Chilton Investment Services

Weekly Update

November 20th, 2017

Visit our website!

www.chiltoninvestmentservices.com

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

Timothy W.A. Horan

CIO-Fixed Income

646-443-7748

thoran@chiltontrust.com

Gregg Manjerovic, CFA

Taxable Portfolio Manager

646-443-7768

gmanjerovic@chiltontrust.com

Stephen Stowe, CFA

Head of Credit Research

646-443-7866

sstowe@chiltontrust.com

Laura Ridolfi

Associate Portfolio Manager

646-443-7792

lridolfi@chiltontrust.com

Eamon Marley

Credit Research Analyst

646-443-7745

emarley@chiltontrust.com

Francesca Genovesi

Credit Research Analyst

646-443-7776

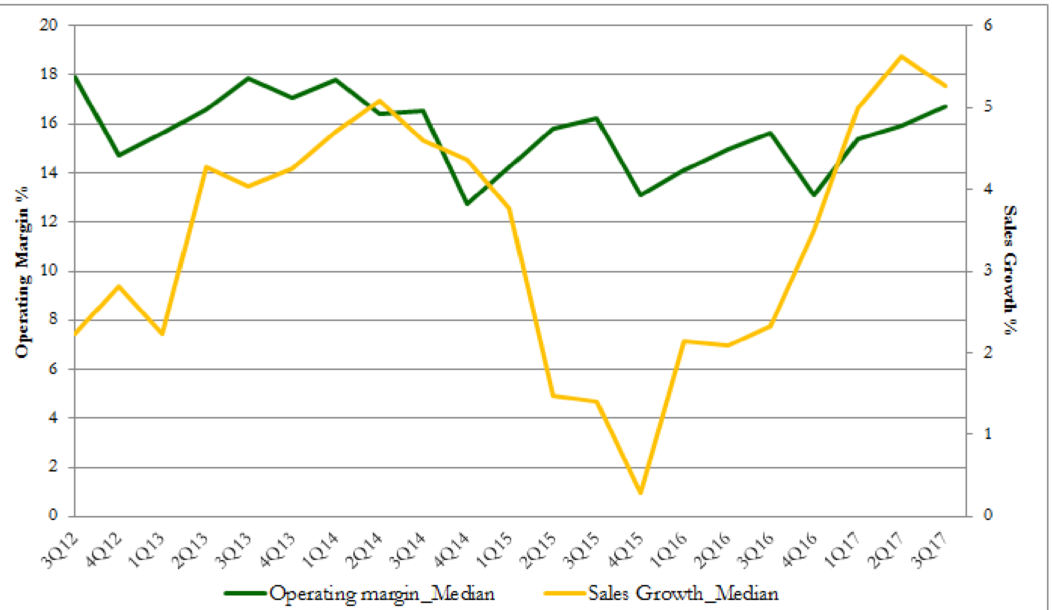
fgenovesi@chiltontrust.com

Third Quarter Earnings: Keeping Up with Change

This year's third quarter earnings season is winding down and overall trends appear strong despite ongoing technological change disrupting certain industries. Our coverage universe showed a modest sequential deceleration in revenue growth to 5.3% from 5.6% but remains strong relative to recent years (Chart 1). Profitability increased, with the median operating margin up 73 basis points. Leverage remains elevated versus prior years but has leveled off sequentially, which we attribute to higher earnings offsetting higher debt levels. Significant contributors to overall revenue growth were energy and tech names. Underperformers included utilities and telecommunications.

Technological disruption across many sectors has been an ongoing theme that continued in the quarter. The retail sector has been plagued with declining same store sales and a number of bankruptcies as juggernauts like Amazon and Walmart further increase their dominance. Major players in the telecommunication and media industries are jostling for position as distribution options proliferate, intensifying the battle for viewers and pressuring pricing. While not facing existential dangers, the U.S. manufacturing sector faces the challenge of boosting profitability while maintaining a relevant strategic focus. U.S. auto manufacturers will need to invest in electric and autonomous technology. And iconic General Electric announced only its 2nd dividend cut since the Great Depression as it struggles to reorient the company.

