Chilton Investment Services

Quarterly Commentary

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Themes in Second Quarter 2016

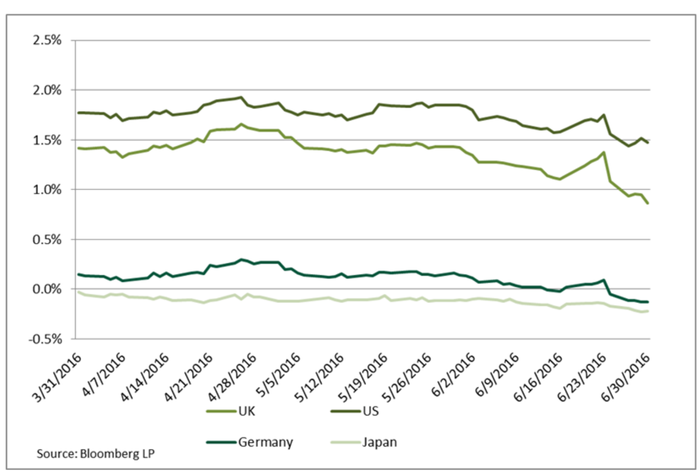
- Tax-Advantaged Strategy: Continued to focus on A-rated revenue bonds in sectors such as transportation, water and sewer, and higher education. Extended duration across accounts given strong technical factors and in anticipation of a flatter yield curve in the second quarter.
- Crossover Strategy: Maintained our overweight allocation to tax-advantaged securities reflecting improved valuations relative to the corporate sector.
- Corporate Strategy: Focused on higher-rated domestic corporate bonds with a concentration on preferred industries such as healthcare and aerospace / defense. Continued to add incremental duration.
- International Strategy: Maintained elevated exposure to US Dollar while adding incremental exposure to the Polish Zloty and Swedish Krona.

Introduction

Moderate US economic growth - together with global consequences of the United Kingdom's referendum on its continuing membership in the European Union (BREXIT) – kept the US Federal Reserve on hold at its June meeting. Following the release of a dramatically weaker May Non-Farm Payroll number on 3 June - with the US adding only 38,000 jobs for the month versus an expectation of 161,000 jobs - US growth concerns escalated. Despite the unemployment rate falling to 4.9%, overall growth throughout the second quarter remained very tepid, with industrial production for the quarter modestly negative. With the US manufacturing sector already under strain from the strength of the US dollar over the past 24 months, headwinds continued to build as reflected in the IMF's downward revision of its US growth forecast. Consumer activity however remained a brighter spot with confidence reaching an index reading of 98 in June, the highest reading since October 2015. Lower energy prices and a better housing market, together with a firm jobs picture (despite moderate wage growth), had given the consumer some additional momentum.

Throughout the 2nd quarter global yields remained under pressure, moving lower as investors increasingly sought safety in government bond markets, magnified by the relative lack of high quality bond supply. By June, the US Treasury market had become the destination for significant inflow from foreign buyers including central banks, pension funds, and insurance companies. The June 8th US Treasury 10 year Note auction had a significant foreign bid that pushed the yield to 1.70%, the lowest since December 2012.

Chart 1: Global Bond Yields Plunge Post-Brexit



Source: Bloomberg LP

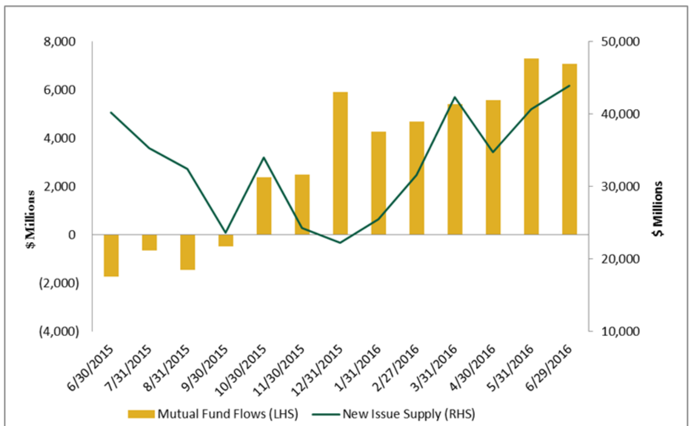
But it was the BREXIT referendum outcome—British voters decision to leave the EU—that tipped the balance. 10 year bond yields collapsed with German Bunds reaching a low of -0.203%, UK Gilts hitting 0.706%, Japanese government bonds reaching -0.293% and the US Treasury yield touching 1.3%. Global bonds investors have driven yields to unprecedented valuations in the wake of continued uncertainty about the economic and political direction of Europe and the broader implications for global growth.

