Chilton Investment Services
Weekly Update
February 12th, 2018

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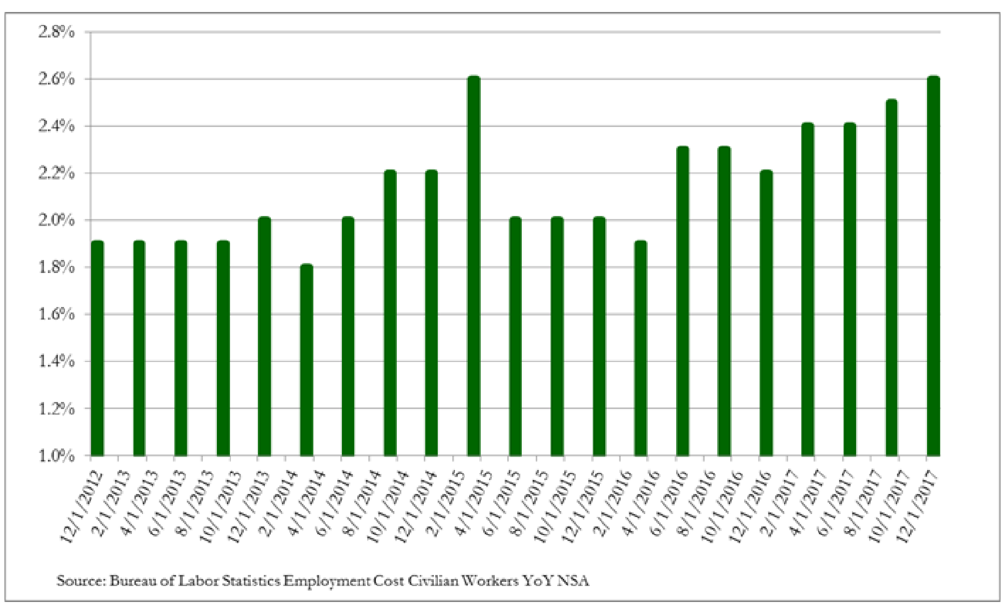
Interest Rate Risk In Focus As Equity Market Swoons

As the stock market officially enters a "correction" (S&P 500 is down 11% since January 26), several long-nascent bond market concerns have begun to manifest, albeit to a degree that is currently moderate and manageable.

1. Inflation concerns surface with the most recent indication being a 2.6% increase in the Employment Cost Index, continuing a steady, multi-year increase (Chart 1). However, broad-based pricing trends remain well-contained. For example, core Personal Consumption Expenditures registered just a 1.5% increase in the 4th quarter of 2017.

Chart 1: Employment Cost (% Change YoY)



2. Federal fiscal deficit is expanding significantly, due in part to passage of the Tax Cuts & Jobs Act. The Congressional Budget Office projects the U.S. budget deficit will increase by $1.5 trillion over the next 10 years, declining to an

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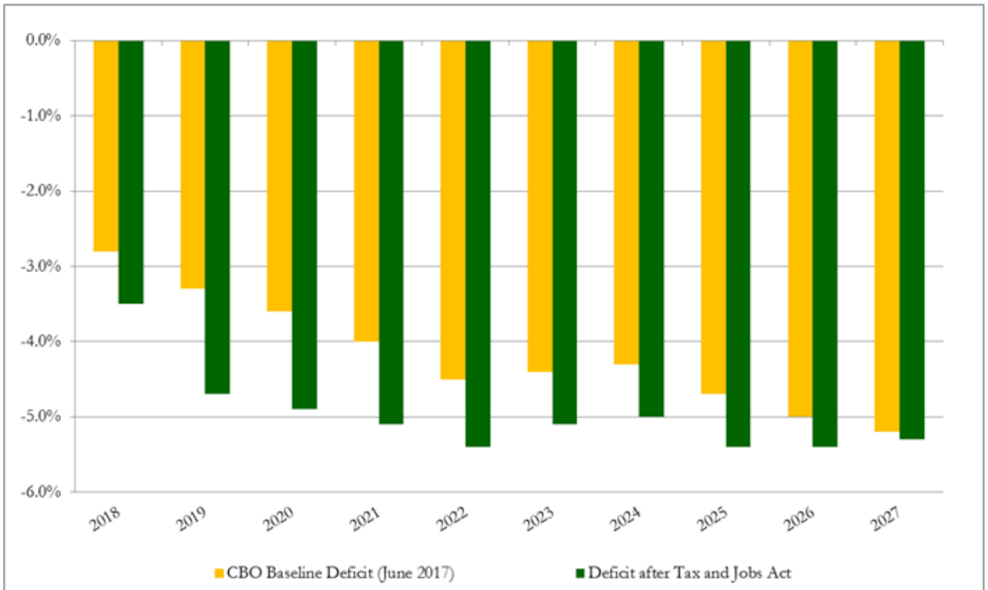
estimated -5.3% of GDP in 2027 versus -3.4% currently[i] (Chart 2).

