Chilton Investment Services

Quarterly Commentary

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Themes in the Second Quarter 2018

Throughout the 2nd Quarter the US economy continued to demonstrate strength, driven both by investment and by deregulation. With business and consumer confidence accelerating, the US economy continued to benefit from job growth and limited pick-up in inflation (charts 1 & 2).

Chart 1: Bloomberg Consumer Comfort Index

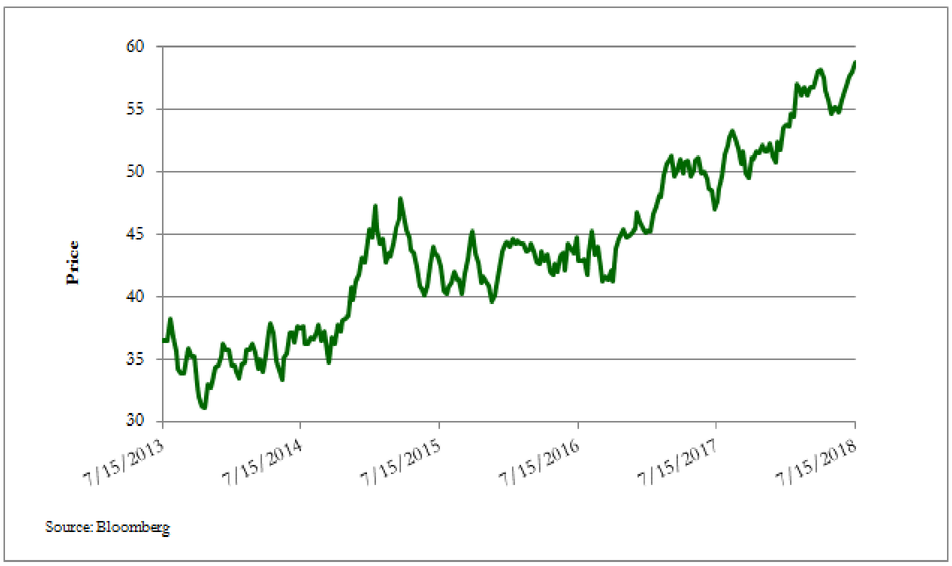
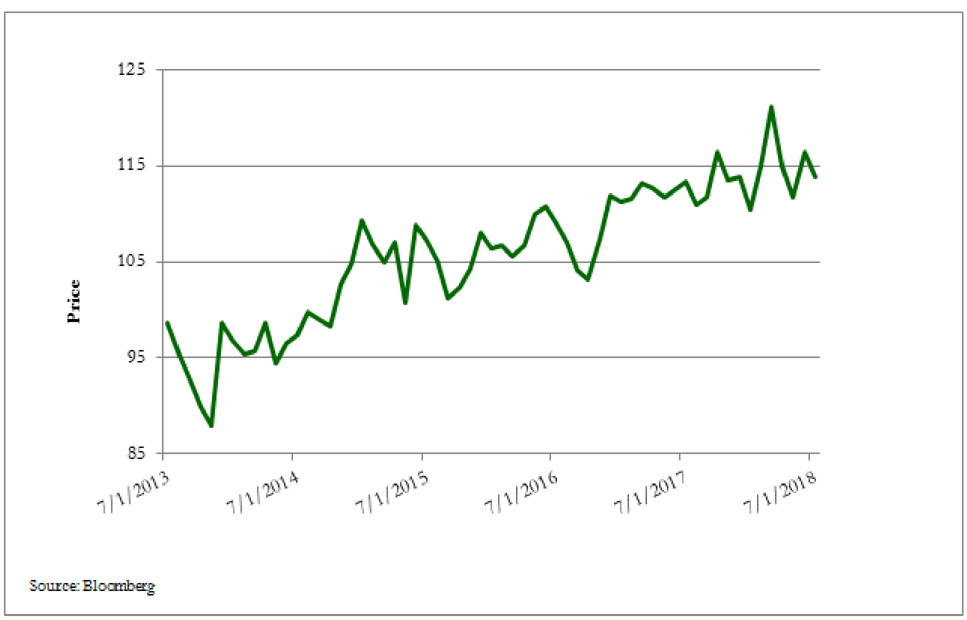


