ClarkCapital MANAGEMENT GROUP

Navigator® Global Opportunity

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March 31, 2014 - Market Commentary

The Chipping Away of the Bull Edifice: The Real Macro Issues to Watch

Executive Summary

- Currency volatility is still one of our key macro concerns.
- The evidence continues to build for a multi-week correction in the equity markets. This correction could have substantially greater down side magnitude and may begin as soon as early May.
- We may experience one final strong up leg before this correction begins.

Whenever looking into the future for possible macro risk issues, it is often best to focus on the problems no one is actively discussing: the so-called "elephants in the room." At the end of this quarter, high frequency trading (HFT) had become the hot topic in the financial news since the launch of Michael Lewis's book *Flash Boys*. Around the time of the book's release, in quick succession, the Securities and Exchange Commission, FBI, New York Attorney General, Commodity Futures Trading Commission and the Department of Justice had opened investigations into a range of practices loosely labeled as HFT.

Active money managers, such as Clark Capital, are not shocked by HFT. The problem has been with us for quite some time, and has been extensively documented in other well written books on the subject.[1] Clark Capital has been contending with this issue over the last few years using counter-strategies with our trading partners in an effort to minimize negative impacts to our trade executions. HFT can be relegated to being a market micro-structural problem and not a major macro issue that keeps us awake at night. It is an operational problem but not a crisis. However, as a caveat, we would note that the exit of some large HFT firms from the markets could create volatility events in the near future.

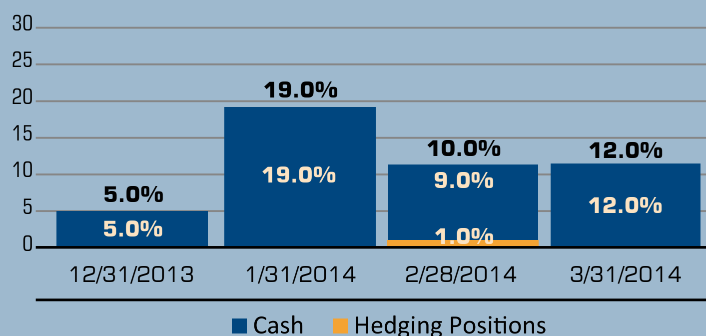
The "elephants in the room," about which we are concerned, are related to currencies. It is no secret that the emerging market members of the G20 have not been happy with the extraordinary liquidity operations of the major central banks. They consider the Federal Reserve Bank's actions an abuse of U.S. reserve currency status and have made tentative steps to establish a system to bypass the "petro-dollar" in future trade arrangements. Last year, China, Russia, India,

Target Allocations (as of 3/31/2014)

