Chilton Investment Services

Quarterly Commentary

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Themes in Fourth Quarter 2016

- **Tax-Advantaged Strategy**: Focused on AA and A-rated revenue bonds in sectors such as transportation and power. Maintained a neutral duration relative to the benchmark given increased negative fund flows and uncertainty regarding future tax-reform.

- **Crossover Strategy**: Maintained an overweight allocation to tax-advantaged securities due to attractive valuations versus the taxable sector.

- **Corporate Strategy:** Maintained a neutral duration relative to the benchmark in light of Fed policy, election, and geopolitical risks. Focused on sectors such as financials, consumer staples, and industrial products.

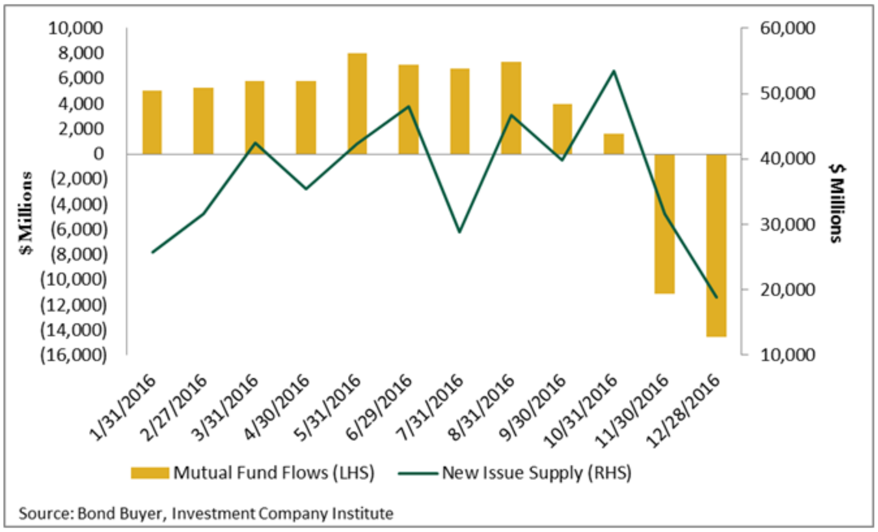
- **International Strategy**: Maintained a U.S. dollar overweight. Federal Reserve policy divergence from global central banks indicated dollar strength.

Municipal Market

The municipal market faced significant pressure in 4Q16, mostly in reaction to November's Presidential election results. Uncertainties surrounding fiscal stimulus, increased federal infrastructure spending, increased borrowing needs and the possibility of "reflation" caused significant market instability across broader fixed income markets. And specific to municipals, uncertainty regarding President-elect Trump's tax reform proposals also contributed to a rise in yields. Candidate Trump proposed consolidating individual income tax brackets from the current seven tax brackets into three, with ordinary income tax rates of 12, 25 and 33 percent. On the corporate side, Trump has proposed a steep reduction in business income taxes, from 35 to 15 percent.

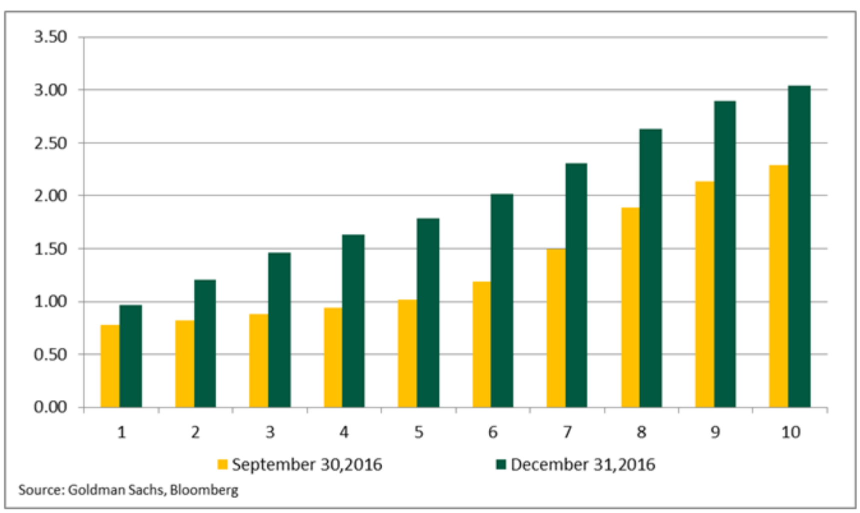
In addition to potential tax changes, the municipal market came under additional pressure in Q4 due to a significant increase in new issuance leading up to the election, along with weak fund flows contributed to market dislocation and at times a lack of price discovery. According to the Bond Buyer, new issue volume for the fourth quarter was up 21.6% with $103.9 billion of new debt issued compared with $85.5 billion from the same period last year. On the demand side, the Investment Company Institute reported that retail investors redeemed approximately $24 billion from mutual funds. The combination of net outflows and new issue supply (see Chart 1) readied the market for negative price returns in the quarter.

Chart 1: Municipal Mutual Fund Flows vs. New Issue Supply



As seen in the chart below, the municipal market experienced immense volatility with yields on AAA-rated securities rising significantly (see Chart 2). Rates in the short-end of the municipal yield curve fared better as investors remained cautious to term-structure and volatility risk, leading them to favor short duration securities as yields in the 1-2 year sector rose 19 to 39 basis points. The intermediate and long-end of the municipal yield curve experienced the most volatility with rates rising 58 to 83 basis points. According to Bloomberg, yields in the municipal market closed out the year near their highest levels in more than two years.

