Chilton Investment Services
Quarterly Commentary
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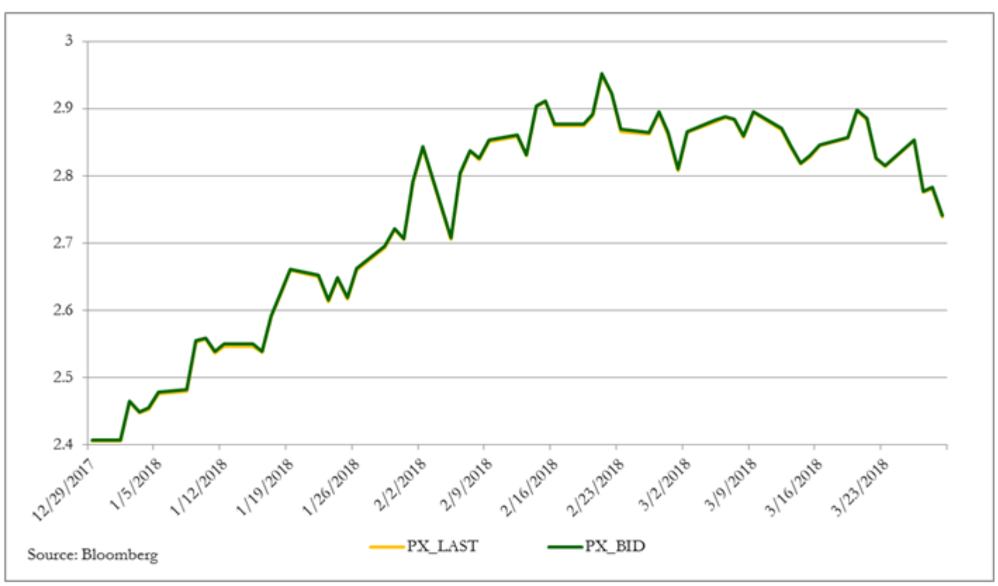
Themes in the First Quarter 2018

The first quarter of 2018 began with evidence of synchronized global growth in developed and emerging economies. Benefiting from the European Central Bank's (ECB) multi-year quantitative easing efforts, European economic performance in particular was a surprising standout, complementing GDP growth close to 3% in the US and slightly better growth in Japan. This raised expectations for a synchronized and stronger Q1 GDP performance across global economies.

The first quarter witnessed the successful transition of Federal Reserve leadership from Chair Janet Yellen to new Chair Jerome Powell. With the US economy "running hot" at full employment and with upward pressures on inflation emerging in wages and commodity prices, the stage was set for Powell to preside over the Fed's most recent increase in the federal funds target rate by 25 basis points at the March meeting. In addition, Federal budget deficit expectations increased with passage of the Tax Cut and Jobs Act of 2017 as well as the Federal spending plan for fiscal 2018. These factors prompted fixed income markets to reprice higher by quarter end as evidenced by the US Treasury 10 Year (chart 1).

Chart 1: US Treasury 10-Yield Yields (December 2017-March 2018)



Questions remain as to why the US Treasury yield curve has demonstrated a continuing tendency to flatten. Higher US Treasury yields should begin to attract longer-term buyers, especially when compared to other global market yields. During the quarter, there was some evidence of increased foreign demand for Treasuries, particularly from China, which may have helped to contribute to the flattening. Demand from traditional institutional buyers such as insurance companies and pension funds also likely contributed. While some have suggested that the flattening is a harbinger of a recession, we believe it is too soon to reach that conclusion.

As we look forward for the balance of year, we expect that the Federal Reserve will continue to normalize rates at the June, September and December meetings. We also look for the US Treasury yield curve to maintain a modest positive slope upward, suggesting that the US economy will continue to grow moderately, benefiting from tax cut driven investment, some infrastructure spending and continued strong domestic demand.

