# Chilton Investment Services
## Quarterly Commentary
## January 29th, 2018

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***Please feel free to reach out to us. We look forward to your phone call.***


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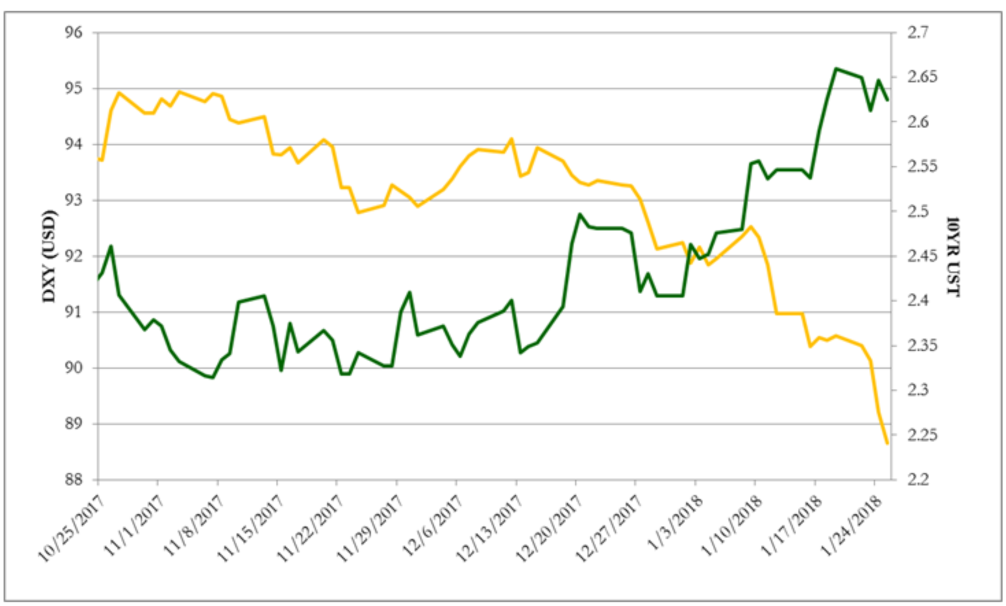
*The Fourth Quarter of 2017 represented a critical moment in the intersection between monetary and fiscal policy in the US. In December, the Federal Reserve continued to normalize interest rates and Congress enacted and President Trump signed into law the most significant Tax Reform since 1986.*

Against a backdrop of the price-of-money going up, the US embarked on an experiment in growth, designed to make US companies more globally competitive through lower tax rates, while setting up a climate for repatriation of foreign profits. Together with other measures to increase investment and employment at home---and while also through individual tax cuts and increased wages simultaneously spurring domestic demand and spending—the thought is that this will ultimately lead to increased tax revenue through overall elevated growth.

It's a big bet on the power and lasting benefits of tax-cut lead growth, and it comes with a hefty price tag; it could ultimately cost upwards of up to $2 trillion and have significant implications for US interest rates and the US dollar.

**Trends in the U.S. Treasury Yield vs. U.S. Dollar**




The Fourth Quarter was already a moment of US yield curve flattening for the US Treasury bond market, as reflected by the spread between UST 2 year to UST 10 year notes compressing from a high of 85 basis points to 51 basis points, reflecting the continued pressure of rising front-end rates (Oct 1—UST 2year—1.48% and 29 Dec 1.88%) and limited upward movement in longer rates (Oct 2—UST 10 year 2.34% and 29 Dec. 2.4%). Yield curve compression further signaled that investors remained quite comfortable with the current outlook for US inflation, with CPI ex-food and energy remaining below the Federal Reserve's target level of 2.0% throughout the Quarter (Q4).