Chart 2: University of Michigan Current Economic Condition Index



Throughout the Quarter, the Federal Reserve stuck to its game play for transparency, following through in June with a well-telegraphed Federal Funds hike of 25 basis points in keeping with its assessment of current conditions which demonstrated robust economic strength, together with its expectations for meeting its intermediate inflation objective. The result in the bond market was a further flattening of the yield curve. This is typical when the Fed tightens. The problem is that this normalization process – coming from the zero interest rate level of the crisis of '08 – is anything but typical.

Looking forward, the debate will continue as to whether the US economy still needs more rate hikes or whether the Fed should slow or even stop its reduction of its balance sheet. Our Chilton FI central case remains for two more hikes in 2018 (September and December). We continue to see a strong employment market and upward price pressures to which the Fed should want to respond. The strength of the USD may provide some relief on the import price-side of the economy – albeit with a natural lag – but it would not be sufficient to derail the primary goal of normalizing rates at this moment of economic "lift-off".

Chilton Strategies Outlook

- **Municipal Strategy:** Due to ongoing normalization of rates by the Federal Reserve and strong municipal market technicals, we focused on both the new-issue and secondary markets to maintain a neutral duration relative to the benchmark. We strategically focused new purchases on A and AA-rated revenue bonds in the hospital, utility and higher education sectors.
- **Crossover Municipal Strategy**: We continue to maintain an overweight to the Municipal sector as expectations for Mergers and Acquisitions could cause corporate spreads to widen. We tactically added AA and A-rated municipal revenue bonds inside of 6 years to maintain a neutral duration relative to the benchmark.
- **Taxable Strategy:** Due to the ongoing normalization of interest rates, corporate yields continued to drift higher. We utilized the primary and secondary markets to maintain a neutral duration versus the given benchmarks. Yields at the highest level since early 2016 provided an attractive entry point. We focused on adding sectors that temporarily cheapened due to merger related issuance such as telecom and consumer staples.

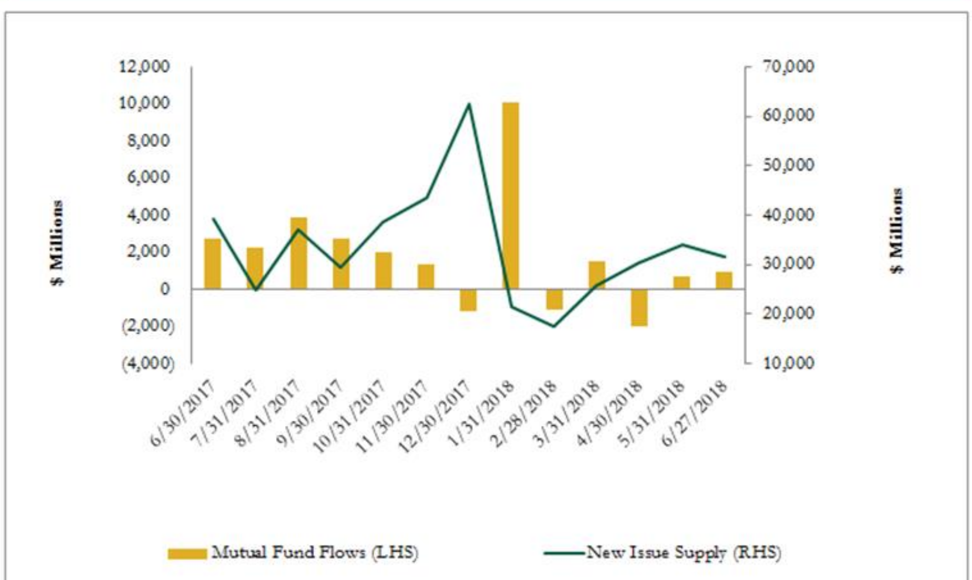
- **Global Strategy:** Global growth has remained adequate and we have largely maintained both a diversified basket of non-USD positions and a base of USD Treasuries. We have continued to underweight currencies that have negative carry in government bonds due to central bank intervention, such as Swiss Frank., Japanese Yen, and the Euro. With escalating tensions with China over a potential trade war we exited Chinse Yuan positions at an attractive time. While we don't believe China will "weaponize" the Yuan with devaluation, China appears to be pursuing looser monetary policy while the Federal Reserve has continued to move rates higher. This mismatch in monetary policy may put pressure on the Yuan in the near future.