Chilton Strategies Outlook

- **Tax-Advantaged Strategy:** Due to ongoing normalization of rates by the Federal Reserve, we utilized both the primary and secondary markets to maintain benchmark neutral duration. We focused on A and AA-rated issuers in sectors such as transportation, hospital, higher education and toll-roads.
- **Crossover Strategy**: We maintained our overweight to the Municipal sector as corporate bond valuations widened due to short-end funding pressures in the taxable markets. We tactically added AA-rated municipal revenue bonds inside of 5 years in an effort to maintain a neutral duration relative to the benchmark.
- **Corporate Strategy:** Investment grade (IG) corporate credit underperformed for the first time in eight quarters, with credit spreads demonstrating a positive correlation to higher interest rates in contrast to market expectation. Credit spread widening was driven by concerns over trade policy, lower demand (or the expectation of lower demand) from US companies with overseas cash holdings, and a slowing in foreign demand due to rising USD hedging costs. The combination of higher rates and wider spreads was felt most dramatically at the short end of the IG curve which saw yields rise by 50+ basis points. Longer maturities rose in the range of 35-40 basis points. We utilized both primary and secondary markets to modestly adjust duration and remain neutral to the benchmark.

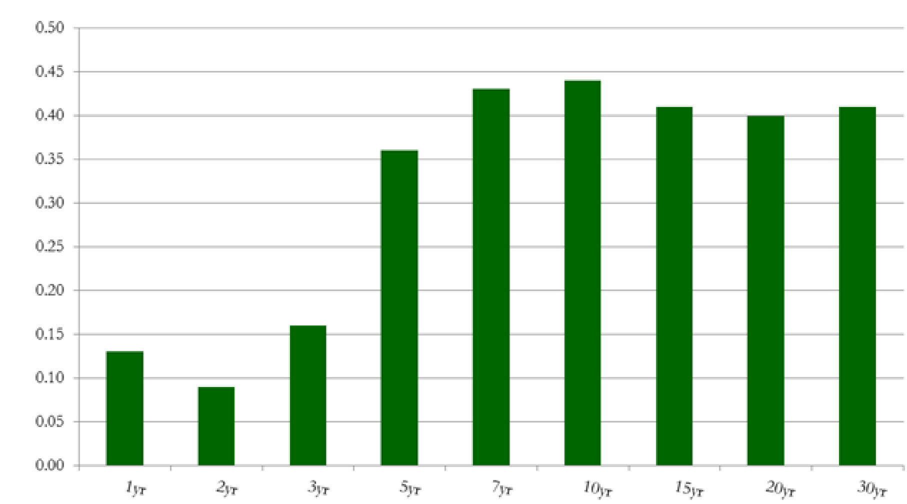
- **International Strategy:** With the ongoing theme of coordinated global growth, we saw opportunity to continue to add to our diversified basket of non-U.S. dollar positions. This included positions in the Philippine Peso, Russian Ruble, and Malaysian Ringgit.

Municipal Market

As seen in chart 2 below, the municipal market experienced immense volatility across the yield curve driven by instability in the US Treasury and equity markets as well as stronger than expected domestic and global economic data. In addition to the improving economy, the investor community focused their attention on Federal Reserve interest rate "normalization" process with consensus expecting at least 3 federal funds rate hikes in calendar year 2018. The first of these was made at the March 21st Federal Open Market Committee (FOMC) meeting.

Despite expected strong municipal market technical factors due to the "January Effect" (a combination of heavy bond calls/redemptions and limited long-term supply) municipal yields nevertheless rose across the curve. Rates in the short-end fared better as investors remained cautious to term-structure and duration risk leading them to favor short duration securities. For the quarter, yields on 1 to 3 year AAA-rated securities rose 9 to 13 basis points. The intermediate and long-term sectors of the curve underperformed with yields increasing 36 to 44 basis points. As a result, the yield curve reversed its flattening trend. The spread between 1 and 30-year securities widened 25 basis points from 113 basis points in December 2017 to 138 basis points, month-end March.