**Macro Outlook for 2018**

- **Macro Positives: Our Central Case**
  - Federal Reserve continues to "Normalize Rates" with 3 well "telegraphed" moves up of 25 basis points, pushing overall US rates higher across the yield curve
  - Synchronized global growth continues, with US, Europe, Japan-, China, and Emerging Markets all delivering better growth levels and "smarter" globalization trends
  - Elevated global growth leads to high inflation levels particularly for commodities but does not prompt the ECB or Bank of Japan to remove policy accommodation
  - New Fed Chairman Jerome Powell builds a consensus for a re-definition of price stability and full employment with an economy running "hotter," breaking through classic Non-Accelerating Inflation Rate (NAIRU) levels
  - Trump and a Republican-led Congress succeed in passing a $1 Trillion+ Infrastructure spending bill to rebuild America, creating more jobs and higher growth potential for the US economy, and enabling the Republicans to "hang-on" to majorities in both House and Senate in the Mid-term election
  - Positive outcome for US economy with- resolution of NAFTA re-negotiation and other successful Trade deals; no "trade war"
  - Further USD weakening benefits US exporters and does not prompt an acceleration in Fed rate hikes

- **Possible Risks and Challenges**
  - Wage-lead inflation accelerates following the wage gains prompted by the Tax Cuts, testing the Powell-Fed's inflation fighting credibility
  - Trump's "Weak USD policy" aimed at driving up US exports triggers a US Treasury funding crisis, with foreign investors demanding higher yields for buying US Treasury paper causing a steepening of the yield curve and driving UST 10 year rates through

3.125%

- US Growth decelerates late in the second half of 2018 with the economy not able to adjust fast enough to higher rates, particularly in the housing sector
- Trump Administration unleashes "trade war" policies triggering higher inflation
- Republicans lose control of one or both Houses in Mid-Term elections—leading to the prospect of grid-lock and reversal of key Trump policies that benefit economic growth
- Outbreak of further tensions with North Korea over its nuclear program, together with other cyber/geo terrorism resulting in a " flight-to-quality" into US Treasuries that keeps rates too "low-for-too long," which sets up the possibility that the Fed "over-reacts" to inflationary pressures leading to a policy mistake
- Far-right wing coalition-wins –in the Italian national election calls into question further European integration, giving rise to a possible Brexit-like moment for Italy, and halting further Euro strength

## Chilton Strategies Outlook

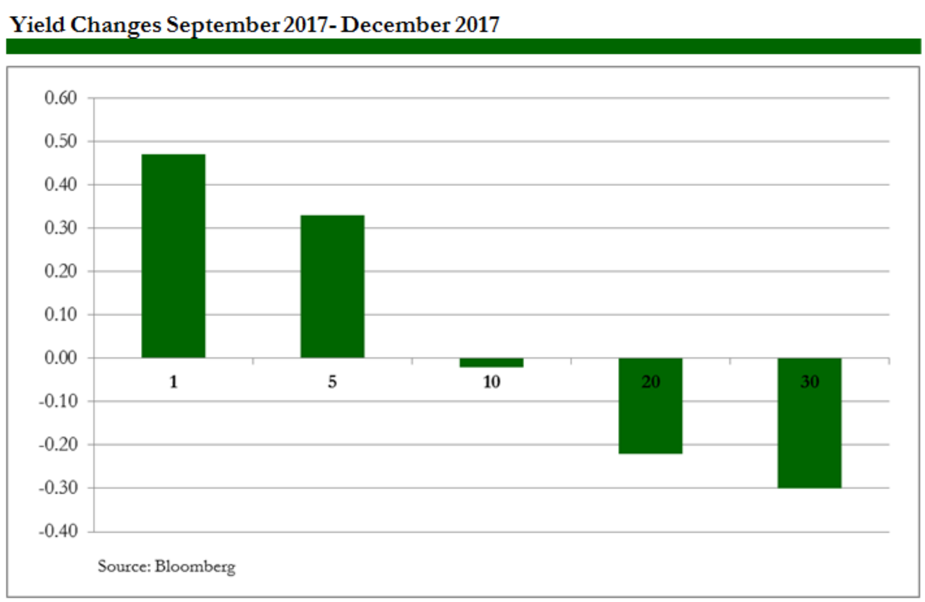
- **Tax-Advantaged Strategy:** Due to anticipated changes in the new tax law, we utilized the primary market to maintain benchmark neutral duration. We focused on the A and AA-rated revenue sectors throughout the quarter such as transportation, hospital, higher education and toll-roads. In addition, we added to the pre-funded sector in anticipation that the final tax bill would end opportunities for issuers to advance-refund their debt.
- **Crossover Strategy**: Municipal/Corporate valuations reversed course in the fourth quarter; therefore we adjusted our target weightings to the corporate sector. We opportunistically added A and AA-rated municipal revenue bonds in the 5-7 year maturity range.
- **Corporate Strategy:** In light of improving global growth, corporate bonds have continued to out-perform with spreads tightening for the seventh straight quarter. As corporate bond spreads continued narrowing, we are pursuing sector and name rotation strategies to achieve higher yields and total return opportunities. Adding names in the biotech, consumer discretionary, and travel sectors and opportunistically adding Newell which temporarily widened due to an unexpected earnings miss (we had previously reduced our holding of the name due to a then-rich valuation).