Municipal Market

According to the Bond Buyer, new issue volume for the quarter was down 11.6%, with $96.1 billion of new debt for the second quarter, compared with $108.7 billion from the same period last year. Despite the dearth of new issue supply, the municipal market continued to face significant pressures due to factors such as waning retail demand, stronger than expected domestic economic data, a volatile macro environment, global trade tensions, and expectations of a tighter monetary policy.

As seen in the chart 3, investors remained slightly cautious. As reported by the Investment Company Institute, retail investors redeemed approximately $239 billion from mutual funds with April witnessing the majority of the outflows. The combination of negative fund flows and market volatility contributed to negative price returns in the quarter.

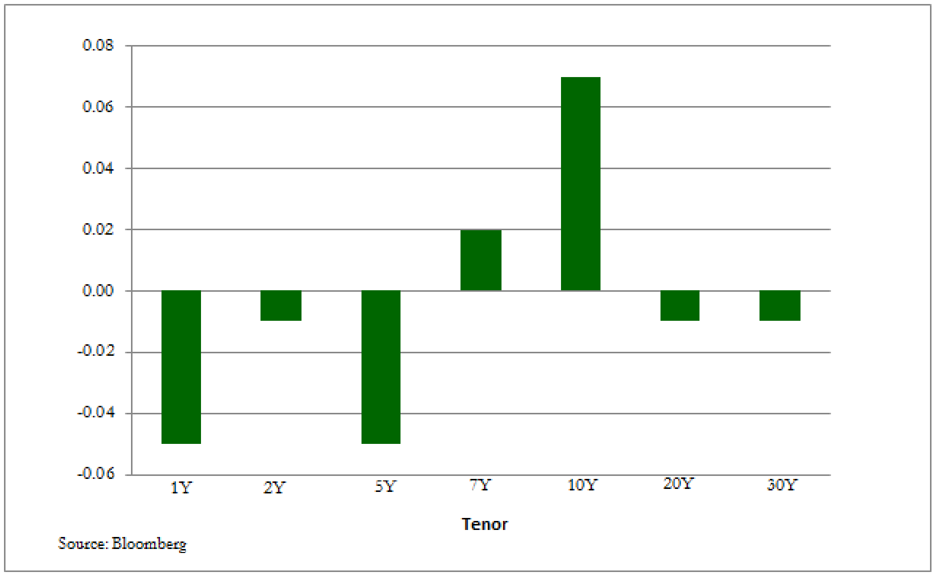
Chart 3: Municipal Mutual Fund Flows vs. New Issue Supply



Source: Bond Buyer, Investment Company Institute

While total returns were mixed across the municipal yield curve, staying short paid off for investors in the second quarter. As seen in chart 4, short duration municipals protected investors from rising interest rates. Yields in the 1 to 5-year sector declined approximately 1 to 5 basis points while the yields in 7 to 10-years increased 2 to 4 basis points. The municipal curve modestly steepened throughout the quarter as the short-end outperformed the intermediate and long-dated securities. The spread between 1 and 30-year securities widened 7 basis points from 138 basis points in March to 145 basis points, month-end June.