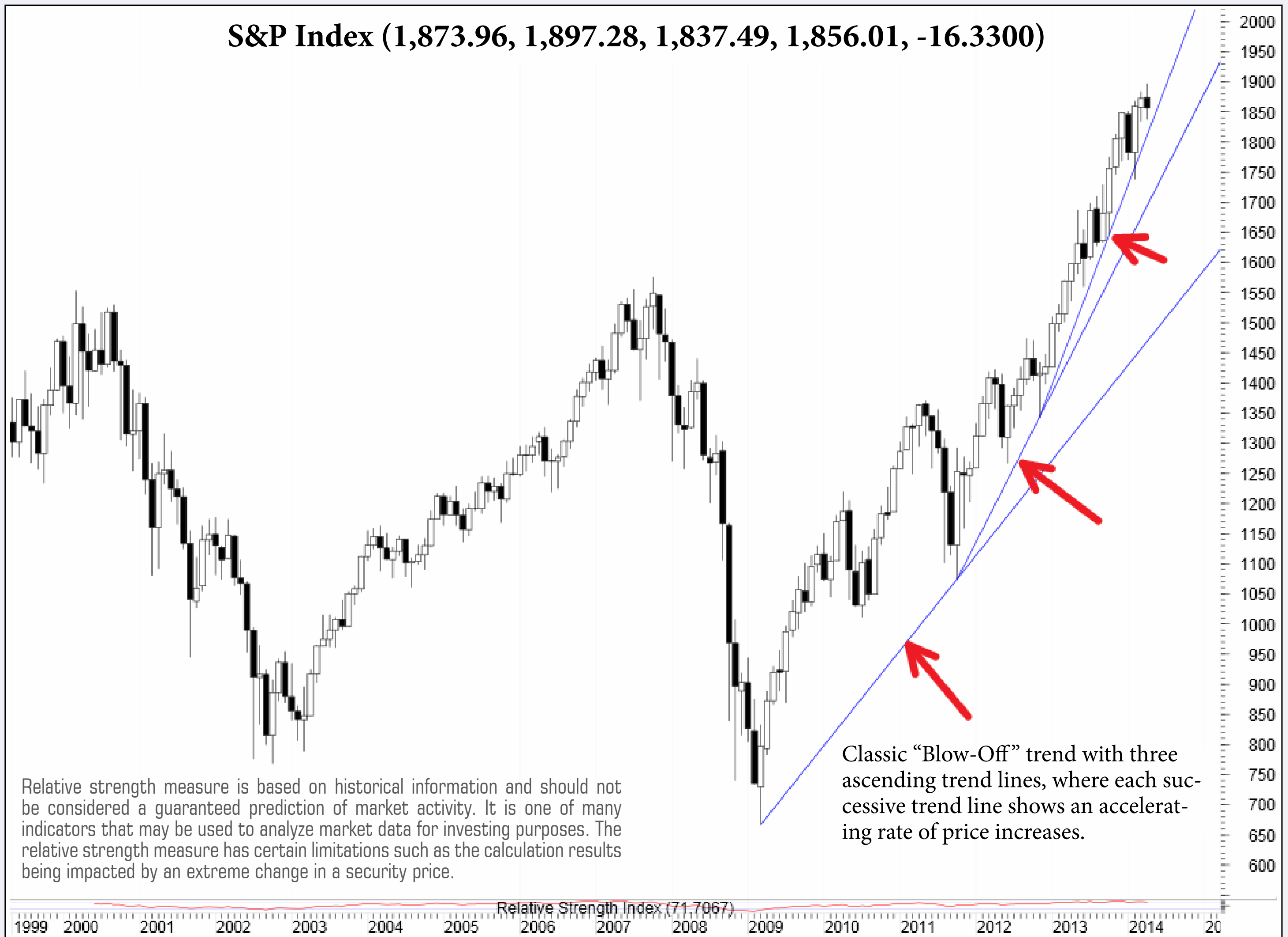
US EQUITY		**70.0%**
SPY	SPDR S&P 500 ETF	35.0%
QQQ	POWERSHARES QQQ TRUST	35.0%
SECTORS		**8.0%**
FCG	FIRST TRUST ISE NATURAL GAS ETF	5.0%
GDX	ENERGY SELECT SECTOR SPDR FUND	3.0%
FIXED INCOME		**10.0%**
TLT	ISHARES BARLAYS 20+ YR TREASURY BOND	10.0%
CASH		**12.0%**

This is not a recommendation to buy or sell any particular security. Please see attached disclosures.

Defensive Positions (Last Four Months)



Asset allocation may vary and the targets shown will be affected by market conditions, account guidelines or restrictions.



Data Source: Bloomberg. *Figure 1*

Brazil and South Africa had made initial arrangements for the creation of a BRICS Development Bank as well as that of a world currency to marginalize the dollar.

The crisis in the Crimea may serve to accelerate this process, pushing Russia to develop long term bi-lateral trade agreements with the Chinese in order to mitigate any impacts from U.S. sponsored sanctions. In May 2014, President Putin will meet with the Chinese in Beijing, where it is expected a major trade agreement will be negotiated, sponsoring future non-dollar dedominated trade. This is all part of a Russian trade expansion eastward within a greater Eurasian framework[2]. Although the speed of development of these structural changes is glacial, it may create currency crises along the way as global currency reserve adjustments are made.

