Chilton Investment Services

Weekly Update

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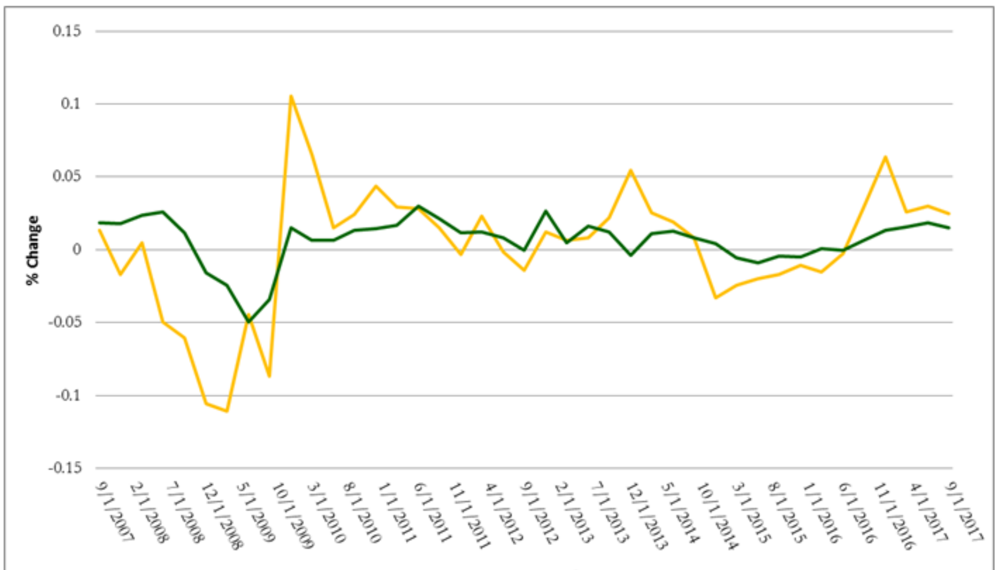
Good Outlook For Corporate Credit

In a continuation of the trend we noted last year, fundamental corporate credit conditions continue to improve though leverage remains elevated relative to historic levels. While we believe investment grade and high yield valuations are rich, given the expectation for only a gradual movement upward in interest rates in 2018, an allocation to corporate credit makes sense as it provides incremental yield cushion which should yield modest excess returns over Treasuries.

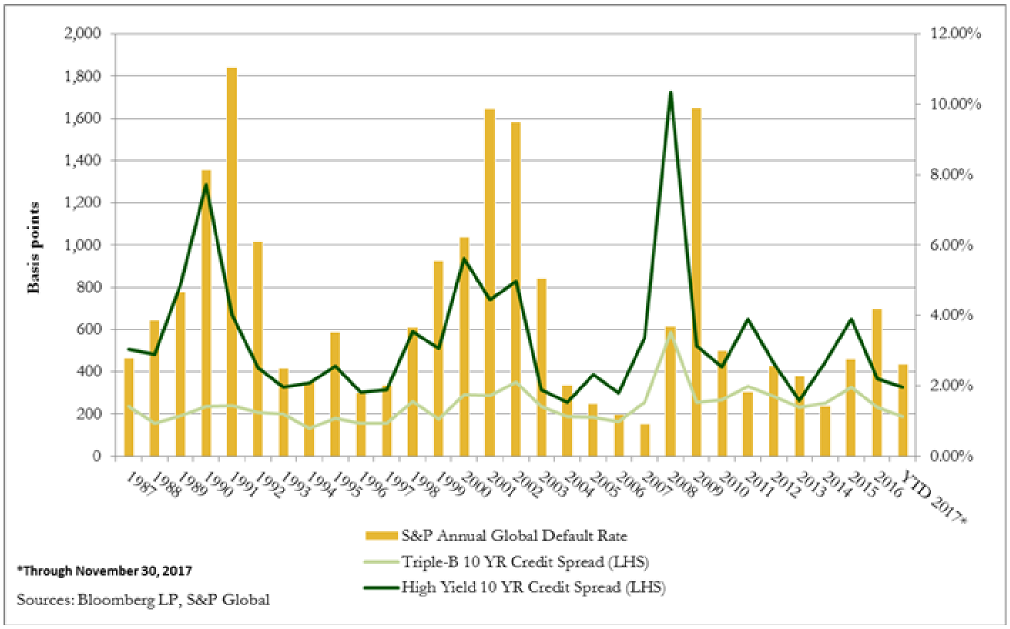
Chart 1: Corporate Sales and Profits Continue Modest Growth



