

Harry J. Clark, CFP® Chief Executive Officer, Editor in Chief

Why This Time Is Different



The Navigator Report from the first quarter was titled “Record Highs, Is a Hangover Next?” You may recall that the S&P 500 finally eclipsed the old highs of 1527 reached on March 24, 2000 and 1565 reached on October 9, 2007 on the last day of the first quarter, March 28, 2013. The equity markets have continued higher during the second quarter making the first six months the best in fourteen years. The two prior highs were followed by declines of 47% and 56% respectively. **This raises the question “Is a Hangover Next?” even more.**

The S&P 500 closed out the first half of 2013 with a gain of 13.83% for the best start to the year since 1998. But Japan did even better with a gain of 32.6% for its largest gain in the first half since 1972. While fundamentals have been okay with earnings moving in the right

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direction, the real driving force behind the moves in the U.S. and Japan has been the respective Central Banks buying of huge amounts of bonds in the open market. In the U.S. the amount is \$85 billion

per month while in Japan it is \$77 billion. It was hoped that the money would flow into the economy but we believe that most is going into the stock markets.

Unfortunately, other markets did not fare as well as the U.S. and Japan so far this year. European stocks were essentially flat while Emerging Markets declined 10.9% based on the MSCI Emerging Market Index. Exchange traded funds that track China lost 19.6%. Brazil lost 21.6%, and Russia dropped 15.8%. Precious metals were not immune to the damage as the Gold ETF lost 26.5% and is now down 58% from the high of 2012. The Silver ETF declined a whopping 35.4% so far this year.

WHY IS THIS TIME DIFFERENT?

The answer is VALUATION! The chart below shows the S&P 500 from 1996 to the present. It shows the two prior peaks and where we are today.

At the first peak in 2000, stocks were way overvalued. Do you remember the dot-com era? We were in the midst of the dot-com bubble. Stocks were the most expensive they had ever been with a P/E ratio (price to earnings ratio) of just over 30. **That was the highest valuation of the century and we know what happened next, a decline of 47%.**

In 2007, stocks had also gotten to a pretty high P/E ratio when the financial crisis began with the Lehman disaster. **The subsequent decline of 56% was the biggest since the Great Depression. Millions of investors swore off buying stocks forever.**

CLARK CAPITAL WELCOMES ANTHONY SOSLOW, CFA®



As part of our commitment to our advisors and clients we are continuously adding to the intellectual capital of our portfolio professionals. In that light, we are pleased to announce that Anthony

Soslow, CFA® has joined Clark Capital’s Portfolio Management Team as Senior Portfolio Manager. He was previously President and Chief Investment Officer of Global Capital Management, Inc.

With over 25 years of portfolio management experience utilizing both a quantitative and fundamental process, Mr. Soslow is highly regarded among his peers. His All Cap Strategy began in 2000 and has an enviable record. Mr. Soslow’s management of the International ADR portfolio has also been strong. Each year the International ADR annual composite return (net) has outpaced the MSCI EAFE (net) since its inception on January 1, 2008*. Mr. Soslow will also take over management of our small-cap equity portfolio.

His addition highlights our continued commitment to providing innovative investment solutions and world class service to our advisor partners and clients.

*Past performance not indicative of future results. Please see attached disclosures.

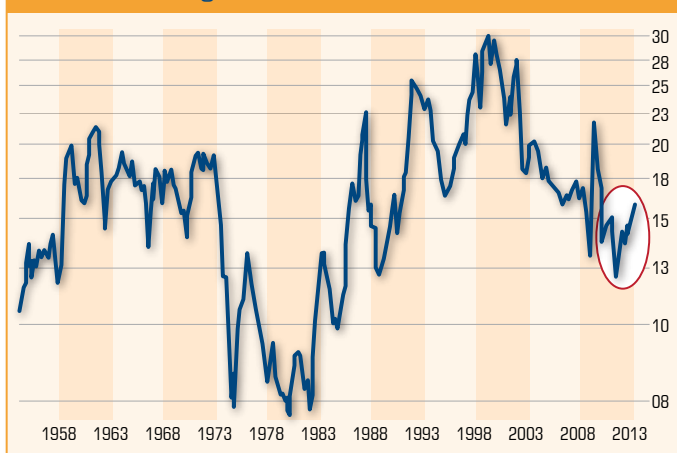
S&P 500 Index



Source: Conference Board

But today P/E ratios are at what we believe to be a fair value of 15 to 16. You can see from the chart that this is a level far below many peaks over the past 50 years or so.

