Clark Capital
MANAGEMENT GROUP

Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

Third Quarter 2016 — Portfolio Commentary

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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.

IN BONDS, NO ONE CAN HEAR YOU SCREAM

The famous 1979 "Alien" movie by Ridley Scott used the line: "In space, no one can hear you scream" as its advertising trailer. A central banks movie is playing out in 2016 with a similar epigram, being in danger in a hopeless situation as their policies become less effective in propping up equity and bond markets throughout the globe. Here are some of the dangers causing investors to scream in the third quarter:

Corporations under Fire Causes Spreads to Widen

- Apple ordered to pay $14.5 billion fine for back taxes by the EU. Apple's corporate tax rate was deemed too low for operating in Ireland.
- EpiPen scandal breaks out over the cost charged to consumers by Mylan, the generic drug maker.
- 5,300 employees fired at Wells Fargo over two million unauthorized phony accounts set-up for customers. Other employee practices come to light. The CEO is called to testify in front of Congress and could be forced to resign. Wells Fargo stock tanks and bond spreads widen.
- Department of Justice wants $14 billion from Deutsche Bank to settle mortgage claims. Hmmm, $14 billion – that number seems familiar. Tit for tat because of the Apple fine?

Central Bankspeak Heats Up as We Approach September Fed and Bank of Japan Rate Meetings

- August, Fed Vice Chairman Stanley Fischer says the U.S. economy has nearly reached its targets.
- August, Bank of England cuts rates to avoid a Brexit recession.
- August, San Francisco Fed President John Williams says if Fed waits too long to raise rates, the economy will create imbalances and overheat.
- August, at its annual meeting at Jackson Hole, Wyoming, Fed Chair Janet Yellen notes a stronger case for raising rates.
- August, at Jackson Hole conference, Haruhiko Kuroda, Governor of the Bank of Japan (BOJ), says the bank won't hesitate to boost stimulus.
- September 9, Fed dove, Boston Fed President Eric Rosengren hints at a need for gradual removal of policy accommodation. Equities sell-off after his speech amid fears of a Monday confirmation from fellow dove Fed Board Member Lael Brainard.
- September 12, with the intervening weekend to prepare and soothe the markets, Brainard confirms her dovish view and squashes the idea of a Fed rate hike at their scheduled meeting the following week.

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Are you feeling alone yet? Your portfolio helpless against the constant battle of what to do with fiscal policy and central bankers. Ready to scream while some central bank somewhere practices Alien policies never tried before? I mean QE and negative rates were certainly Alien economics prior to the financial crisis in 2008.

The Fed Blinks Again...the BOJ Admits Negative May Not Be Good

The Federal Reserve left interest rates unchanged at their September meeting. The August unemployment report was on the weak side after strong reports in July and June. The Fed's jawboning in August and September was an attempt to put a quarter percent rate hike on the table. However, the markets' perception that the Fed would stay on the sideline with the November election proved correct as rates were left alone. December looks like a 50/50 proposition for a rate hike and it may depend on market volatility after the election.

The BOJ also had their September meeting and it happened to coincide with the Fed's. It was anticipated the BOJ would continue to delve into negative interest rate policy. Instead they shifted and will seek to control yields across different maturities, specifically targeting the 10-year bond and pegging it at 0%. It is a slight admission that negative rates may have limited effectiveness going forward. Any hope of positive yields should help pensions and insurance companies.

Policy Contagion or Policy Purgatory?

Contagion is defined as the transmission of disease from one person to another. If one of the central bank sneezes, do all markets catch a cold? The yield curve is widely viewed as a business cycle indicator. Yield curves around the world continued to flatten in the quarter. Low bond market yields around the globe are persistent and could foreshadow a global recession.

