First Quarter 2016

Clark Capital MANAGEMENT GROUP

navigator® REPORT

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Fourteen Corrections and Counting!

The above heading refers to the fact that the current Bull market has had fourteen corrections (of at least 5%) and, at the moment, seems to still be alive. There were two significant corrections along the way, one was 19.4% in mid-2011 and the current one at 14.2%. The current case has been pretty extensive since the market, based on the S&P 500, peaked on May 21, 2015.

The year 2016 began with a waterfall decline with the market losing 10% over only six days. It was the worst ever first two weeks of a year. A recovery began on January 20th, which failed in early February. The decline then resumed to eventually bottoming on February 11th, having a loss for the year at that point of 10.38% and reaching a 22 month low from the May top of 14.2%.

The massive recovery has given new hope that the Bull market is still alive even though there are many obstacles to its survival.

The *Stock Trader's Almanac* says, "As goes the S&P 500 in January, so goes the year." **This has been wrong only eight times over the past 65 years for an accuracy rating of 87.7%.** Pretty scary! Election years have been positive 73% of the time since 1928. Over those 22 election years, 16 were positive and eleven of the 22 election years produced double digit returns while four produced double digit losses. Interestingly, two of the four double digit losses occurred in 2000 and 2008 as bear markets were getting under way and where January showed losses of 5.1% and 6.1%. The average gain over all election years since 1928 has been 6.9%. The largest loss was in 2008 at 38.5%. Without that loss the average gain is 9.1%. **Is it an omen that the last two big bear markets began during an election year and both those years had negative Januarys?**

At the February 11th low, as mentioned, the S&P 500 was down from the peak of May 2015 by 14.2% and down 10.38% for the year. *Looking more deeply into the S&P 500 shows that 60% of the stocks in that index were down over 20% from their 12 month highs and 37% were down more than 30%, i.e., in Bear market territory.* The NASDAQ had a loss of 17.9% while the Dow Jones Transportation Average was in Bear market territory with a loss of 24.2%. The Russell 2000 index of small

SUMMARY

Yes, the current Bull market is getting quite old and will come to an end at some point. But for now the Bull seems to have again come alive with the rally from the lows on February 11th. As always, there are pros and cons as to where the markets might go in the short term.

One of the pros is the simple fact that this market has shown an amazing amount of resilience. The market has essentially been flat for 18 months and this alone can tend to relieve stress and act as a correction. **Also, the nine month decline from May 2015 to February 2016 drove many indices into Bear market territory.** This could be deemed consistent with a cyclical Bear cycle in an ongoing secular Bull which is similar to several declines of the 1960s, 1980s, and 1990s.

One negative is the chart of the LEI shown on page three. If there is a recession in the offing, the equity markets usually decline in anticipation. And quite often the market will decline in anticipation of a recession that never shows up.

Another major negative is the action of margin debt. *Margin debt as a percent of GDP has been a consistent predictor of market peaks for the past fifty years as reported by InvesTech.* The lead time is usually twelve months from the peak to the beginning of a Bear market. Margin debt peaked in April 2015 and has been declining ever since. If this trend continues then the Bull market has expired. We are looking for a reverse higher in this indicator to tell us the Bull is alive and well.

I would not be surprised to see the S&P 500 decline again this summer,as is normal in an election year, before recovering to end the year with a profit of 5% to 7%.

cap stocks is also in Bear market territory with a loss of 25.6% from the highs. **This shows just how severe losses were during the decline from the May 21, 2015 highs to the February 11th low.**

Losses from the May peak to the February bottom should not have come as a surprise. A 10% correction occurs on average once every 12 months, and the last one was 44 months before the May 2015 peak. Like a spring, you can only stretch the market so far before it pulls back with a significant loss. This time was the third of the five longest periods between 10% corrections at 44 months. *Two of the other four times the correction heralded the beginning of new Bear markets in 1966 and 2007 while one heralded the crash of 1987.* The other time was during the longest Bull market in history between October of 1990 and March of 2000. The market in that case moved higher for another 29 months before peaking in March 2000.