Source: Bloomberg LP

Standard & Poor's reports that the US speculative-grade default rate is expected to decline to 2.7% by September 2018 from 3% at year-end 2017[i] as the energy default wave continues to recede (Chart 2). Per our update published on December 27, we expect the recently passed tax reform bill to be modestly positive for U.S. corporate credit. Leverage does remain at multi-decade highs following heavy issuance in recent years and credit quality in the corporate market has declined accordingly with approximately half of the investment grade market comprised of BBB-rated debt versus 39% in 2012. In the twelve months ended September 30, 2017, corporate financial policies showed some improvement as share buybacks fell 5.3%[ii] and balance sheet cash levels continued to rise from a recent trough in the 1st quarter of 2015. Capital expenditure growth has been modestly positive for several quarters, in no small part due to the stabilization of the energy and mining sectors. Capital market conditions remain favorable with strong global demand for US credit based on the relative yield advantage and fundamental prospects.

Chart 2: Default Rate Continues to Recover from 2016 Energy Cycle



Industry Outlooks

Our long term portfolio industry allocations are based on fundamental outlooks over a multi-year time frame while recognizing the current phase in the credit cycle for each industry. Outlooks have shifted moderately more positive to start 2018 (Table 1), reflecting the solid growth outlook.

Table 1: Industry Outlooks Increasingly Biased Positive

Positive	Neutral	Negative
Aerospace & Defense	Automotive	Drillers & Servicers (Energy)
Banking	Chemicals	Retail
Cable	Consume Products	
Capital Goods	Healthcare	
Construction	Food & Beverage	
Energy Exploration & Production	Insurance (P&C)	
Insurance (Life)	Media	
Leisure	Metals & Mining	
Midstream Energy	REIT	
	Technology	
	Telecommunication	
	Tobacco	
	Transportation	
	Utilities	

Fixed income investors have continued to favor US corporate credit, leading to spread compression across sectors over the past year (Charts 3 & 4).

Chart 3: Investment Grade- All Sectors Tightened with Banks and Metals & Mining Leading