Chart 1: Revenue Growth and Operation Profit Margin Trends



Source: Bloomberg LP

Some key highlights from the 3rd quarter include:

Retail disruption was led by Amazon (AMZN) as its expand-at-any-cost strategy influences competitive behavior across the industry.

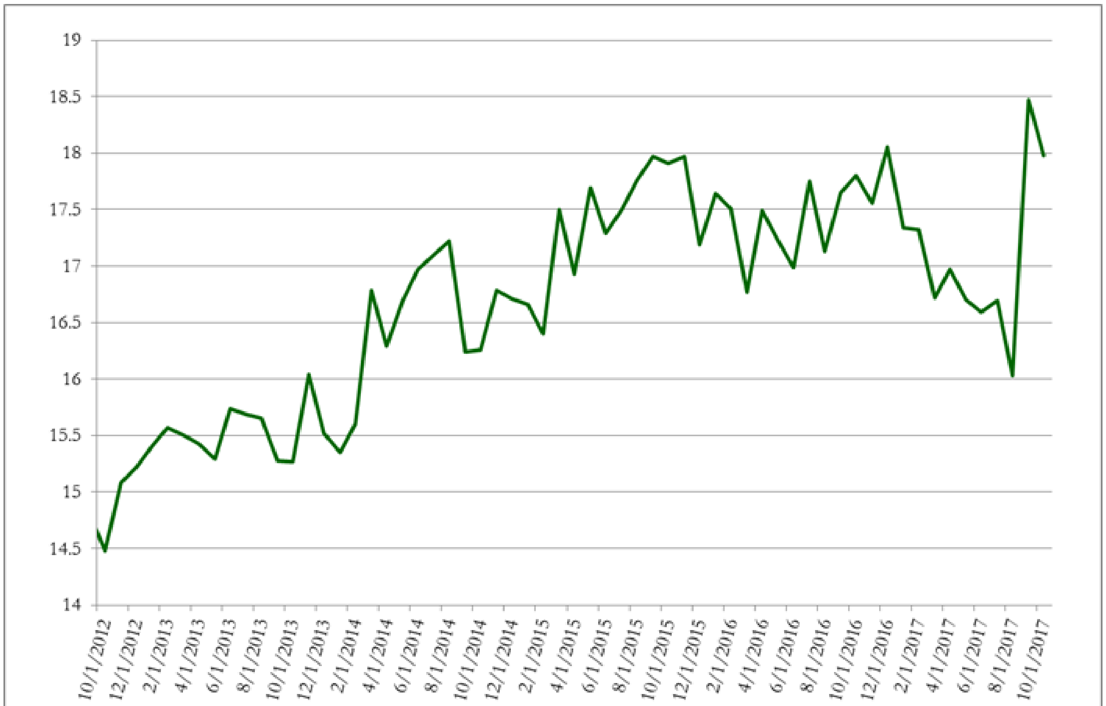
AMZN has experienced perennial double-digit sales growth including a 29% increase in the third quarter, excluding the acquisition of Whole Foods. The company has gained market share with offerings such as the popular Amazon Prime subscription and aggressive price competitiveness. These practices constrain the Company's profitability as operating profit fell 40% year-over-year despite the strong top line performance and higher profits at its cloud computing business. **Wal-Mart Stores (WMT),** which we view as AMZN's top retail rival, posted very strong results. U.S. same store sales (SSS) rose 2.7% and e-commerce sales jumped 50%. WMT has avoided SSS declines in recent years by investing heavily in e-commerce including online ordering / in-store pickup. Other strengths include online grocery, ongoing store remodels and maintaining its historical competitive pricing driven by ruthless supply chain efficiency. We expect Walmart will continue to be a formidable player in the difficult retail environment thanks to its scale, robust cash generation, and strong investment grade balance sheet.