RECOVERY

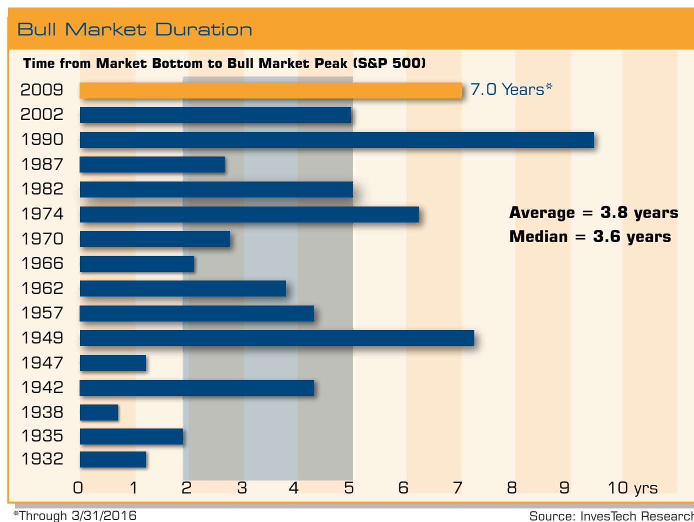
A furious rally began on February 12th producing one of the biggest turnarounds in nine decades. That rally bought the S&P 500 to a slight 16 point or 0.8% gain for the year. The U.S. fared much better than the rest of the world with Europe declining 2.4%, the United Kingdom losing 2.3% and Japan losing 7.3% in U.S. dollar terms. Emerging markets were the surprise as they gained 5.6%. **The massive recovery has given new hope that the Bull market is still alive even though there are many obstacles to its survival.**

This Bull Market Could Join AARP!

On April 28th, the current Bull market will become the second longest on record and second only to the massive rally from October 1990 to March 2000.

According to Morningstar (a mutual fund rating service) this Bull market has driven the S&P 500 higher by 190% including dividends since March 9, 2009 when it launched. Despite these gains and the long time this Bull has been around, most investors are still lukewarm towards stocks. According to the Investment Company Institute, investors have sold a net $623 billion U.S. stocks since March 2009. All of this while corporate profits have increased by 282% since the start of the Bull market.

Yes, this Bull is pretty darn old as is the economic recovery. The current economic recovery is now the fourth longest since 1900 at 6.8 years. The average recovery lasts 3.8 years and the longest ever is from 1991 to 2001 or 10 years.



*Through 3/31/2016 Source: InvesTech Research

Neither economic recoveries nor Bull markets end from just old age. Just as Bull markets become Bear markets, economic recoveries become recessions. In both cases they end from various factors such as higher interest rates, declining profits, lack of business investment, and competition from outside sources.

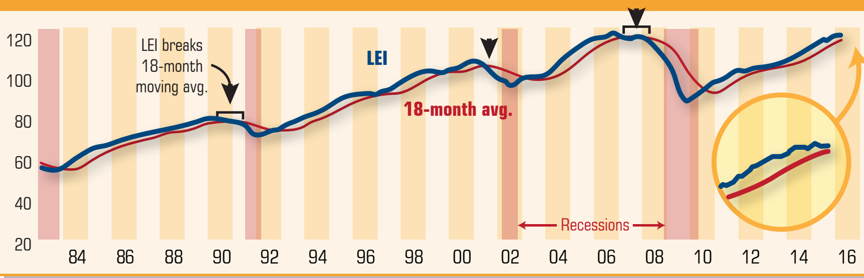
The next chart, from James Stack's InvesTech Research, shows the Leading Economic Indicators (LEI) and shows that they are close to reversing the positive trend of the past seven years.