Why are these currency issues important to us when we continue to enjoy an extremely market-friendly Federal Reserve? Succinctly stated, the Federal Reserve primarily serves U.S. interests, while the other central banks serve their own respective parochial interests. Although there are coordinated central bank actions, they are the exception rather than the rule. Currencies are the equilibrating mechanisms between economies and they are not easily controlled, at least not unilaterally. In addition, currency trading is typically highly leveraged, with leverage sometimes reaching 100:1. When money stock, cur-

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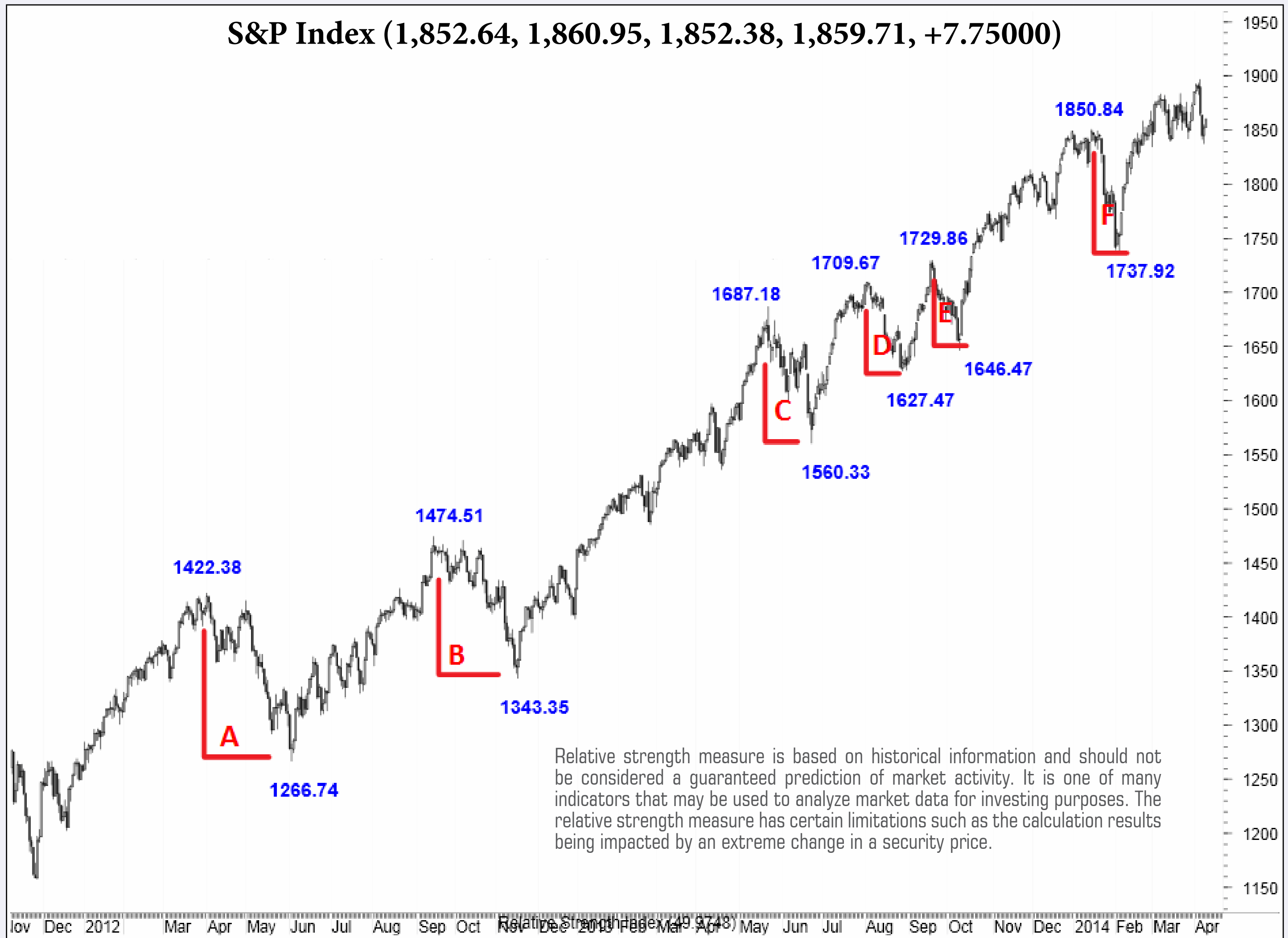

Data Source: Bloomberg.