The intense competition in retail caused by e-commerce disruption has forced a number of heavily indebted retailers into bankruptcy protection. Several investment grade consumer durables names, such as **Newell Brands (NWL),** were impacted by the Toys R US filing in September and incurred bad debt expense related to trade receivables claims. Ultimately, we expect the Toys R Us issue to be manageable for its vendors given their ability to reach the consumer through multiple retail channels (online and through other retail customers). NWL did face several company-specific issues during the quarter including weak core sales growth, weaker product mix, and hurricane-related raw material costs. This contributed to a significant selloff in the stock and widening in credit spreads. However, for now, we believe the company remains on track to reach its 2018 debt reduction goals following the 2016 leveraging acquisition of Jarden based on our expectations of cost savings, synergy realization and adequate cash flow and liquidity.

Like retail, automobiles face technological disruption in the form of electric and autonomous vehicle technology and shared mobility.

September and October U.S. auto sales volumes were boosted by hurricane-related replacement demand (Chart 2), however a turn in the auto cycle is inevitable and sales volume will likely trend lower from here. Estimates suggest annual U.S. will be in the high 16 million range in the next few years, down from a high of 17.5 million in 2016. Quarterly results from **General Motors (GM)** and **Ford (F)** were testament to their ability to optimize cost structure and remain very profitable despite lower wholesale volumes. GM was particularly impressive as margins held up despite a 26% decline in volume as the company worked to balance dealer inventories and prepared for a truck launch. Both auto-makers have ongoing cost-cutting programs which should position them to stay abreast of technological change by allowing continuous investment through the cycle. In terms of the disruptive themes of electrification, autonomous driving, and ride sharing, GM appears to be relatively well-positioned as it has communicated its specific initiatives more concretely than Ford. Compared to the final product manufacturers (Ford and GM), the auto sales slowdown is likely to be felt more acutely by suppliers such as **Goodyear Tire & Rubber (GT)** which has already displayed vulnerability to the cycle. Competition and manufacturer production cuts contributed to weaker sales volume which combined with raw material headwinds to produce a meaningful decline in the company's operating profit.

Chart 2: Monthly U.S. Auto Sales Seasonally Adjusted Annual Rate (SAAR) in millions



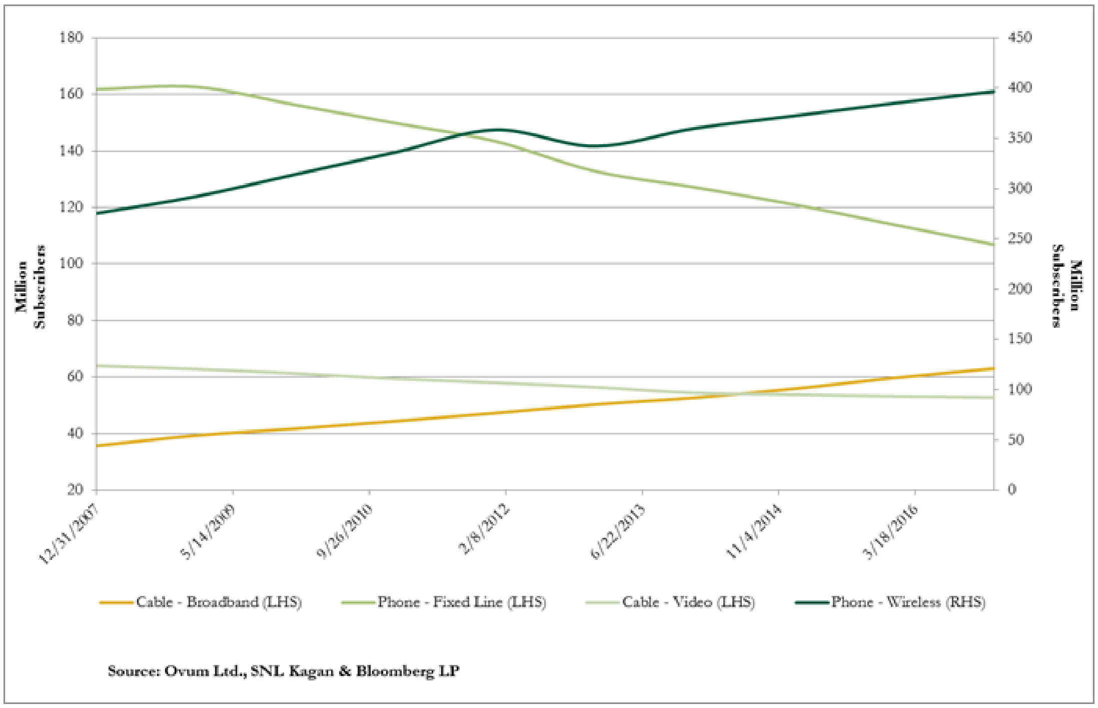
Source: WARD's Automotive Group, Bloomberg LP

