Chilton Investment Services

Quarterly Commentary

October 15th, 2015

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

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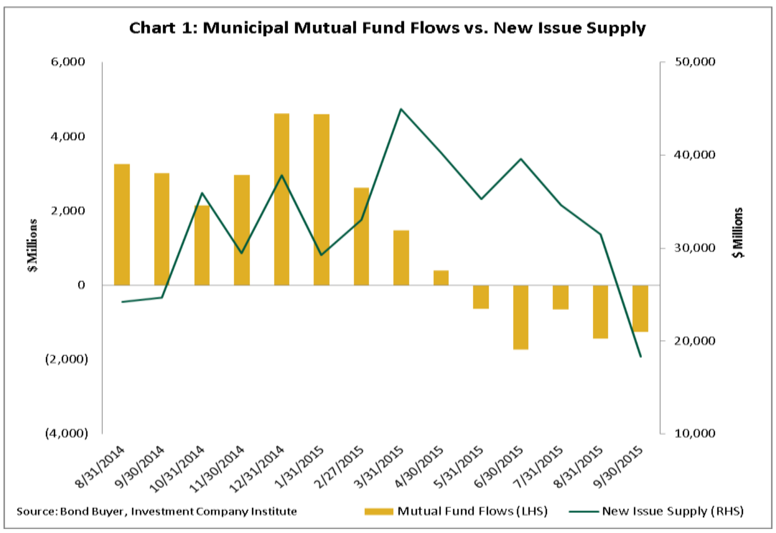
Themes in the Third Quarter 2015

- Tax-Advantaged Strategy: Overweight A-rated bonds, focusing on securities backed by specific revenue streams; maintaining a neutral duration position relative to the benchmark
- Crossover Strategy: Tactically swapped out of corporate exposure and increased allocation to tax-advantaged securities reflecting improved relative view of Muni market
- Corporate Strategy: Pivot to U.S. domestic orientation in face of further pressure on industries linked to global commodity prices
- International Strategy: Maintain elevated exposure to US Dollar and added exposure to Sterling

Municipal Market

The municipal market closed the quarter with solid performance. Factors such as weaker economic data and declining Treasury yields contributed to positive price returns for the asset class. Improved technical factors also played a pivotal role in the performance of the municipal market throughout the quarter.



On the supply side, municipal issuance was slightly above last year's third quarter level but volume declined significantly relative to the first and second quarters of 2015 (Chart 1). According to the Bond Buyer, issuance for the third quarter was only $84.4 billion, following issuance of $107.8 billion and $116.4 billion in the first and second quarters, respectively. A decrease in refunding volume, uncertainty around the outcome of September's FOMC meeting and general market volatility all contributed to the decline in long-term issuance. Demand for tax-advantaged securities remained weak as reflected in continued negative mutual fund flows. This reflects investor caution over the fixed income asset class as Federal Reserve rate hikes loom. Partially offsetting this has been sizable coupon income and principal reinvestment money which has been accumulating at the second highest rate in the past 10 years. Furthermore, an increasing belief that the Fed may not begin to normalize rates this year helped stabilize fund outflows late in the quarter.

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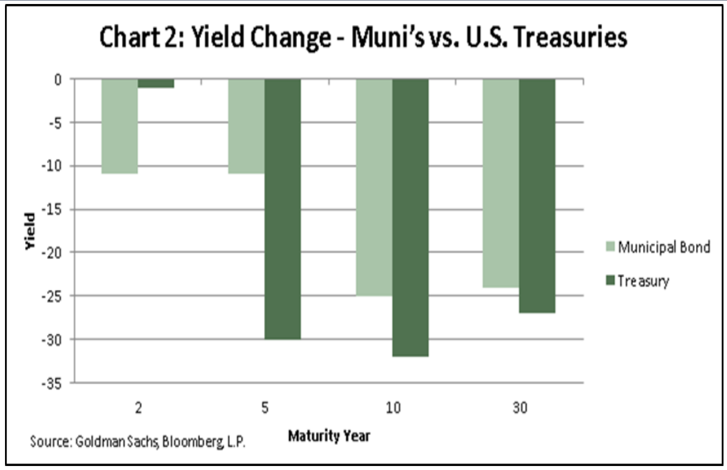
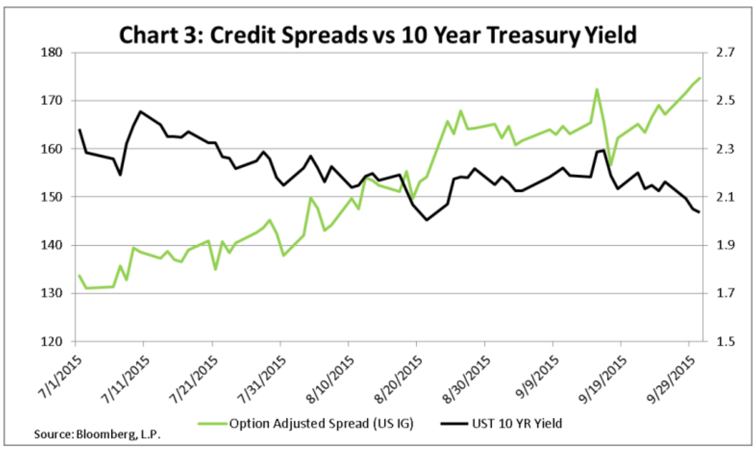


The municipal yield curve reversed its steepening trend experienced in the second quarter. The curve flattened as short-dated securities significantly underperformed long-dated municipals, resulting in the spread between 2 and 30-year securities tightening from 265 basis points in June to 249 basis points in September. Despite the decline in yields across the curve, municipals were unable to keep pace with US Treasuries (Chart 2). With the exception of the 2-year sector, municipal rates underperformed relative to their US Treasury counterpart with the most significant underperformance transpiring in the 5 and 10- year sectors. For example, the AAA-rated 5-year yield declined 11 basis points to end the quarter at 1.27% while the 5-year US Treasury decreased 25 basis points for the same period.