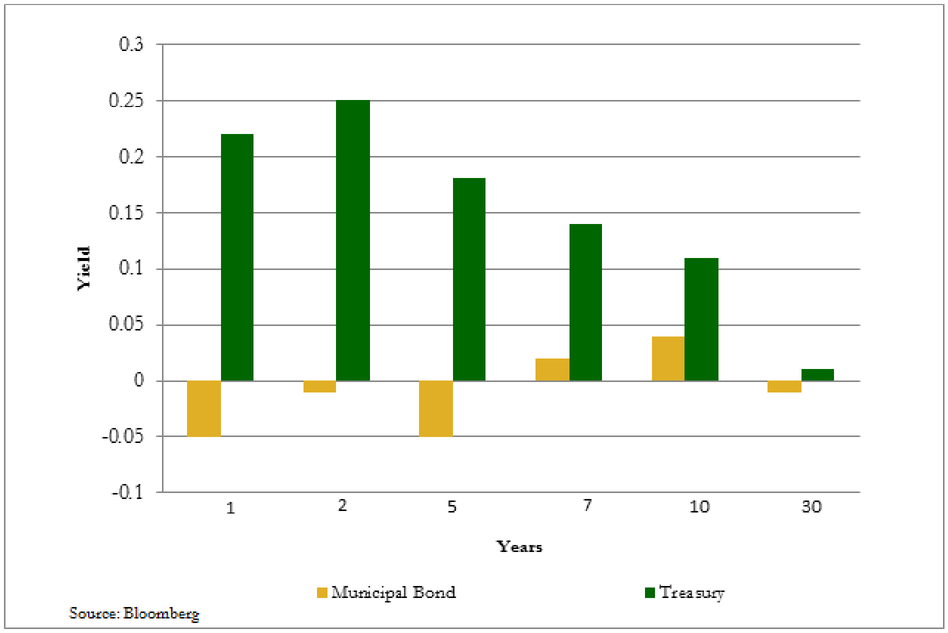
Chart 4: Municipal Yield Changes March 2018-June 2018



The Municipal/Treasury yield comparison illustrates the relative performance between municipals and US Treasuries over the March 2018 to June 2018 period. As depicted in chart 5, the municipal sector closed the quarter with significant outperformance relative to its US Treasury counterpart.

By the end of the second quarter, the 1, 2 and 5-year maturities were the best performing sectors on the municipal yield curve. For example, the 2-year sector experienced 7 percentage points of tightening as AAA-rated municipal yields were unchanged and 2-year US Treasury yields increased 32 basis points. In the 5-year sector, US Treasury levels over this time period rose from 2.56% to 2.75%. The equivalent municipal levels were 2.04% and 1.99%, respectively, causing the Municipal/Treasury ratio to compress 5 percentage points. Overall, the 1, 2 and 5-year municipal ratios appear rich relative to comparable US Treasuries.

Chart 5: MMD Curve vs. US Treasuries



Corporate Market

Corporate securities found a measure of stability in the second quarter. Continued economic growth and solid corporate earnings were beneficial to corporate spreads but trade war fears and large investment grade supply were drags. As can be seen in the chart below, investment grade corporate spreads widened for a second quarter. However, many investment grade indices' total return numbers were more mixed this quarter, aided by more stable US Treasury yields and higher starting yields, which offset the spread widening.

Chart 6: Investment Grade Corporate Spread

	Investment grade spreads were pressured by heavy supply as issuers issued debt for a combination of reasons, including (i) to get ahead of expected higher rates in the future, (ii) to finance acquisitions, or (iii) to finance other capital and/or expansion plans. Walmart and Bayer led issuance with deals of $15 billion or larger. General Mills and Keurig Snapple were other notable issuers this quarter. To highlight that the spread widening in investment grade was due to issuance and not credit concerns within the marketplace, the BBB ratings group where much of the recent issuance was focused was the worst performing corporate cohort, losing -1.2%. The lowest rated corporates B and C rated bonds, returned 1.52% and 3.58%, respectively according to the ICE Corporate indices.