Figure 2

Table 1: S&P 500 Corrections Since 2012

	Date of High	Date of Low	Range High	Range Low	Price Corrections: Points	Price Corrections: %	Time of Corrections: Calendar Days	Time of Corrections: Trading Days	Comparison to Prior Correction
A	4/2/2012	6/4/2012	1422.38	1266.74	156	10.9%	63	43	
B	9/14/2012	11/16/2012	1474.51	1343.35	131	8.9%	63	43	"B" Less in Price, Equal in Time to "A"
C	5/22/2013	6/24/2013	1687.18	1560.33	127	7.5%	33	23	"C" Less in Price, Less in Time to "B"
D	8/2/2013	8/28/2013	1709.67	1627.47	82	4.8%	26	18	"D" Less in Price, Less in Time to "C"
E	9/19/2013	10/9/2013	1729.86	1646.47	83	4.8%	20	14	"E" Equal in Price, Less in Time to "D"
F	1/15/2013	2/5/2013	1850.84	1737.92	113	6.1%	21	14	"F" Greater in Price, Equal in Time to "E"

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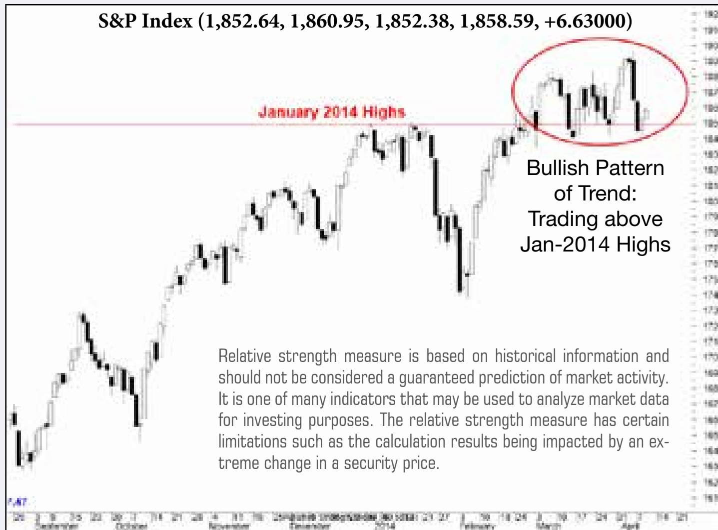
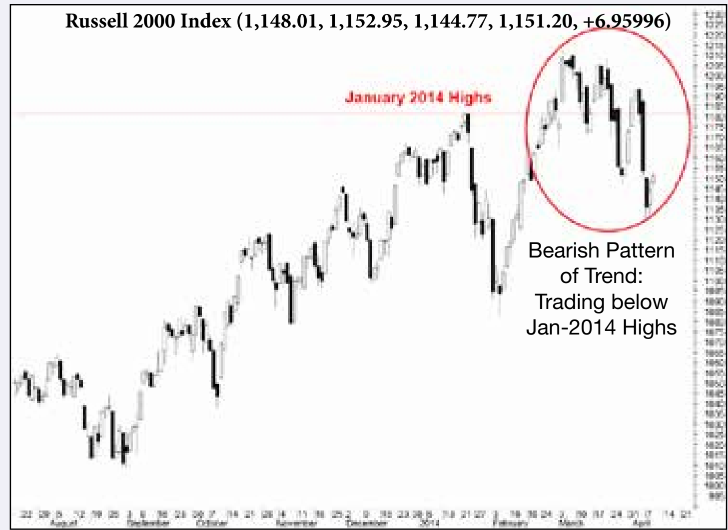
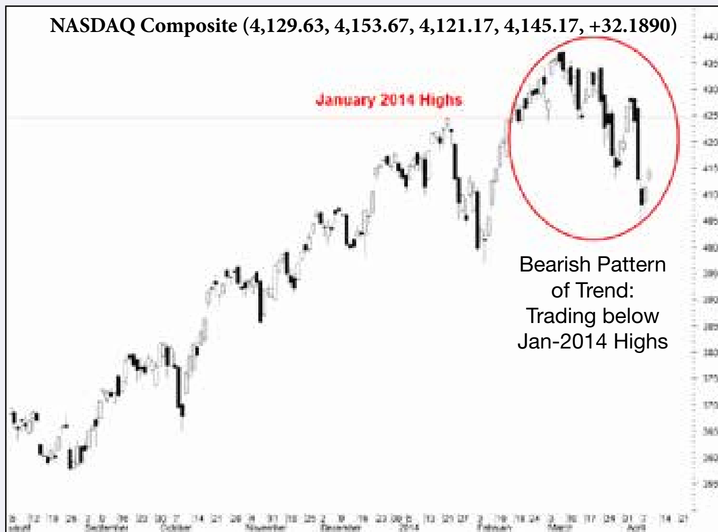


