ClarkCapital MANAGEMENT GROUP

Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

Third Quarter 2015 — Portfolio Commentary

THE GOOD, THE BAD AND THE UGLY...AND THE RATE HIKE

Jamie Mullen
Senior Portfolio Manager

As Senior Portfolio Manager, Jamie developed and manages the Navigator Global Opportunity portfolio and manages the Premier Fixed Income Strategies. In addition, Jamie manages covered call options deployed on individual stocks and exchange traded funds in the Premier Portfolio Group and implements collar strategies on individual blocks of stocks. He is a member of the Clark Capital Investment Committee. Jamie has over 25 years of experience with fixed income securities. He began in municipal credit research and worked in public finance before moving to a position in trading where his experience included trading municipal bonds and employing fixed income futures and futures options. He has extensive experience in dealing with mutual funds, and trust departments and money managers. He received his degree from St. Joseph's University.

The Good

Real GDP for the U.S. came in at 3.7% for the second quarter. Over the summer, monthly payroll gains averaged 221,000, and the jobless rate dropped to 5.1% as reported after the September unemployment report.

The Bad

The full effects of the China yuan devaluation which happened at the end of June was felt during the second quarter. Commodity prices continued to sell off. Asian, emerging market, European and U.S. markets sold off with slower growth the new prospect globally. The S&P 500 was down 6.94% during the quarter.

The Ugly

The humanitarian crisis is roiling Europe. Tens of thousands of people are leaving the war torn mid-east and heading to the borders of Germany, Poland, and Hungary. The European Union (EU) is trying to find places to disperse the refugees across the EU countries. Chancellor Merkel of Germany has estimated that as many as 800,000 refugees will attempt to live in Germany this year. The costs to her country to educate, house and feed the masses will be in the billions.

The Rate Hike

There is a scene in the iconic Clint Eastwood movie bearing the title of this article, in which Tuco (played by Eli Wallach), having fled to a shanty town, takes a bath in a ramshackle hotel and is surprised by a bounty hunter. As the bounty hunter talks and holds his gun on the outlaw, Tuco shoots and kills the would-be assassin with a gun he's been hiding under the bubble bath. Tuco then mutters the classic line, "When you have to shoot, shoot. Don't talk."

Which brings us to the FOMC and the September confab. Yellen, if you're going to raise rates, raise rates, don't talk. In our view, this was a complete misstep by the Fed. They have done nothing but talk about raising rates in 2015 and, even though the market was split on the outcome, the status quo and the way it was communicated after the meeting did more harm than good. The result? Equity markets sold off, Treasury bonds rallied.

If you have read my previous market updates, I have been in the "lower for longer" camp for years. I did not think a rate hike was in the cards in 2015. But with so much talk about the 2015 rate hike by all the Fed governors as they grab TV and print time, I thought they were boxed in and had to raise.

After all, domestic activity continues to lead the Fed in the direction of a rate hike. So what was new that caused them to blink? Apparently heightened downside risks to global growth.

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For years we were told it was employment and inflation mandates. Now apparently, global concerns are on the agenda too. The real issue is how do you normalize interest rate policy when QE was not a normal policy?

The Year in U.S. Treasury Interest Rates

	12/31/14	3/31/15	6/30/15	9/30/15
2 year	0.66%	0.55%	0.64%	0.63%
5 year	1.65%	1.37%	1.65%	1.35%
7 year	1.97%	1.70%	2.08%	1.73%
10 year	2.17%	1.92%	2.35%	2.03%
30 year	2.75%	2.53%	3.12%	2.85%

Source: Bloomberg

The yield curve had steepened through the first two quarters of the year but by the third quarter, two-year bonds to 30-year bonds narrowed 26 basis points. Global growth concerns and Fed rhetoric on the rate hike is driving divergent outcomes on the yield curve. The two-year bond hovers near 60 basis points, positioned for a possible rate hike in 2015. The 10- and 30-year bonds have rallied, focused on the possibility of slower U.S. growth moving forward.

European Bond Yield Rally

	5 year		10 year	
	6/30/2015	9/30/2015	6/30/2015	9/30/2015
France	0.32%	0.21%	1.19%	0.98%
Germany	0.07%	0.00%	0.76%	0.58%
Italy	1.24%	0.74%	2.33%	1.72%
Spain	1.12%	0.88%	2.30%	1.88%
Portugal	1.68%	1.13%	2.98%	2.38%

Source: Bloomberg

European interest rates moved lower. The China yuan devaluation, economic slowdown in China and commodity weakness contributed to a volatile quarter in 10-year interest rates across Europe. The final move lower in yields appeared to be as a result of the U.S. Environmental Protection Agency (EPA) issuing a Notice of Violation of the Clean Air Act to German automaker Volkswagen. The EPA charged that the German automaker had equipped vehicles having turbo charged diesel engines with software that resulted in the engines testing as having low enough emissions to meet the U.S. standards. Under non-test circumstances, emissions from these cars were up to 35 times higher. Volkswagen stock plunged over the last days of the quarter, sending the German DAX lower along with the rest of Europe's bourses. The result was EU bonds rallied into September 30th.

The Portfolios at a Glance

The third quarter can tend to be rocky in the municipal market. Low coupon re-investment and maturities coupled with the summer doldrums can lead to some adjustment in prices. This year that was not the case as equities sold off and Treasury bonds rallied. All supply was absorbed but municipals did lag Treasuries, and the spreads on municipal bonds widened out versus Treasuries.

The structure we like in municipals is quality AA names with 4% coupons due in the 2025 to 2030 range with shorter calls in the 2021 to 2023 range. In our opinion and being in the "lower for longer camp," buying bonds at 120 to 140% of Treasuries is a value.

In taxable bonds, BBB credit spreads continued to widen out. High yield was very weak as dropping of commodity prices is really taking a toll on bonds in the oil and natural gas space. Looking at the quarter, the place to be was long duration and 100% Treasuries. Our portfolios weakened into the end of September as the proverbial "window dressing" occurred and Treasury bonds rallied hard. We plan to continue to build par in our portfolios and welcome the wider BBB spreads. Who doesn't want more yield and income?

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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.

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The Barclays U.S. Corporate High-Yield Index covers the U.S. dollar 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.

The Barclays 30-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

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The Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

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