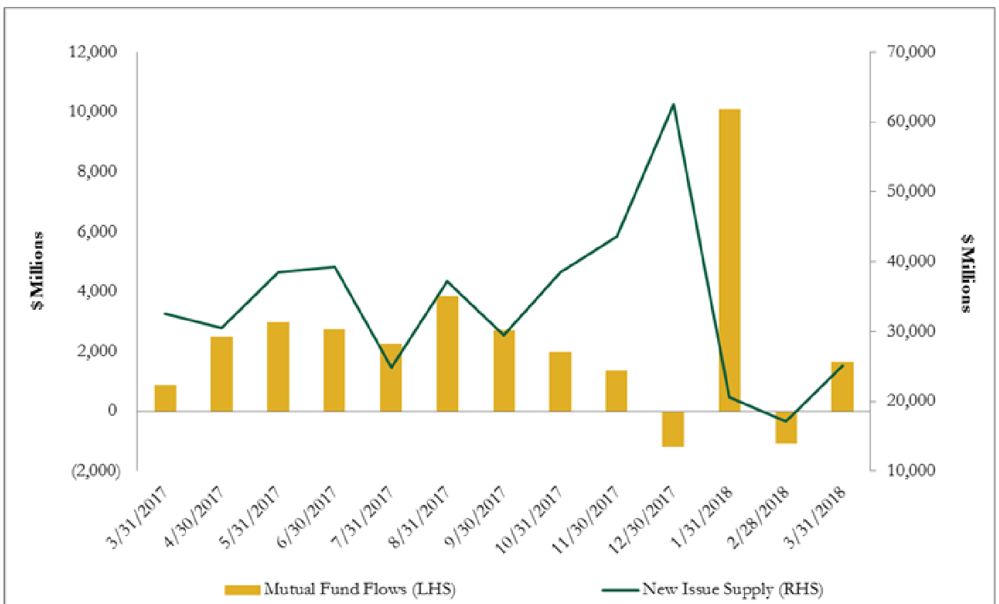
Chart 2: Municipal Yield Changes December 2017- March 2018



Source: Bloomberg

The major theme of the quarter was the lack of long-term new issue supply and waning retail demand. As reported by the Investment Company Institute, retail investors contributed approximately $10.6 billion to mutual funds in 1Q2018, with January capturing the majority of inflows (chart 3). Municipal fund flows moved into negative territory in February as investor risk aversion peaked. On the supply side, issuance declined dramatically as the municipal market felt the impact of the Tax Cuts and Jobs Act of 2017. The Act eliminated tax-exempt advance-refunding as well as incentivized many issuers to pull issuance forward into the 4th quarter of 2017 given uncertainty over the Act's final form. According to Barclay's Capital, approximately $40 billion of long-term bond issuance was brought in December 2017 mainly from 1Q2018. Issuance for the first quarter fell to $62.8 from $91.9 billion, a 31.9% decrease from the same period last year. In addition to the decline in "new money" issues, refunding deals fell to $3 billion from $9.3 billion a year earlier (Source: Bond Buyer).

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



Source: Bond Buyer, Investment Company Institute

Corporate Market

The seven quarter run of outperformance in the investment-grade corporate sector ended in the first quarter of 2018. This underperformance was driven by both higher Treasury rates as well as wider corporate credit spreads, a surprising result given that this correlation is usually assumed to be negative. Conventional wisdom holds that rising US Treasury yields indicate an improving economy, meaning that credit spreads would be expected to tighten. However, despite beginning the year by tightening to pre-financial crisis lows, IG credit spreads reversed and headed wider for the quarter (chart 4).

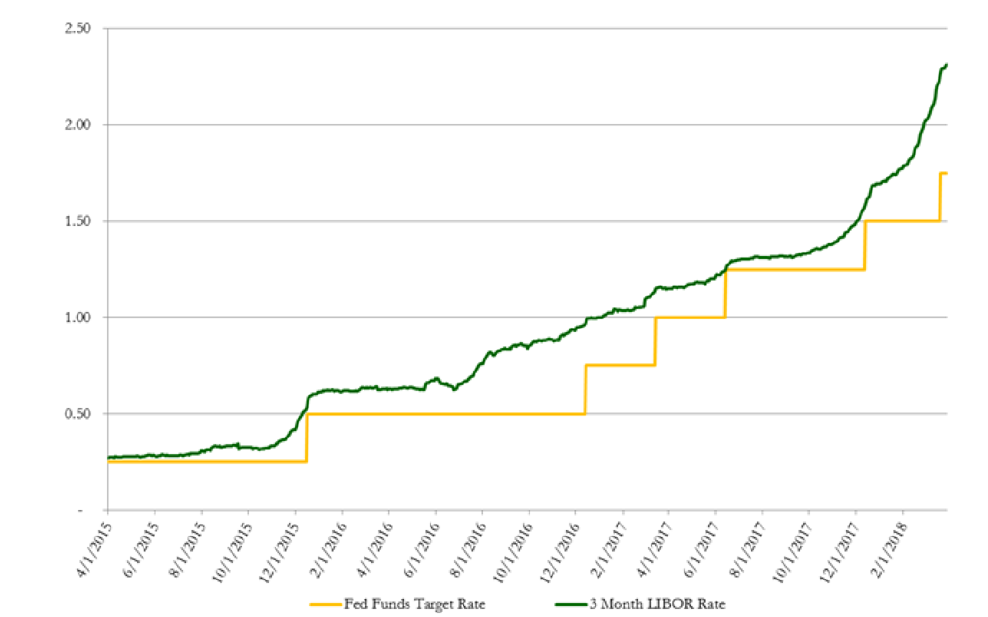
Chart 4: Investment Grade Corporate Spread