Data Source: Bloomberg. *Figure 3a*



Data Source: Bloomberg. *Figure 3b*



Data Source: Bloomberg. *Figure 3c*

rency flows and arbitrage relationships are disrupted this leverage creates high volatility in other financial markets. In our June 30, 2013 commentary, we reviewed the history of some past crises where currency disequilibrium was the spark that lit the fire. The Federal Reserve "put" won't immunize us from these risks, and we refuse to become complacent because of it.

Now let us review the tactical aspect of this quarter's portfolio management. As you can see from our end of month defensive positions (bottom right on page 1), we have primarily used cash for tactical defensive purposes. In fact, our intra-month cash position in the last half of January was almost 40% during our last correction, which lasted only 14 days. Because of our technically driven process, we enjoyed positive relative portfolio performance versus the S&P 500 this quarter.

Although the S&P 500 was up only 1.30% for the quarter, the trend is still in a strong position and in "blow-off" mode. As we've noted in the last two commentaries, a "blow-off" up trend is where the trend accelerates upward, with each subsequent correction along the way being less in terms of price and time. Once a final high is in place, then a more serious correction ensues. What clues do we look for in order to identify this final high? In January we saw some early warning signs in the nature of this trend that suggest the next fast move up may be the last in this cycle.

First, for the sake of perspective, let's take a "high-altitude" look at the S&P 500 through the monthly chart in Figure 1. Note the three ascending trend lines since 2009, where each steeper trend line shows accelerating price momentum. This steepness of slope is not sustainable.

Now let's focus down into the area of the last ascending trend line in Figure 2, starting in 2012. In the accompanying table (Table 1), we list all the corrections since the beginning of 2012, along with each correction's associated time and price statistics. Since the beginning of 2012, note how each successive correction has been less in price and time during this "blow-off" period; that is, until the last two corrections. In September 2013, the decline matched in price the prior decline but still took less time. In January 2014, we received

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the first warning shot of trouble with the "blow-off" trend, where the decline "overbalanced" in price the prior decline by 30 points, while equaling the prior decline in time (i.e. ,14 trading days, no "overbalance" in time). This is a well-established method to signal an imminent completion of a "blow off" trend, where the analysis suggests the next move up will put in the high that will be followed by a subsequent first move down greater than 113 points (probably matching 156 points which was the largest correction within the trend). This first down move would also "overbalance" time as well, exceeding 14 trading days. More importantly, it will mark the beginning of a much more significant multi-week correction.

There will be a host of other technical considerations that could help us confirm a top. With respect to the pattern of trend, the S&P 500's entire March sideways consolidation traded on top of the December/January swing high, a bullish trading pattern. However, this same pattern of trend has not occurred in the NASDAQ and Small Caps; where these indices have been trading deep below their January swing highs. This trend incongruence between Russell 2000 and NASDAQ versus the S&P 500 is a bearish inter-market non-confirmation.

In closing, a growing list of technical elements are weakening this five-year bull cycle which ultimately may result in a major equity market correction. There is a strong probability the equity markets will enjoy one last euphoric swing higher. Afterwards, we believe our risk management process may add substantial value to our portfolio's relative performance in the ensuing correction.

1. Broken Markets, Arnuk, Sal L. & Saluzzi, Joseph C., Pearson Education, 2012 and Dark Pools, Patterson, Scott, Crown Business, 2012.

2. "Russia looks east as it seeks to rebalance trade interests," Financial Times, April 3, 2014.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The NASDAQ Index is a market-weighted index of all common stocks listed on the NASDAQ exchange.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI World Index is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance.

The MSCI World Index ex. U.S. is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S.

The MSCI Emerging Markets Index is a freefloat-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The MSCI All Country Europe is a freefloat-adjusted market capitalization index that is designed to measure the performance of European equity markets.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The VIX Index is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries and government-related & investment grade U.S. Corporate securities that have a remaining maturity of greater than one year.

The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity, and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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