S&P 500 Long-Term P/E Ratio



Source: Bloomberg

In addition, projections of earnings going forward are favorable. Our economy has hardly begun to grow since the great recession of 2008-09 and there is a lot of room for improvement. According to a compilation, by Bloomberg, of earnings estimates by Wall Street analysts, the P/E ratio by the end of 2013 should be at 15 times earnings; by the end of 2014, 13.5 times and by the end of 2015 at 12.2 times. Based on these estimates, the S&P 500 could be substantially higher by the end of 2015.

Another factor that is present today and was not in either 2000 or 2007 is extremely low interest rates. While rates have moved higher during the past several weeks, they are still quite low by historical measures. **Bonds do not offer the yields, or the growth potential, that may be achieved in high quality dividend paying stocks.** As you will read here later, the Great Migration out of bonds and into stocks has, in our opinion, just begun. **Just as the "Lost Decade" in the equity markets seems to be coming to an end, the "Lost Decade" in the bond markets may be just beginning.**

THE GREAT MIGRATION

This phrase refers to the possibility that massive amounts of assets could flow from the bond markets into the stock markets.

It appears this migration has already begun as the bond market displays a totally different story than the equity market so far this year. As mentioned in the year-end 2012 report, we said that the longest bull market in bonds was at an end. During a CNBC interview on December 17th with Rick Santelli, I had said that the yield on the 10-year Treasury note would exceed 2.41% and potentially 2.71% during 2013. Although no one said it out loud, I believe that they were thinking "what is this guy smoking?" The longest bull market of almost any asset class in recent times lasted from 1981, when bond yields were 16%, to 2012 when yields bottomed at 1.4%. That was a thirty-one year bull market. Notice that the 1981 to 2012 bull market followed the 1954 to 1981 bear market in bonds. While the graph only began in 1954, the actual bond bear market began in 1941. That was a forty year bear market!! Please notice that in both bear markets and bull markets prices do not always go up or down. There are potentially opportunities for profit in all types of markets.

10-Year Constant Maturity Treasury Note Yields



Source: Ned Davis Research

During 2012, the Barclays U.S. Aggregate Bond Index had a gain of 4.81% for its twelfth straight profitable year. That was last year! That index suffered its worst quarterly setback in nine years and is down 2.44% year to date. While the yield on the 10-year Treasury note had moved from the low of 1.4% in 2012 to near 2.0% early in the second quarter, it had moved down to 1.63% by May 2nd. Yields then rose to 2.72% after Federal Reserve Bank Chairman Bernanke said that the QE program of purchasing \$85 billion of bonds monthly might start to be wound down sooner than people had expected. **His news conference on May 22nd started a true rout in the fixed income market.**

To show how devastating the bond market rout (dubbed the "Great Liquidation") is you must go back to 1994, a year generally viewed as an Armageddon for bonds. Then the 10-year note yield increased by .90% during a comparable two month period when the Fed raised rates four times. This time the yield increased by about the same amount .85% over the past two months. In 1994 that move was a 20% increase in yields but this time it is almost 40%. **And from the**

low of 1.4% in 2012, rates are up 60% on the 10-year Treasury bond. This has been one of the worst drubbings in bond market history!

Investors have poured \$1.26 trillion into bond funds over the past six years. According to recent ICI (Investment Company Institute) data, Bond fund assets were \$3.56 trillion at the end of April while U.S. equity mutual funds had assets of \$6.61 trillion. Money market funds have assets of \$2.59 trillion as of June 26.

Preliminary numbers from ICI show that evidently spooked investors pulled out an estimated \$60.5 billion in bond funds during the month of June thus beginning the “Great Migration.” This compares to the prior record of \$41.3 billion withdrawn in October 2008 during the worst moments of the financial crisis. Several large bond funds also took hits with Pimco’s Total Return fund down 3% and Vanguard’s Total Bond Market fund down more than 2% for the year so far.