As you can see, the LEI peaked last November and is very close to crossing over the 18 month moving average. That would indicate that a recession is, on average historically, eight or nine months away. The soonest any recession has started after the LEI crossed the average has been four months. The LEI to the Coincident Economic Index, which tends to lead, is indicating that the LEI may cross over indicating a recession is in the offing. If a recession starts in nine months, it would end the current recovery and make it the second longest since 1900 at over 7.5 years old. *Reinforcing this possibility is a survey of corporate CFOs where 31% said they expect a recession within the next nine months*.*

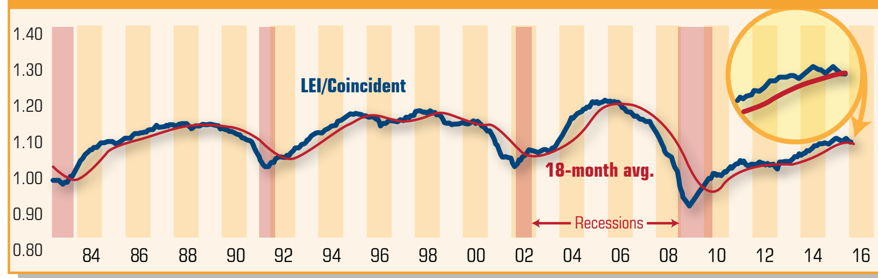
A further indication that this market may be on borrowed time is the lack of Initial Public Offerings (IPOs). Volume for the first quarter was a slim $700 million in new offerings compared to $5.5 billion in the same quarter last year and a record $37.6 billion raised in the third quarter of 2014. The amount raised was about the same as was raised in the first quarter of 2009 when we were in the grips of the Great Recession. This in itself does not indicate an end to the current market run but is just one other item to indicate that the economy and market are getting long in the tooth.

*Source: Duke University CFO Global Business Outlook.

U.S. Leading Economic Index (LEI)



Leading Economic Index to Coincident Economic Index



Source: InvesTech Research

CORPORATE EARNINGS

Corporate earnings is the fuel that powers the equity markets. According to Thomson Reuters, quarterly earnings are forecast to decline by 7.1% in the S&P 500 for the past quarter compared to one year earlier. *This would mark the biggest drop since the third quarter of 2009 and the third straight quarter of accelerating declines.* Earnings weakness in the past quarter is also broad-based with seven of the ten S&P 500 sectors expecting lower earnings. Negative earning preannouncements are running at four to one versus positive ones which is not a good sign for the equity markets. The Energy sector is expected to swing to a loss for the quarter for the first time since 2002. With the economy in a slow growth mode and international economies weak, we could be in for a protracted period of lowered earnings expectations. One bright spot could be the dollar. The rapid rise of the dollar over the past year has hurt foreign earnings of U.S. companies, but over the past two months the dollar has declined by 4.1% easing the pressure. If the dollar stays at the current level or even drops somewhat, foreign earnings could recover nicely. Favorable earnings comparisons are not expected until the third quarter of this year which may be too late to avoid a larger decline in equities.

A well-known strategist from Societe Generale in Paris, Albert Edwards, released a statement saying, "Newly released U.S. whole economy profits data show a gut wrenching slump. Whole economy profits never normally fall this deeply without a recession unfolding.... Whole economy profits tend to be a leading indicator of the business investment cycle. Historically, all recessions are effectively caused by slumps in business investment driven by a profits downturn.*"

BONDS

At the beginning of 2016, everybody was of the opinion that bond yields had nowhere to go but higher. The Fed (Federal Reserve Bank) had raised rates by 0.25% in December for the first time in seven years. And Fed Chair Janet Yellen has publicly stated that she had intended to raise rates at least three or four more times in 2016. As the market decline unfolded, and foreign central banks pushed their yield into further negative territory, the Fed relented on its pledge to raise rates. At the moment, we are only giving a rate increase as late as December a 61% chance of happening. As it turns out, bonds were the place to be during the first quarter.