Technology is also having a disruptive impact on the telecommunication, cable and media industries, leading to a surge in rumored and proposed mergers and acquisitions, although to-date the number of completed deals remains lower than expected.

The U.S. Department of Justice is reportedly asking for major asset sales or threatening to block the pending **AT&T (T)** and **Time Warner Inc. (TWX)** merger on antitrust grounds. Such a move would be highly unusual if one views this as a typical "vertical" media merger in which a distribution company (AT&T) acquires a content producer (TWX). The DOJ may try to make the case that certain content is considered too essential to be owned by one distributor though recent secular changes in the media industry make this a difficult claim, presaging a possible court battle. Termination of the merger would likely be positive for AT&T and Time Warner credit spreads though the more likely outcome is that the deal is consummated with either a modest amount of asset sales and / or conditions.

Charter Communications Inc. (CHTR) briefly spooked the market with results that included weaker than expected subscriber growth, raising questions around the integration of the company's recent Time Warner Cable and Bright House Networks acquisitions. As shown in Chart 3, cable and telecom companies face ongoing pressure from secular declines in legacy business lines (cable and fixed phone). Any hint that is company is unable to offset these losses with new broadband or wireless business will send investors running for cover. CHTR management continues to characterize their own weakness as temporary and reiterated their belief that subscriber levels will stabilize in the near term and full merger benefits will accrue starting 2019. The stock briefly sold-off before recovering though volatility is expected to persist given speculation around the company as an acquisition target.

Chart 3: Cable and Telecom Companies Seek to Offset Fixed Phone and Cable Losses with Broadband and Wireless Growth



Qualcomm (QCOM) received an unsolicited acquisition offer from Broadcom (AVGO) which seeks to buy the larger wireless semiconductor maker for a total deal value of $105 billion which would represent the largest technology deal ever, topping Dell's 2016 $67 billion takeover of EMC. QCOM has rejected the AVGO offer and plans to continue with its own, previously announced acquisition of NXP Semiconductor. We view the NXP acquisition as favorable for QCOM whereas the AVGO offer would require a substantial amount of new debt. QCOM bonds sold off in response to the AVGO offer. Despite these swirling merger rumors and the company's ongoing legal battle with Apple, we still like QCOM and note that the company posted solid, consensus-beating results for the quarter.

General Electric (GE) shocked the equity market, announcing only its 2nd dividend cut since the Great Depression as new CEO John Flannery accelerates the company's turnaround. The company has struggled to generate sufficient returns on capital and the number of business lines will be reduced via asset sales, currently targeted at $20 billion. The company should ultimately emerge smaller and less diversified but more focused on the more profitable areas of aviation, power and healthcare.

The last two months have been challenging for bio-technology company **Celgene (CELG)** which in mid-October suspended late-stage trials on a key developmental drug (Mongersen for Crohn's disease) and revised down its near term profit guidance. Despite the ensuing sharp sell-off in the stock, we continue to approve the bonds as the company remains cash flow positive. Credit spreads widened in the few days following the announcement but have since mostly retraced. We are focused on trial results and regulatory approvals for a potential blockbuster in Ozanimod which will take place through 2018.

Office technology company **Pitney Bowes (PBI)** missed earnings guidance and announced that its Board is considering strategic alternatives in light of continued declines in the legacy postage metering business. We are cautious on the name due to several quarters of underperformance but continue to hold the bonds in high-yield accounts due to the company's continued positive cash flow and valuation. In addition to the outcome of the Board's strategic review, another catalyst over the next year is the success of the company's integration of September acquisition Newgistics which should boost PBI's e-commerce position.