Corporate Market



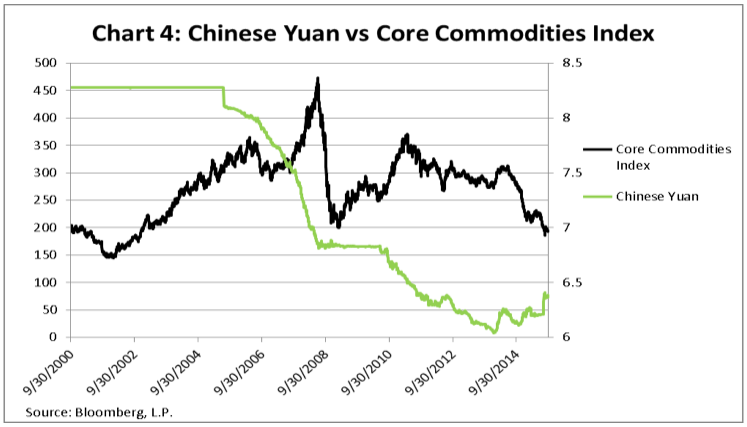
During the third quarter, corporate credit spreads continued to widen, reaching three year highs. A number of factors contributed, primarily an overall "risk-off" market tone driven by weaker economic news abroad and culminating with the Yuan devaluation on August 11th and the subsequent fall in global equities. The typical relationship between Treasuries and corporates was restored as the 10 year U.S. Treasury note fell in yield throughout the quarter and spreads drifted wider (Chart 3). The reduction in China's growth projections had a particularly strong impact on commodity prices. This led to heavy pressure on basic materials and energy sector bonds.

Adding further pressure to spreads, issuance levels remain elevated and investment-grade issuance is on pace to surpass last year's record $1 trillion by approximately 20%. We believe that a significant portion of this issuance has been driven not by growth prospects but financial engineering. An example is Hewlett Packard pricing $14.6 billion to finance the split of the company into HP Enterprise and HP Inc. We expect this trend to continue in 2016 with continued M&A activity in sectors such as healthcare and technology. Meanwhile Anheuser-Busch InBev could issue debt to finance a portion of its mega $106 billion acquisition of SABMiller, pending regulatory approval. Finally, in this stricter regulatory environment, broker-dealers remain largely unwilling to commit balance sheet capacity to corporate debt, even for newly underwritten deals. This has served to further cloud pricing in the corporate market, causing bid-ask spreads to widen and increasing the implicit cost of trading debt in the secondary market. On the positive side, buyers stepped up in the third quarter as investors purchased a total of $18.9 Billion more corporate bonds than they sold (Table 1), a factor which mitigated spread widening.

Despite an improvement in economic data and equity rally at quarter end, this lingering supply-demand imbalance in the corporate bond market will have to clear before we believe we will see sustained spread narrowing. Despite these factors, corporate spreads have become more attractive at the widest levels in 3 years. We are focusing on the still benign US economic outlook in particular those sectors likely insulated from the fall in global commodities prices such as consumer cyclicals, automotive, housing-related and retail.

Table 1: Dealer to Client Volume (Millions)			
	Client Sells	Client Buys	Net
July	134,339	141,285	6,946
August	120,389	129,448	9,059
September	138,998	141,969	2,971
3Q15 Total	393,726	412,702	18,976
Source: TRACE, Bloomberg, L.P.			

International Market



The most significant story in the foreign exchange market this quarter was the unexpected decision by the People's Bank of China (PBOC) to let the Yuan weaken by the most since 1994. Following the approximately 3% devaluation, stocks and commodities sold off, dragging down other Asian and emerging market currencies, some hitting levels reminiscent of the 1997-1998 Asian financial crisis. Meanwhile, the Thomson Reuters Core Commodity Index hit its lowest level since 2003 (Chart 4). These sell-offs typically create fear, causing portfolio managers to seek safer investments such as fixed income and perceived stronger currencies such as the USD.

The Yuan devaluation could also presage a broader trend of lower global goods pricing, potentially increasing import price deflation in the US economy. As it turns out, the Federal Reserve incorporated this increased global market turmoil in its September decision to leave the Fed Funds rate unchanged. Despite this delay, we remain long the US dollar in our international strategies while global currencies continue to remain volatile due to the uncertain prospects for global growth. We also took the step of adding exposure to Pound Sterling, believing the United Kingdom will continue to benefit from a moderate economic expansion while possessing relatively lower exposure to China and commodity prices.