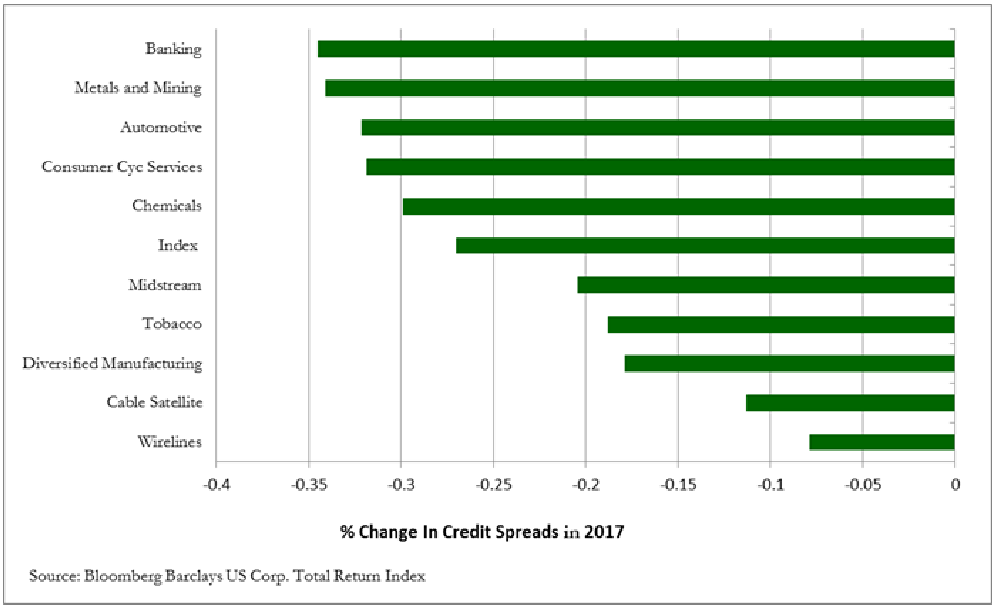
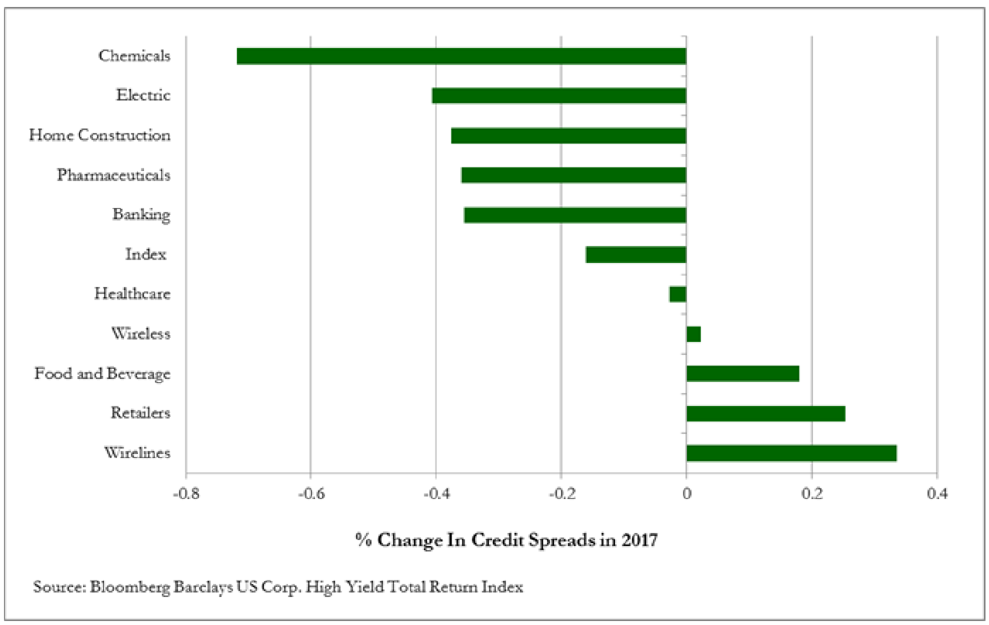
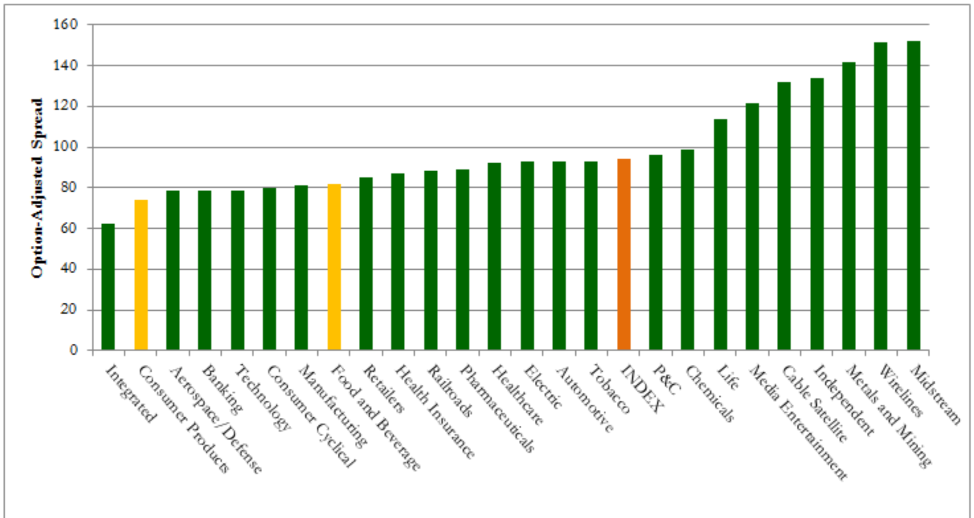


Chart 4: High Yield- Chemical Outperformed in 2017, Wirelines Underperformed



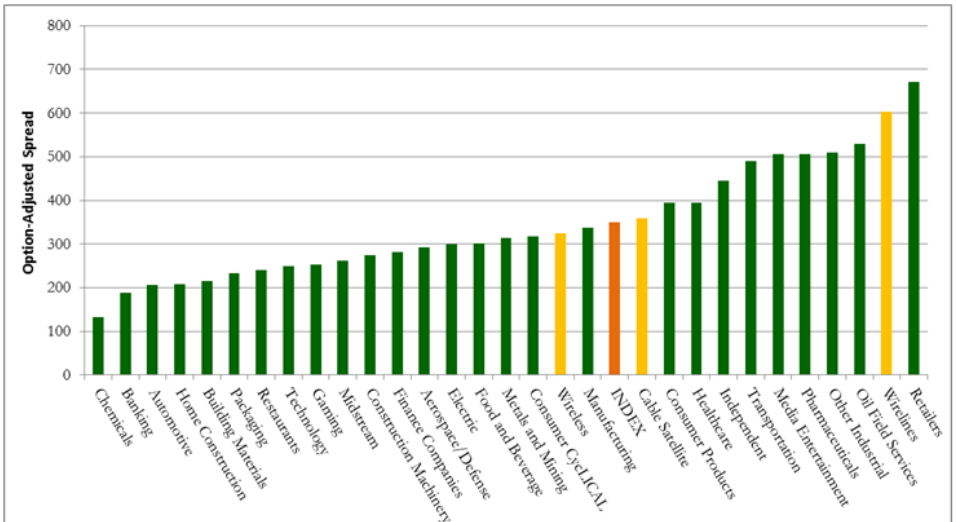
In this environment, name and security selection are increasingly important as recent outperformance has eroded yield compensation across sectors (Charts 5 & 6). Below we highlight some of the more important fundamental industry outlook changes as well as relative value investment recommendations.