- **International Strategy:** Due to further strengthening of non-U.S. economies, we saw opportunity to continue to add to a diversified basket of non-U.S. dollar positions such as the Indian Rupee, Chinese Yuan, and Mexican Peso.

## Municipal Market

The municipal market was mixed as we closed out 2017. Short-dated municipal yields came under extreme pressure as economic data reported throughout the quarter was supportive of faster growth and the expectation that tax reform could give a further boost to growth. In addition, the Federal Open Market Committee (FOMC) raised short-term rates at the December 13th meeting by 25 basis points and noted the potential for three additional rate hikes in 2018 due to "faster growth and the labor market remaining strong in the new year".

The chart below (Chart 1) illustrates the change in the municipal yield curve throughout the quarter. According to Bloomberg, AAA-rated yields from 1 to 5-years increased 33 to 47 basis points. Expectation that further rate increases would be more supportive for further yield curve flattening facilitated the outperformance of the intermediate and long-dated sectors as yields declined 2 to 30 basis points. As a result of the increase in short-term yields, the municipal yield curve flattened to its tightest level in 2017. Thus, the spread between 1 and 30-year securities compressed 77 basis points from 190 basis points in September to 113 basis points, month-end December.



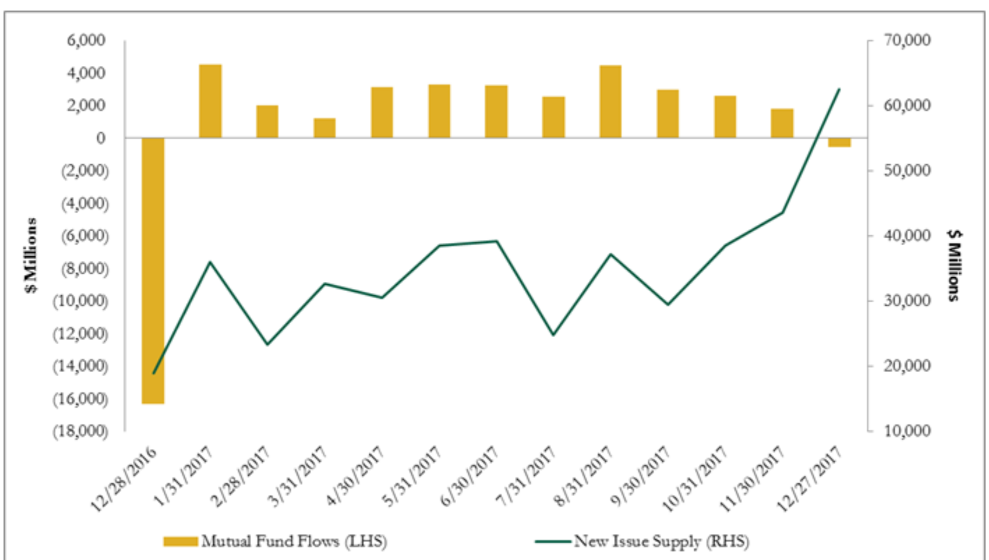

Even with the decline in yields in the intermediate and long end of the yield curve, the last quarter of the year brought an increase in volatility, driven by the uncertainty surrounding the passage of the tax bill and its effects, if passed, on the municipal bond market. In early November, the municipal market was caught off guard as the tax reform package proposed in the House included two major provisions that would greatly impact municipal issuers. The

House proposal sought to repeal the tax exemption on Private Activity Bonds (PAB) which in turn could potentially increase borrowing costs for charities, higher education, housing, hospitals and museums and other non-profits. In addition, the House proposal sought to repeal the tax exemption on advanced refundings, which allowed municipal issuers an opportunity to lower their higher outstanding debt. These proposals impacted both supply and demand for the asset class from November to year-end. On the supply side, there was no shortage of long-term issuance which at times weighed heavily on the market. There was a frenzy of issuance in November and December as Public Activity insurers and municipalities, looking to refund outstanding debt, rushed to close deals before the new tax law took effect on January 1, 2018. According to the Bond Buyer, November issuance increased 31% and December witnessed a 200% increase from the same period last year. December's bond issuance hit a record $62.5 billion and surpassed the previous record set in December 1985 of $54.7 billion. For the quarter, issuance was up 33%, with $144 billion of new debt issued compared with $108 billion from the same period last year (Source: Bond Buyer).