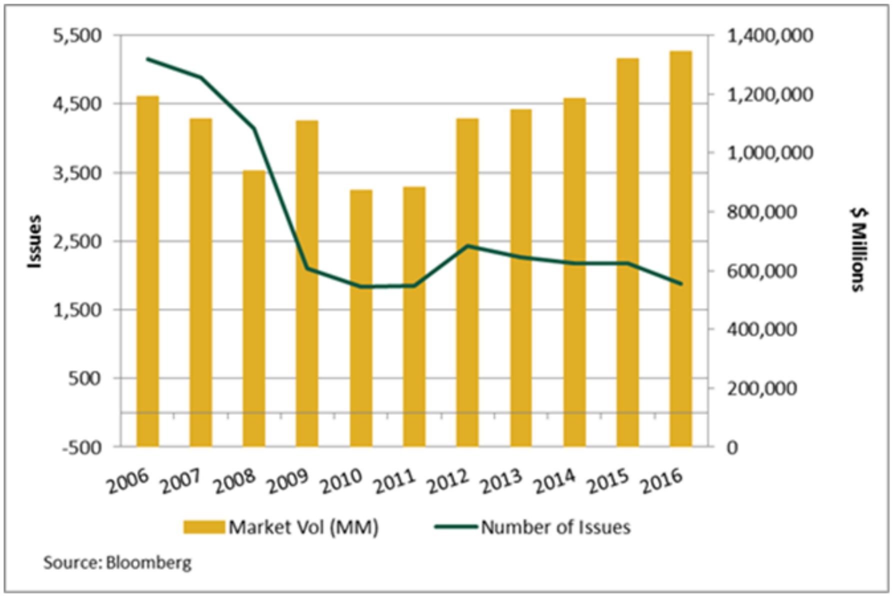
Chart 2: AAA General Obligation Yields September 2016 - December 2016



<u>Corporate Market</u>

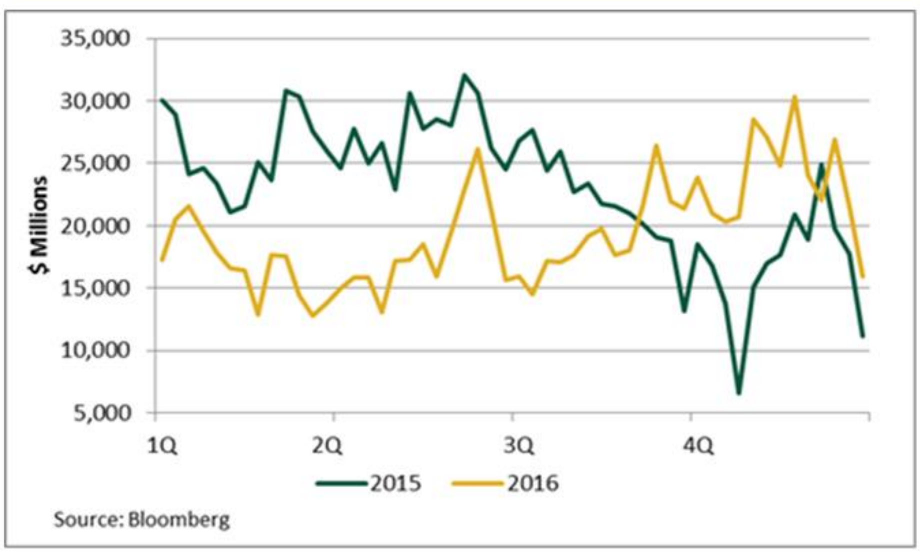
What a difference a year makes! Perhaps the best way to sum up the 4th quarter of 2016 is to compare it to the 4th quarter of 2015. Both quarters witnessed a Federal reserve rate hike and heavy corporate debt issuance. Putting the magnitude of recent corporate debt issuance into context, 2015 saw the highest corporate issuance level since the financial crisis and was immediately surpassed by 2016 issuance with both years topping $1.3 Trillion (Chart 3).

Chart 3: Investment Grade Corporate New Issuance



Additionally, in both quarters broker/dealers reduced their corporate bond inventory by ~50% (Chart 4), normally a strong negative for the market. However differences below the surface

Chart 4: Dealer Corporate Balance Sheets



created very different results. The 4Q15 broker/dealer inventory reduction was volatile and eventually became disorderly, creating a liquidity gap and widening spreads. However the 4Q16 version was a much more orderly process where bonds found ready buyers, resulting in corporate credit outperformance as can be seen in the corporate spread chart (see chart 5). The key drivers were a much more sanguine outlook for corporate credit quality, fed by steady economic growth and a relatively muted impact on funding costs of interest rate increases.

Chart 5: Investment Grade Corporate Spread

Source: Bloomberg, US Dollar Investment Grade All Cash Bonds Index

Expected GDP growth of 2.1% for 2016 is much stronger than the 2015 figure of 0.9% and the economic outlook and sentiment is considerably stronger than witnessed a year ago with the stabilization of the commodity markets. Additionally, funding conditions have remained accommodative despite the first Federal Reserve interest rate hikes since 2006. Through the 4th quarter of 2016, 3-month Libor reached a 7 year high, hovering just below 1.00%. This was driven by both increased money market regulation and expected future rate hikes. This funding pressure would conceivably be negative to corporate spreads though the market has thus far adjusted with very little impact. However, these increases bear watching as they percolate though the system and could impact the economy in various tangible ways such as borrowers' credit card and car loan rates. Conversely, higher lending rates would ordinarily be positive for financial institutions and are expected to help banks offset the costs of higher short term funding rates. However, for broker dealers, dependent on short term funding to hold corporates in inventory it is an added pressure on the corporate market that bears watching in the short term.