Chilton Investment Services

Quarterly Commentary

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Themes in Third Quarter 2016

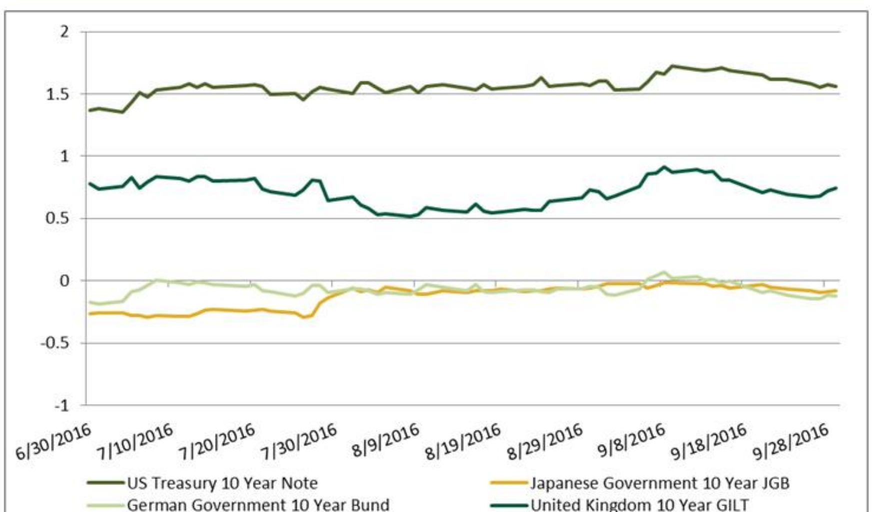
- **Tax-Advantaged Strategy**: Focused on AA and A-rated revenue bonds in sectors such as healthcare, utilities, transportation, and higher education. Maintained a neutral duration relative to the benchmark given increased long-term new issue volume, declining mutual fund flows and uncertainty surrounding Fed Policy.
- **Crossover Strategy**: Maintained overweight allocation to tax-advantaged securities due to attractive valuations versus the taxable sector.
- **Corporate Strategy:** Targeted higher-rated domestic corporate bonds with a concentration on preferred industries such as financials and healthcare. Added incremental duration on market back-ups.
- **International Strategy**: Trimmed a number of currency exposures to increase US Dollar weighting. Initiated exposure to Chinese yuan anticipating their inclusion as a reserve currency.

A more balanced US economic outlook characterized developments in the 3rd Quarter, with the Federal Reserve's FOMC voting to remain on hold at its September meeting. Led by stronger growth in consumer spending and a continued housing recovery, the US economy showed additional signs of strength including an improving labor market. Non-farm employment growth averaged close to ~200,000 during the 3rd quarter, reflecting success in accomplishing the Fed's mandate to achieve "full employment" though without a meaningful pick-up in wages. While somewhat more elusive, even the Fed's inflation target seemed to be at last poised by the end of September for lift-off, prompting three voting FOMC members to dissent.

Meanwhile, US Bond markets continued to grapple with a host of internal and external issues ranging from the US Presidential election, the consequences of Brexit, more than $10 trillion of bonds carrying negative yields, as well as a strengthening of energy and commodity prices. The conclusion for most market participants remained that the Fed is *not behind the curve**…..yet.*** But the all clear for bonds will come only when the Fed is ready to remove excessively accommodative policy, perhaps in the form of a December-post election rate hike---still to be debated and delivered by the Yellen Fed.

Against this backdrop, 10 year rates for the 3Quarter ranged as illustrated:

Chart 1: 10 Year Government Bond Yields

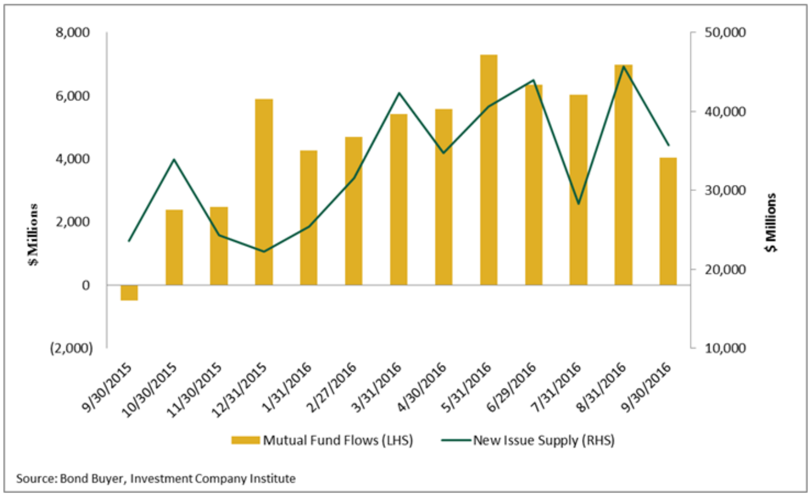


Source: Bloomberg LP

Municipal Market

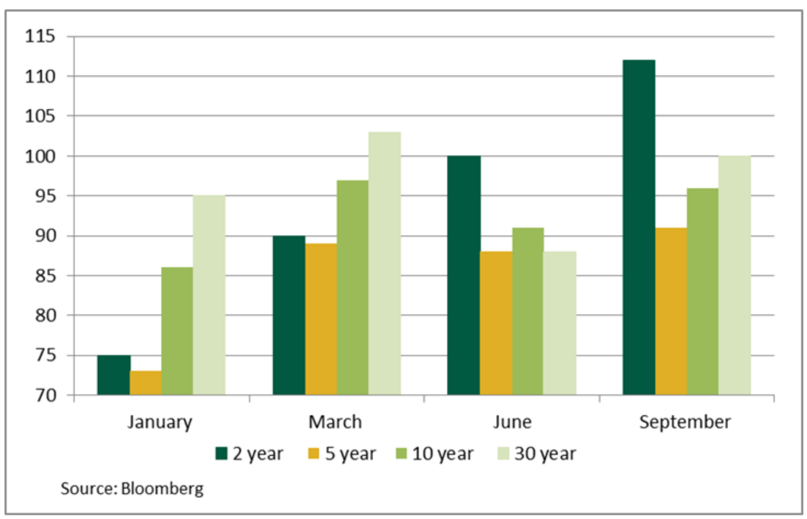
The municipal market ended the quarter on a negative note. Weakening technicals associated with declining redemptions and coupon reinvestments, changes in the regulatory environment, and an increase in new issue supply contributed to higher yields and negative total returns.

Chart 2: Municipal Mutual Fund Flows vs. New Issue Supply



According to the Bond Buyer, issuance for the quarter was $109.6 billion or 18% greater than the same period last year when issuers sold $92.6 billion. The Investment Company Institute reported data shows demand for municipal securities decreased from the highs seen in the second quarter. The combination of a reduction in net inflows and greater than anticipated new issue supply (shown in the green line in the chart Mutual Fund Flows vs. New Issue Supply) set the stage for the markets first negative total return quarter of 2016. For the quarter, yields on 1 to 4-year AAA-rated securities rose 18 to 24 basis points. Yields in the intermediate sector rose 13 to 16 basis points while yields in the long-end witnessed increases of 25 to 29 basis points (source: Bloomberg).

Chart 3: AAA-rated Municipal Yields as a percent of Treasuries



The Municipal/Treasury ratio chart above illustrates the relative performance between municipals and U.S. Treasuries over the June to September period. Municipals significantly underperformed their taxable counterparts during this period. Underperformance was most pronounced in the 2-year sector of the municipal yield curve due to implementation of money-market fund reforms which took effect in mid-October. These reforms can generally be described as simultaneously increasing money-market pricing volatility while giving money funds greater discretion to preserve liquidity and manage their credit profile. Over the quarter, 2-year AAA-rated yields increased 24 basis points while Treasury yields increased 15 basis points. As a result ratios widened 12 percentage points to comparable Treasuries.

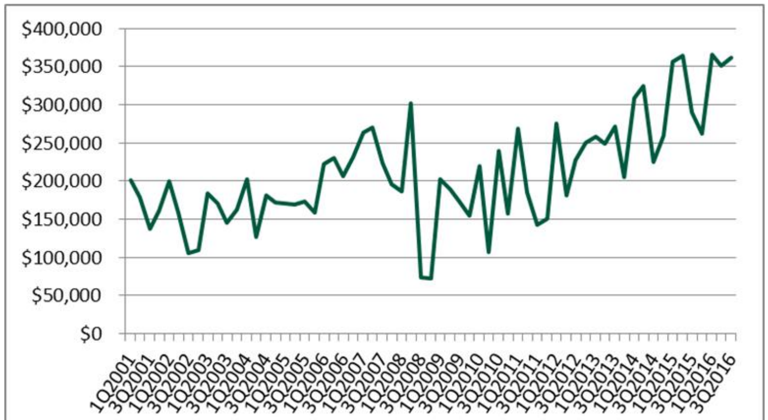
Corporate Market

The 3rd quarter ended as the 2nd went out - with a major central bank beginning a corporate securities purchase program. While the European Central Bank is one quarter into its purchase program, begun June 24th, the Bank of England began its program on Sept 27th. The BOE program is a £10 Billion, 18 month corporate asset purchase program which coincided with a cut in the policy rate to 0.25%. The changes were intended to stem the impact on the British economy from the Brexit vote by lowering borrowing rates, particularly for corporate borrowers. Meanwhile, on US shores, several Federal Reserve governors talked hawkishly ahead of the September 21st meeting which left a few economists and traders anticipating a hike. It all came to naught as the Federal Reserve passed on a hike. With the US economy seeming to move steadily along and the Fed on pause, foreign central bank asset purchases became the theme of the quarter for the corporate market. Investors abroad came looking for yield in the US and corporate spreads ended the quarter tighter (see chart 4 - below) and at the tightest quarter end level since 2Q15.

Chart 4: Investment Grade OAS Spread

In this environment the market readily absorbed heavy corporate supply (See chart 5 below) as a number of notable issuers came to market. The first and third quarter of 2016 now rank as the first and second busiest for investment grade issuance in history. Microsoft ($19.75B), Teva Pharmaceutical ($15B), and Shire Pharmaceutical ($12.1B) took advantage of an environment conducive to bond sales to debt-finance large acquisitions. Microsoft led the way with its LinkedIn purchase. Financial issuance increased as well and was particularly heavy in July and August as financial institutions continued to raise capital to meet heightened regulatory requirements and stress testing.

Chart 5: Corporate Supply



Source: Bloomberg

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