The Fed tried to interject some independence in August and September by putting rate hike talk on the table. The market did not believe them. Fed funds futures adjusted the small probability higher but the Fed passed. The BOJ, which may be the world's largest hedge fund, seemed to have more influence on the market with their policy meeting than the Fed. The central banks' policies while seemingly becoming less effective are increasingly linked together for the health of the global economy. Another scenario is that we are in Policy Purgatory.

Purgatory is a place between heaven and hell where people suffer while they wait their move to a better place. Now that sounds like where the central banks have us. Slow growth, not meeting inflation targets are standard results of fiscal policies in the industrialized countries. Overindebted societies, which can be argued to be deflationary, present another not-so-fun characteristic. Central banks are trying to move us along to a better growth environment but have us stuck for an indeterminant time. Low interest rates which hurt savers and pension funds persist.

Is it Contagion or Purgatory? Deutsche Bank may hold the answer.

Deutsche Bank and the Fourth Quarter Ahead

We end the quarter with Deutsche Bank fending off rumors of insolvency. Estimates of trillions of euros of derivative exposure have the market comparing them to a Lehman moment. Well this is really "Too Big to Fail" German style. The CEO is claiming all is OK. Rumors surfaced of a German government bailout which was resoundingly denied by Chancellor Merkel. The stock hit a 52 week low before sharply bouncing higher on the last day of the quarter.

Credit default swaps on the bank moved higher and spreads on the debt widened. Confidence is a fragile thing, and everyone is confident until one of their trading partners doesn't pick up the blinking phone to execute trades with them. Once rumors happen, confidence can be shattered. But this bank is really an integral part of the global financial system. Here, the belief is that the central banks will not lose control of this situation.

Hopefully they will all be singing "Oh Tannenbaum" as volatility around the bank subsides by the end of the fourth quarter. So, in bonds, can no one hear you scream? Nope, it just means lower for longer is still the trade in fixed income.

Sleepy End of Summer in Munis

The August-September reinvestment period of interest payments, called and matured bonds for munis, coupled with end of summer lower volume traditionally has created some softness in the muni market. With persistently low and negative rates in sovereign debt worldwide, munis, with their investment grade ratings, continue to provide relative value in fixed income.

September did provide some back up in yields as the 10-year Treasury bond moved from the mid 1.50s % yield in August to a high of 1.72% on September 13th. Muni dealers were looking to reduce their inventory heading into the September Fed meeting enabling us to buy some selected credits at slightly higher yields than just weeks before.

As the quarter ends there is generally an eye towards the next month's employment report. It has always been our opinion that this is really the most important measure of the economy. If you build it they will come . . . if you employ them they will spend. Any trading around that number should surely focus on the possibility of a December rate hike since the Fed will be on hold with the upcoming November election.

High Yield Bonds Remain Strong...Treasury Bonds Remain Anchored Below 1.7%

The 10-year Treasury bond opened the third quarter at 1.44% yield. The closing high yield was on September 13th at 1.72%. Our macro view that bonds trading below 1.70 to 1.74% keeps the bullish view intact held true in the third quarter. Volatility was low, keeping high yield bonds firm despite Fed and BOJ rate meetings scheduled in September. Low volatility and firm high yield prices kept the S&P 500 within 2% of its all-time closing high of 2190 reached on August 15th.

All the calm may eventually give way with the upcoming U.S. presidential elections. The result in November could be the determinant factor in how the market moves over the coming quarters. The election is the main focus and has removed some of the spotlight placed on the central banks.

The Fed held rates unchanged at their September meeting. They did, however, reduce their target rate projections for the end of 2017 and 2018. The BOJ also kept its rates unchanged but announced plans to target its 10-year bond at 0%. Simply put, as rates go negative, the BOJ reduces purchases. Rates turn positive, they increase purchases to try to achieve the 0% target. It seems a small concession that maybe negative rates were not achieving the desired result. We have ended these missives with the same conclusion: Lower for longer still exists.

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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 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 S&P 500 Index measures the performance of 500 large companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

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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.

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.

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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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