Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

First Quarter 2016 — Portfolio Commentary

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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.

CENTRAL BANKS POLICIES . . . EVERYONE GETS A TROPHY

The Players

- U.S. Federal Reserve (the Fed)
- The Bank of Japan (BOJ)
- The European Central Bank (ECB)
- The Peoples Bank of China (PBOC)

The Basic Rules

1. Central Banks provide an ample supply of cheap money to banks in order to encourage lending to various individuals and businesses.

2. Central Banks manage their currencies to keep a competitive balance against other currencies so exporters can thrive in a global market place.

The first Rule should provide job growth to the population's work force. The second Rule helps set and maintain inflation targets.

What Did Players Do in the First Quarter to Satisfy the Rules?

In January, the BOJ stunned the markets with a negative interest rate policy in an attempt to drive the yen lower and stimulate exports. The result was the opposite as the yen soared and stocks moved lower. The 5-year Japanese government bond (JGB) ended the quarter at a -.19% yield and the 10 year at a -.04% yield.

In March, the ECB expanded its negative interest rate policy. Monthly bond purchases would be raised to 80 billion euros from 60 billion. The new twist was the purchases would include non-financial investment grade corporate bonds. The ECB also raised (or is it lowered? It's difficult to keep track of negative rates.) to 40 basis points the fees the ECB charged banks.

The result was European rates dropped further. German 5-year rates went from a -.04% yield to a -.33% yield. French bonds went from .08% to a -.20% yield. Also with negative rates at the end of the quarter were Sweden, Netherlands and Switzerland. Italy and Spain rallied but did not go negative for the 5-year issue. The real market mover though is Germany, where the 10-year rates closed the quarter at .15%, a 47 basis point rally from the close of 2015.

Next up is the PBOC. The PBOC is apparently trying to stabilize the yuan. The effort is trying to manage bubbles in equities and property markets by reversing course on margin rules and short selling. But the real bazooka is "re-educating" the press to relate the "real" story of the improving economic numbers in China.

The last player in our group is the Fed. The Fed did not raise rates at its March meeting. Fed chair Yellen regarded slow global growth, specifically in China, and other emerging markets as concerns. All this, despite data and U.S. trends that support slow economic growth and continued positive trends in employment.

How Did This Work Out?

Entering 2016, the consensus was that U.S. Interest rates would rise, with the Fed set on a course to raise short term rates four more times. It didn't happen. The 10-year U.S. Treasury ended the first quarter of 2016 at a 1.77% yield, down from the close of 2015 at 2.29%.

Gold, the only currency substitute since the dawn of man, was up by 16%. This may be a vote of non-confidence in the Central Banks' policies.

U.S. equity markets bungeed from -11% mid quarter to rebound to close +1%.

The dollar retreated 4% for the quarter, helping commodities rally. So where do the roots of the equity bounce come from? Is it from the falling dollar, commodities rebounding, or the Fed on hold? The answer lies in:

"Greater Gradualism"

The Fed is clearly swimming against the tide. They are trying to set a course of policy normalization to higher interest rates. The market interprets hiking rates as "tightening." The availability of credit determines if the Fed is tightening, and the banks are awash in cash reserves. Higher rates should steepen the yield curve and help bank profitability. In contrast the BOJ, ECB and PBOC are easing so the Fed is facing headwinds.

"Greater Gradualism" is a term Yellen used in a speech at the end of the month, giving notice the Fed won't be fighting the tape of other Central Banks easing. There is some dissent on the Federal Reserve voting committee, most notably from James Bullard and Stanley Fisher, as to the pace of the rate hikes. But Yellen's speech clearly announced to the markets she was in charge. The market has calmed and the fed funds futures market is only pricing in one rate hike in December.

To summarize, "Greater Gradualism" has allowed the dollar to steady at lower levels, keeping equities firm and positive on the year. Equity volatility has dropped. Oil has rebounded off its lows. High yield bond spreads have contracted. Gold "bugs" are happy hiding in their bear currency dens with positive returns in 2016. Bond bulls have been rewarded, with the "lower for longer" trade still working.

Everyone is a winner. . . Everyone gets a trophy.

Muni's Behave as Expected

January began much as the last year ended with strong demand and positive returns in the first couple of weeks as a result of thin new issue supply. Typically more attractive spreads come into the market in the March-April time frame. The new issue calendar will increase and tax season can cause some mutual fund outflows.

There are two types of structures that we have been focused on. The first is a 4% coupon structure which is callable in 6 to 9 years with stated maturities of 11 to 15 years. The second is 3.25 to 3.5% coupon structure in the 9 to 12 year range, again with shorter calls. With a 10-year Treasury trading below 2%, we have liked the yields as a percentage of Treasuries that are available.

New issue supply in California was of notable interest in the quarter. On February 29th, 2+ billion of bonds were priced by four issuers. California Statewide Communities Development Authority issued a student housing bond rated BAA1 by Moody's. Los Angeles Public Works Department issued bonds rated A1/AA. San Diego issued sewer revenue bonds rated AA+. Los Angeles Unified School District issued bonds rated AA2 by Moody's. A plethora of various credits in this high-tax state was met with eager buyers.

The deal that would really set the tone for the market was 2.8 billion California GO bonds that came to market the first week of March. That deal was attractively priced, aggressively subscribed for, and traded up in the secondary market after the bonds were allocated.

Overall, with low yields throughout the world, the muni market in our opinion seems attractively priced. With Treasury rates range-bound and stuck below 2% in 10 years, muni cash flow makes them appear to be a decent place to invest.

Credit Was Volatile

Since the beginning of 2016, crude oil plunged and found a low on February 11 at $26, a 29% drop. This pulled the S&P 500 down 10% with global markets suffering larger losses. High yield credit spreads widened dramatically. Commodity bonds suffered double digit losses. Chesapeake Energy, a large high-yield index bond, was trading in the $40s and, at year end, it plunged into the teens and the market seemed priced for an imminent default.

Investment grade credit spreads widened out. The sell side was trying to be active, but there were very few buyers. Treasury bonds were the only place to move large blocks of investment grade paper.

Then, as all markets do when pushed to a sentiment extreme, they somehow found a bottom. Oil rallied, stocks bounced. Credit spreads rallied aggressively. Chesapeake came up with the money to pay a March 15th debt payment and the "risk trade" was back on.

If you went away for a three month vacation without access to news, you would come back and look at your bond returns, smile and say nothing much happened, except you probably would clip a few coupons for return. We know differently. Since our belief has been "lower for longer," it doesn't appear the biggest threat to the market is rising interest rates. Of bigger concern in the future is if Central Bank intervention becomes less effective. We will wait and see what the market's reaction is. With an active management approach we will adjust accordingly.

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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.

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 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 Barclays U.S. Government and Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment grade U.S. corporate securities that have a remaining maturity of greater than 1 year. In addition, the securities have $250 million or more of outstanding face value, and must be fixed rate and non-convertible.

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.

The Barclays 10-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.

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.

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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