HIGH YIELD BONDS

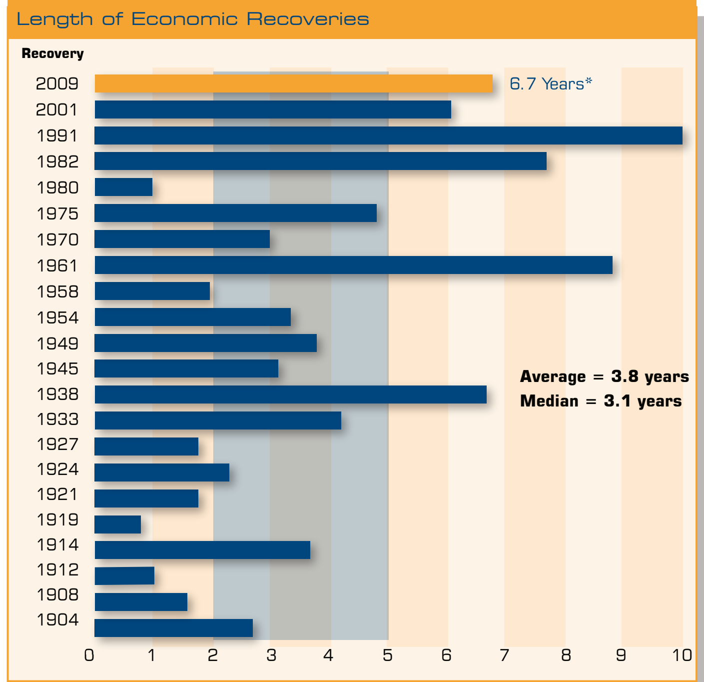
High yield bonds declined by over 5% in 2015 mostly due to problems in the oil patch and basic materials. Our high yield bond program, including the FITR (Fixed Income Total Return) separate managed account and our Tactical Bond Mutual Fund, was essentially flat last year. High yield bonds continued their decline in 2016 and were down 5.16% by February 11th. It is no coincidence that high yield bottomed the same day that oil bottomed. Crude oil has jumped sharply, posting its strongest five week rally since 2011. There are many articles that warn of defaults in the high yield sector. Ex-Energy and Materials high yield defaults have made a post crisis low of 1.2%. Overall default rates in this sector have risen to 2.9%, still a far cry from the historical average rate of 4.5%.

As you may know, these high yield bond programs move between high yield and high quality (U.S. Treasury) bonds and cash (T-bills). The program moved to Treasury bonds on December 9th and stayed protected in this class until again entering the high yield space on February 29th. That trade was noteworthy as high yield declined and Treasuries advanced. The Barclays U.S. Corporate High Yield Index

*Source: Newsmax.com

declined 3.5% while the Barclays Treasury 7-10 Year Index rose 4.2% for a net difference of 7.8%. These changes were dictated by our relative strength high yield model. The top performing holdings for the quarter were Treasury positions, the iShares 7-10 Year Treasury ETF (IEF) and the Barclays Long-Term Treasury SPDR (TLO). Top detractors were Barclays Short-Term High Yield Bond SPDR (SJNK) and PIMCO High Yield Fund Institutional (PHIYX). On February 29th, the positions were again fully invested in high yield through a diversified mix of three high yield ETFs and six actively managed high yield mutual funds.

Results for the quarter are 6.16% for the separately managed account program and 7.1% for the tactical bond mutual fund (net of fees).



*Through 3/31/2016

Source: InvesTech Research

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

The S&P Small Cap 600® measures the small-cap segment of the U.S. equity market being designed to track companies that meet criteria showing that they are liquid and financially viable.

The Value Line Arithmetic Composite Index uses the arithmetic mean change in the index reflects change if a portfolio of stocks in equal amounts were held.

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. non-convertible, fixed rate and publicly issued.

The Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

Barclays U.S. 7-10 Year Treasury Index measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The MSCI Emerging Markets Index is a free float adjusted market capitalization index that is designed tomeasure equity market performance in the global emerging markets.

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