Other bond declines are:

U.S. Treasury 30-year bond	-9.01
U.S. Treasury 10-year note	-4.87
Municipal bonds	-2.67
High Yield bonds	+1.42

The only fixed income asset classes that still have a gain for the year are high-yield bonds and bank loan vehicles.

While we do not deal with bank loan vehicles, we are very active in the high yield bond market with our “Fixed Income Total Return” program. **This is a tactically allocated bond portfolio that moves between high-yield bonds, Treasury bonds, and Treasury bills.** *A major concern to investors is the impact on a bond portfolio in a rising interest rate environment. We have examined the impact on high yield bonds whenever interest rates increase by at least 1.0%. This has occurred six times since October 1, 1993.* These comparisons use Barclays indices. In every case the impact on high-yield bonds was positive while the impact on 5-year, 10-year, and 30-year Treasuries was negative. The table below details these findings.

	10/1/93 to 11/30/94	2/1/96 to 8/31/96	10/1/98 to 1/31/00	7/1/05 to 6/30/08	1/1/09 to 12/31/09	9/1/10 to 3/31/11	8/1/12 to 6/30/13
Rise in 10 Year Treasury Rates	2.55	1.36	2.24	1.22	1.65	1.00	1.00
Barclays High Yield	1.97	3.25	4.12	4.80	58.21	10.46	7.45
Barclays 30 Year Treasury	-15.78	-10.80	-15.69	-11.18	-25.88	-13.55	-13.96
Barclays 10 Year Treasury	-10.17	-5.82	-10.18	-5.78	-9.76	-6.04	-5.78
Barclays 5 Year Treasury	-4.78	-2.68	-3.73	-2.45	-1.35	-2.17	-2.18

Source: Ned Davis Research

The most glaring example of this impact was from 1/01/2009 to 12/31/2009 when interest rates rose 1.65%. **In that case high yield bonds appreciated by 58.21% while the 30-year Treasury declined by 25.88% for a difference of 84.09%.**

In the most recent case, when rates rose 1.0% from 8/01/2012 to

6/30/2013, high yield bonds rose 7.45% while the 30-year Treasury declined by 13.96% for a 21.41% difference. The 10-year declined by 5.78% and the five-year declined by 2.18% giving high yields advantages of 13.23% and 9.63% respectively.

Based on our data, we believe the best place to be invested in the bond arena may be high-yield bonds in a rising interest rate situation. This may be why our Navigator Fixed Income Total Return program has been so popular.

SUMMARY Secular Markets/Risk/Hedge

The equity markets have been on a tear so far this year while the bond markets have been going in the opposite direction. Yes, the equity markets have finally eclipsed the old highs and that means that the “Lost Decade” in equities is over. **But we are likely entering the “Lost Decade (Decades)” in the bond market.** For the past thirty-one years it has been possible to say that risk in the bond markets was significantly less than in the equity markets. I am not sure that this can be said anymore. But while the bond market suffered quite a rout in the past quarter, it may have been overdone and bonds will potentially rally in price (yields decline) from here for a time.

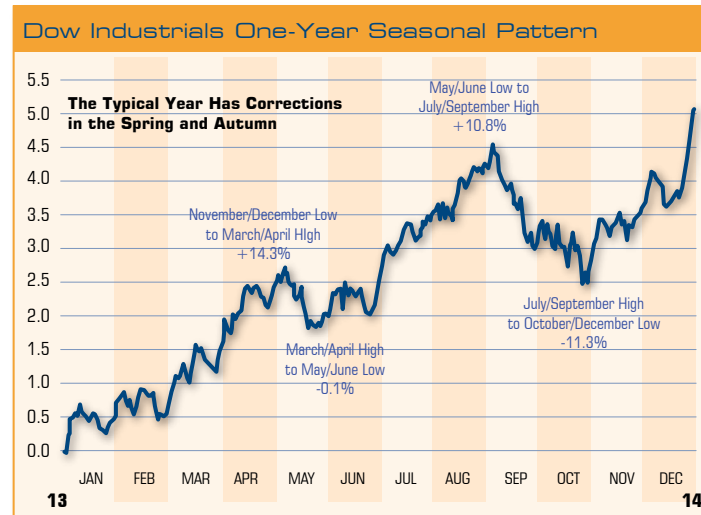
Risk, of course, is a very personal matter. An investor who lost a good amount during the financial crisis and was afraid to put money to work in the equity market was likely correct to select a hedged portfolio. On the other hand, another investor who had only a need for long term investments might not be a candidate for a hedged portfolio.