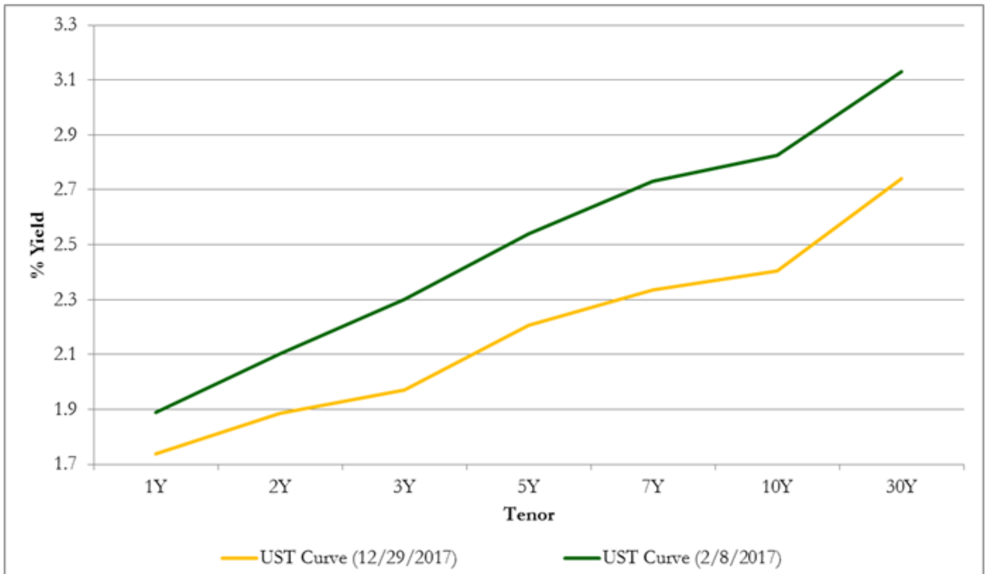
Chart 2: Federal Budget Deficit (% GDP)



Source: Congressional Budget Office

3. Fixed income yield curves have steepened year-to-date (Chart 3) with the 10 year U.S. Treasury note rising over 40 basis points (to current 2.83% yield) and the 30 year bond up 34 basis points (3.15% yield). Meanwhile the 2 year Treasury has increased just 22 basis points (2.09%), indicating a relative shift in market concern toward longer term issues like inflation and deficits versus short-term dynamics related to the Federal Reserve's interest rate tightening cycle. The same steepening dynamic has been witnessed in the municipal bond market as well.

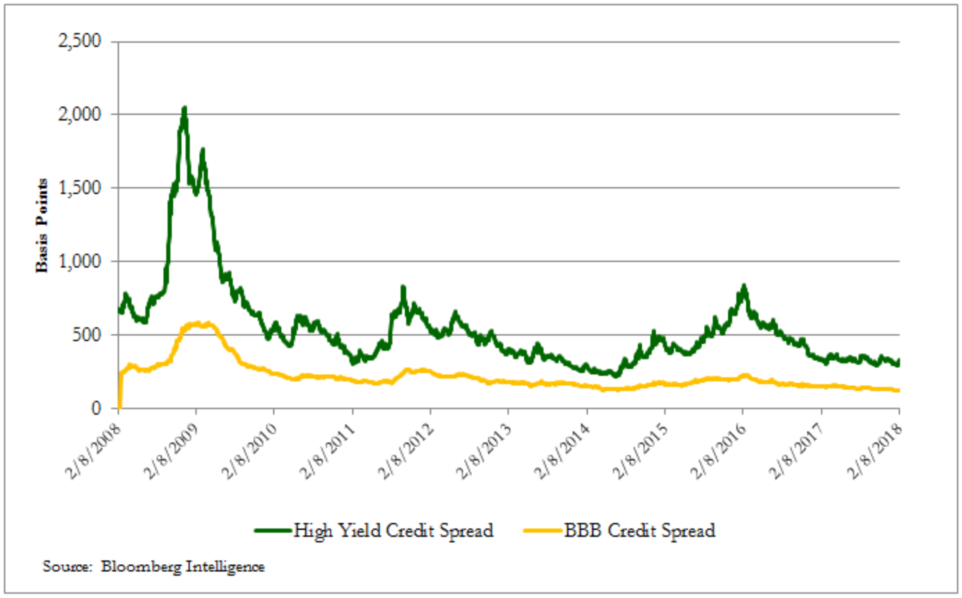
Chart 3: U.S. Treasury Curves Steepening



Source: Bloomberg LP

4. Credit conditions however, remain sound. Credit spreads have widened modestly in the past week, in sympathy with the equity market sell-off. However, as outlined in our [market update dated January 15, 2018](), corporate credit fundamentals remain solid. Global economic activity remains strong with the JP Morgan Global Manufacturing PMI Index at close to a 7-year high[ii]. Even with the recent spread widening, investment grade and high yield credit spreads are at multi-year tights (Chart 4) and market conditions remain healthy.

Chart 4: Credit Markets Remain Sound



In short, we expect market volatility to pick up in the near term but we do not believe we are entering a more disruptive market cycle. Interest rate risk is increasingly in-focus, an expectation long anticipated by the market as the economy strengthened and the Federal Reserve normalized monetary policy. Thus far, it appears to represent a healthy repricing with interest rates remaining historically low and relative value for U.S. taxable bond markets possibly enhanced in relation to lower-yielding bond markets in Europe and Japan. The municipal bond market faces a temporary weakness in demand as the tax reform bill reduced the incentive for banks and property & casualty insurance companies to hold municipal bonds. Both have been reducing municipal bond holdings year-to-date.

[i] "Estimated Deficits and Debt Under the Conference Agreement of H.R. 1…", Congressional Budget Office, January 2, 2018; https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/53437-wydenltr.pdf

[ii] "Global Manufacturing Growth Remains Solid At Start Of 2018", J.P. Morgan Global Manufacturing PMI, February 1st, 2018; https://www.markiteconomics.com/Survey/PressRelease.mvc/cfe31b1e1f424d4ba54db08af4f30a36