Chart 5: Investment Grade Tight Trading Levels Mask Downside Risk for Consumer Non-cyclicals



Source: Bloomberg Barclay's US Corporate Total Return Index

Chart 6: High Yield- Wide Spreads on Wireline Reflects Weakening Business Position



Source: Bloomberg Barclays US Corporate High Yield Total Return Index

- Oil & gas exploration and production companies are upgraded to positive from neutral reflecting the completion of the 2015-16 default cycle, rally in oil prices since mid-2017, growing demand for US oil and LNG exports and much more disciplined capital spending policies. We are overweight the sector given spreads which remain wide of the index even despite strong performance in 2017.
- Healthcare's fundamental outlook is downgraded to neutral from positive. Pharmaceutical and distribution companies have been facing prolonged pressure from declining drug prices, particularly generics. Meanwhile, while long term consumption of healthcare is expected to remain strong, a continued focus by managed care companies and government health care plans (i.e. – Medicare, Medicaid, etc…) on outcome-based pricing has led to lower margins and weak volume growth at hospitals. Investment grade spreads are roughly in-line with the index,

warranting a neutral positioning. We expect M&A in the sector to increase over the next year as the tax reform bill requires companies to repatriate profits held overseas. High yield hospital spreads are slightly wide of the index and we believe a neutral weighting to the sector is appropriate. High yield pharmaceutical spreads are wide, almost entirely reflecting credit-specific weakness in Valeant Pharmaceuticals and Endo International. We do not currently express a view on these names.

- Telecommunication is downgraded to neutral from positive reflecting increasing industry pricing pressures. While mobile voice and data service remains highly essential, the US market is largely saturated and increasingly competitive pricing initiatives such as unlimited data have constrained revenue growth and per-user profits. In addition, cable companies are not only effectively defending their share of the broadband market, they are also encroaching on the telco's home market of wireless service via limited (for now) mobile virtual network operator (MVNO) networks. Favorably, the reversal of Title II regulation (i.e. "net neutrality") should improve pricing flexibility for internet service providers such as telecoms. Given the sector is one of the widest in the investment grade market, we recommend an Overweight position. The situation in high yield is less attractive given pressures faced by legacy wireline companies – we recommend market-weighting high yield telecom.
- Though we continue our neutral ratings of Consumer Products and Food & Beverage, we view these sectors as less attractive at current valuations. These high quality sectors trade through the index (Chart 5), offering limited compensation for elevated event risk such as large M&A transactions or more aggressive financial policy in these low-growth industries. As consumers increasingly buy online and are attracted to health-conscious foods, price transparency and competition from private label and smaller brands could pressure margins. Issuers in these sectors have strong balance sheets that provide the capacity to pursue transformative M&A. At the same time, we believe strong free cash flow characteristics would provide a means of deleveraging should any transactions come to fruition.
- Commensurate with our generally favorable fundamental view of the financial industry, we continue to see value on a relative basis in a variety of sub sectors. Specifically, we have moved the Life Insurance outlook to positive. The fundamental picture for life insurers continues to remain solid as balance sheets and risk based capital ratios remain at historically strong levels. Over the past year, low capital markets volatility, strong investment performance and the slow, albeit steady, rise in interest rates has provided a stable macroeconomic backdrop for most insurers. In addition, the partial delay of the DOL's Fiduciary Rule until 2019 could create a tailwind for variable annuity sales over the next 16 months. Investment-grade Life Insurance bonds remain attractive, trading modestly wider than the index.

	consent of CIS.

[i] " The U.S. Speculative-Grade Default Rate Decreased to 3.0% in December", S&P Global Ratings, 2 January 2018.

[ii] "S&P 500 Q3 2017 Buybacks Increase 7.5% to $129.2 Billion", S&P Dow Jones Indices, 13 December 2017