Many of our clients are still holding our Navigator Unified Managed Account with the Sentry hedge strategy. The UMA accounts by themselves are diversified with low beta exposure. The most aggressive version, level five, returned 5.41% unhedged, which is in line with the portfolios beta exposure. The return was 3.25% hedged (both net of maximum fees as of year-to-date). **A client must ask themselves: “Do I really need all of my investable assets hedged or do I want some additional upside exposure with part of my investments?”**

Another question might be: “As I am approaching retirement should I look for more income in my investments? If so, are bonds the place to go?” A solution to this problem could be to add our Large-Cap High Dividend portfolio of individual stocks to your holdings as a complement to a hedged UMA. This portfolio is managed by Maira Thompson, a 31-year investment veteran. The portfolio has returned 10.64% (net of 3% maximum fee) so far this year with a nice dividend yield. Of course you should discuss this with your financial advisor.

It is our belief that we will not see anything like a 47% or 56% decline similar to 2000 and 2008. This raises the question: “Are we in a Secular Bull market or are we still in the Secular Bear market that began in 2000?” **I have said on many occasions, in writing and during CNBC interviews, that the 2009 bottom was the “low of our lifetime.”** That alone does not mean that we have entered a Secular Bull market because several pieces of data that we look for at a Secular Low were not present. In the markets things never seem to line up perfectly, and in an era of rapid change there might not be the same dynamics at a secular low. But when the new Secular Bull market is acknowledged to be a fact, we will likely look back on the 2009 low as the absolute low.

The chart below shows the one-year seasonal pattern for the Dow Jones. The market has followed that path fairly well so far this year. And yes, we are expecting a correction this fall as is very typical of the year before a mid-term election.



Source: Ned Davis Research

But we disagree with the level shown for the year-end in that chart. We had predicted a top this year in late summer of 1700 on the S&P 500 with a decline and a 1625 level at year-end. Is this correction one where a hedge could protect from loss? Probably not to a great degree! The hedge is designed to help soften a major decline. While we believe it can soften the blow from a smaller 8% to 10% decline, the question still must be: “If we do not expect a major decline (over 20%) anytime soon, is it worth having a hedge that may limit the potential upside of the market?”

“Could a correction of this type confirm that we have entered a Secular

Bull market?” Probably not! I believe that there will be a more substantial correction early next year that will set the mid-term election year low. Then we should expect the mid-term election rally to begin and continue into 2015. This rally has averaged 49% over the past 90 years. **I believe that then we will truly be in a new Secular Bull market.**

But if the secular low price was in 2009, why doesn't the Secular Bull begin until 2014? Historically, Secular Bull moves are not confirmed at the actual low. In the bear market from 1929 to 1942 the low was actually made in 1932. That was a thirteen-year Secular Bear market. The next Secular Bear market began in 1966 and ended in 1982, a sixteen-year bear market. In that case the secular low was in 1974 but the Secular Bull was not called until 1982. So the secular low for this bear market will be in 2009 even though, in my opinion, the Secular Bull will not begin until 2014. That would make this bear market a fourteen-year long Secular Bear.

But after that we could see many years of a great Secular Bull market. The last secular bull lasted from 1982 until 2000, (eighteen years) and gained 1400%. The one before that lasted from 1942 to 1966, and was a twenty-four year secular bull that gained 1200%. The shortest secular bull market of the last century was only seven years long, from 1922 to 1929. But that bull gained almost 500%.

To quote from BlackRock's latest update, “Stocks are reasonably valued, interest rates are low, inflation is not a threat and corporate balance sheets remain healthy — all the more reason why we feel stock prices should move higher over the intermediate term.” We will have corrections from time to time which are a normal process in any bull market. We believe there will most likely be a decline approaching 20% sometime between now and mid-year 2014. This could be caused by the Fed taking away the punch bowl, corporate earnings stalling, or the economy slowing. **In any case, I just do not see anything on the horizon to derail the economic recovery or the long term upward tilt to the equity markets.**

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