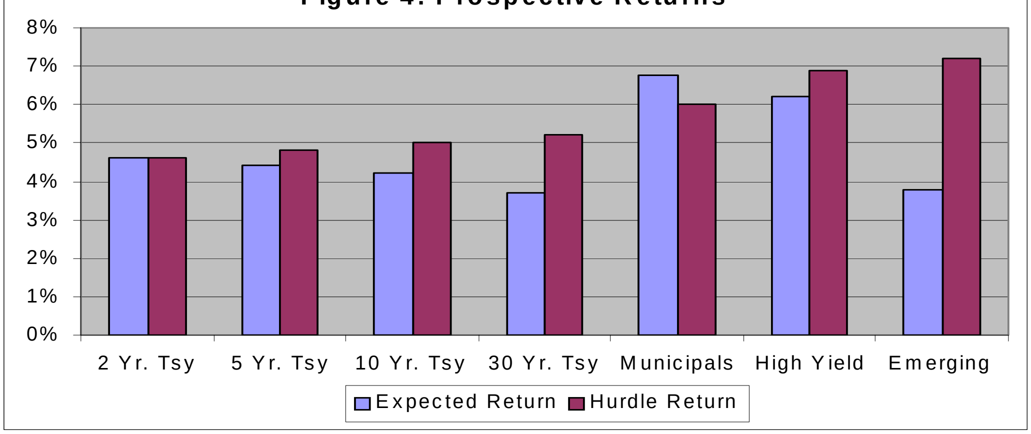

Figure 4: Prospective Returns

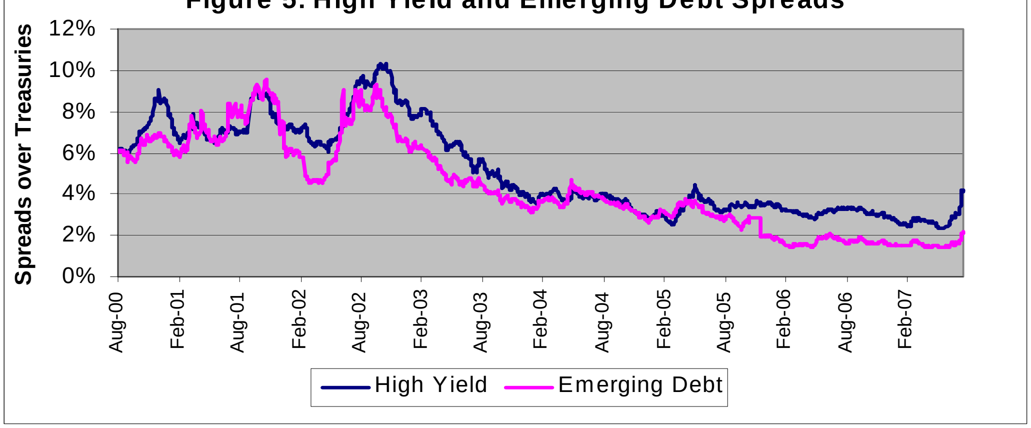

Figure 5: High Yield and Emerging Debt Spreads

Sources: Lehman Brothers, Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	4.3%	8.5%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	2.0%	7.7%		
Japan	-8.3%	4.6%		
UK	6.6%	8.9%		
Emerging	-6.0%	10.8%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is fairly priced except at longest maturities
2-Year	4.6%	4.6%		
5-Year	4.4%	4.8%		
10-Year	4.2%	5.0%		
30-Year	3.7%	5.2%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.8%	3.5%		
5-Year	4.0%	3.7%		
10-Year	4.4%	3.9%		
30-Year	6.9%	4.3%		
US High Yield	6.2%	6.9%	under	Spreads over US Treasuries have widened considerably
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	3.7%	4.7%		
Japan 10-Year	0.8%	2.1%		
UK 10-Year	4.9%	5.3%		
Emerging Markets Debt	3.8%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.7%	-3.7%	-1.9%	Euro is somewhat expensive
Japanese yen	6.0%	-2.4%	6.8%	Yen is slightly attractive
UK pound	-7.0%	-0.4%	-2.1%	Pound is somewhat expensive

Notes: **As of: July 31, 2007**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.

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