Municipal Market

The municipal market continued to exhibit solid performance in 2Q2016. The major factor that contributed to an overall rally in the fixed income markets was the surprise June 23rd result of the British vote to exit the European Union. The outcome of "Brexit" caused an aversion to risk assets and a flight to quality trade into US Treasuries. Global rates plunged as investors believed that central bankers would keep rates on hold or even lower interest rates. In addition, according to Fed Fund Futures the likelihood of an increase by the Federal Reserve to raise short-term interest rates was pushed out to 2017.

Investor demand for municipal securities remained positive throughout the quarter. A combination of net inflows and moderate new issue supply (see Chart 2) readied the market for a positive quarter. According to the Bond Buyer, issuance for the quarter was \$119.2 billion, a mere 0.8% increase than the same period last year when issuers sold \$118.2billion. As reported by the Investment Company Institute, retail investors contributed approximately \$19.9 billion to mutual funds in 2Q2016.

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



Source: Bond Buyer, Investment Company Institute

The result of declining US Treasury yields spilled over into the municipal market. Along with strong municipal market technical factors and global growth concerns, municipal yields declined. As shown in Chart 3, yields in the short-end of the yield curve fell 3 to 18 basis points with the strongest performance coming in the 10 to 30-year sectors with yields declining 35 to 67 basis points. Interestingly, the majority of the decline in 30-year AAA-municipal yields took place after the June "Brexit" vote with yields declining 43 basis points from month-end May to month-end June as investors. Thus, the spread between 1 and 30-year securities tightened 64 basis points from 214 basis points in March to 150, month-end June.

Chart 3: AAA General Obligation Yields March 2016-June 2016

	1 Year	5 Year	10 Year	20 Year	30 Year
March	0.55	1.07	1.70	2.44	2.69
April	0.56	0.98	1.61	2.34	2.58
May	0.58	1.09	1.66	2.25	2.45
June	0.52	0.89	1.35	1.89	2.02
Change	**-0.03**	**-0.18**	**-0.35**	**-0.55**	**-0.67**

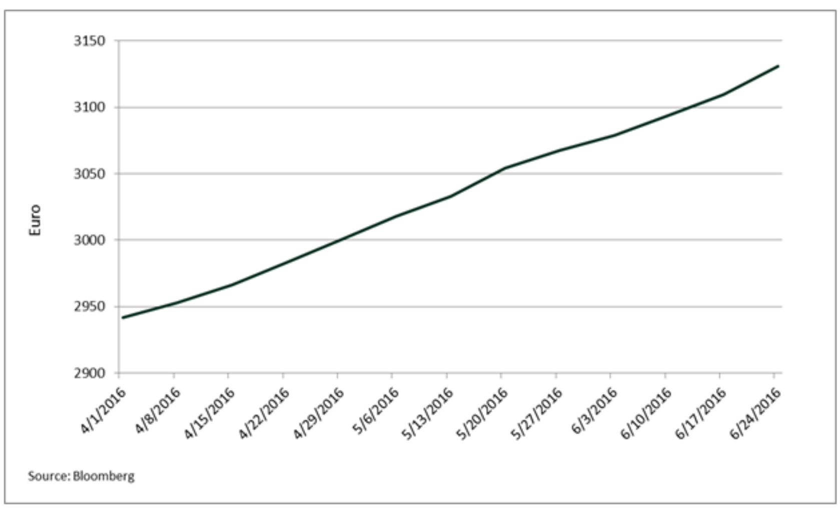
Source: Goldman Sachs, Bloomberg

Corporate Market

Chart 4: IG OAS Spread

The Corporate Market continued to perform well in the second quarter, with spreads continuing to grind tighter (chart 4) despite a number of headwinds such as significant supply expected from merger activity, still slow economic growth, and heightened uncertainty from the Brexit Vote. Outweighing those risks was a continued global search for yield. Many Central Banks around the world are continuing to perform some form of Quantitative Easing, most notably the European Central Bank which embarked on its program of Open Market Purchases of corporate securities. Abbreviated as the CSPP, the program is soaking up EUR 500m of corporate bonds per day. EUR 4.9 Billion was held by June 24 according to an ECB filing and added to a growing ECB balance sheet (Chart 5).

Chart 5: ECB Balance Sheet



European investors looking to replace bonds sold to the ECB are piling into the USD corporate market and even the adverse result on the Brexit vote has not stopped the binge. Following the vote, corporate bond trading seemed to come to a standstill as Treasury yields plummeted in the uncertain environment. However, the pause lasted all of one day as investors assessed the situation and realized that continued Central Bank stimulus and a "Lower for Longer" environment provides considerable cover for credit investors.

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