Credit spread widening was driven by four factors:

1) Tax reform incentivized multinational firms to repatriate foreign earnings, reducing demand for short-dated, IG corporate bonds which had been a popular investment for cash held overseas.
2) Reduced demand from foreign institutional buyers of US credit as the cost to hedge US dollar exposure rose in line with increased US short term rates
3) Trade policy concerns disproportionately impacted IG companies which tend to generate a greater portion of their sales overseas relative to US high yield issuers
4) After a slow start to the quarter, IG supply also picked up led by a $40 billion CVS Health Corp. new issue in early March to fund the Aetna Inc. acquisition.

In addition, market participants have begun to ask whether the Fed's monetary tightening and greater US Treasury funding requirements could create conditions for a corporate funding crunch. During the quarter, the 3-month London Inter-bank Offered Rate (LIBOR) increased 62 basis points, outpacing the rise in the fed funds rate (chart 5). This effectively brings forward the equivalent of two Federal Reserve rate hikes for many corporate borrowers. Frequently this type of increase in the LIBOR rate indicates potential distress in credit markets. However with corporate credit fundamentals and corporate credit spreads still quite tight by historical standards, the widening in LIBOR can be attributed to the pressure exerted by the confluence of higher US Treasury supply and increasing short term rates. The intermediate term impact may be that the funding market is tightening funding conditions at a faster pace than the Federal Reserve intends, possibly pushing the Fed to slow its pace or having implications on economic growth.

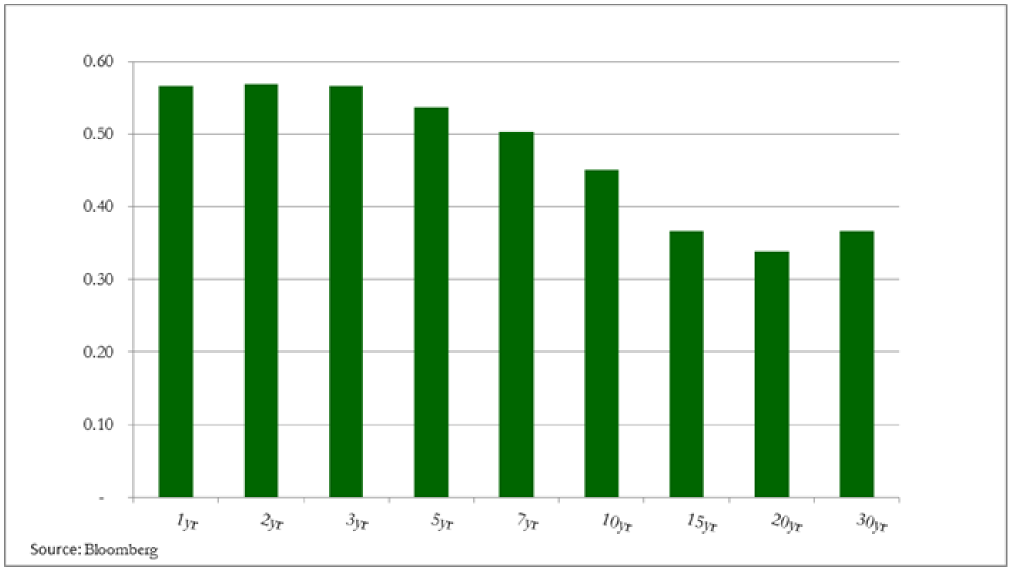
Chart 5: Fed Funds and LIBOR



Source: Bloomberg

The combination of increased Libor spreads, record supply of Treasury issuance and higher credit spreads resulted in higher corporate yields, particularly in the short end of the curve (chart 6). This curve adjustment was quite different in nature than the municipal curve (chart 2) which steepened during the quarter.

Chart 6: Corporate Yield Changes December 2017- March 2018



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