On the demand side, (see Chart 2), inflows into mutual funds slowed from the previous quarter with subscriptions totaling approximately $3.9 billion (Source: Investment Company Institute). The slowdown in investor demand was attributed to volatility in rates in 4Q2017, the magnitude of new issue supply, and uncertainty surrounding the tax bill.

On December 22nd, the President ended the uncertainty and signed the tax bill into law, which preserved the tax-exemption for PABs but ended the ability to advance refund. We took advantage of the increase in supply, with the expectation of a dramatic decline in January 2018 issuance, and maintained a neutral duration relative to appropriate benchmarks.

**Municipal Mutual Fund Flows vs. New Issue Supply**




Source: Bond Buyer, Investment Company Institute

## Corporate Market

The run of outperformance in the corporate sector continues as spreads narrowed for the seventh straight quarter, despite a short period of mid-quarter volatility. (See Chart below). Even the headline making volatility in high-yield was short lived, temporarily pushing back spreads in mid-November before the rally regained steam allowing the sector to plum new ground and end the year on strength.

**Corporate Spreads**


Source: Bloomberg

Spreads continue to tighten across the board as further evidence of a coordinated global growth picture emerges and progress is finally made on the US legislative front. While the tax bill passed through Congress and was signed by the President, some critics maintain that the economic boost from the bill may be modest in the short term. The market however looking at it as a break in the legislative log-jam, and is focused on the combined benefit of tax-reform as well as the next few items on the agenda: the budget (which may firm up defense spending), and the possibility of an infrastructure bill (which if passed could lead to broad based gains in the construction industries). The shift in market focus was evident in that basic materials sectors which had been badly punished in 2015 in a commodities rout made up more ground versus other sectors. Metals and mining, independent energy, and refining led the way, providing some of the best performance in the credit index. Other sectors poised to benefit, such as building materials, construction machinery, and diversified manufacturing, had already tightened in anticipation and were held back this quarter by already tight spreads. Supermarkets also outperformed the index in the fourth quarter, but were more rebounding from underperformance prior in the year, rather than building on prior quarters' strength, as poor pricing power and competition from non-traditional players such as Amazon had weighed on

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| | the sector. |
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