Clark Capital MANAGEMENT GROUP

Navigator® Fixed Income
Jamie Mullen, Senior Portfolio Manager

First Quarter 2017 — Portfolio Commentary

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Senior Portfolio Manager

As a Senior Portfolio Manager, Jamie manages the Taxable and Tax Free Fixed Income Strategies. He is a member of the Clark Capital Investment Committee. Jamie has over 30 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, trust departments and money managers. He received his degree from St. Joseph's University. He joined Clark Capital in 2005.

GO YOUR OWN WAY

Raising rates is (or isn't) the right thing to do.

Fleetwood Mac's iconic 70's song is about the trouble in a relationship and could have meaning to the bond market. It is the consensus that the long-term bull market ended in July 2016 when a double bottom was put on the yield chart of the 10-year bond. Over the 36-year bull market, bond bears reluctantly had to do a dance with the bulls as rates continued lower. Bond bears saw the November election as the breakup of that relationship and felt they could finally go their own way. But could they?

The Rate Hike Rally

The Fed hiked rates as expected in their March meeting by 25 basis points. On Monday March 13th the 2-year Treasury was at 1.37%, the 5-year was at 2.13% and the 10-year was at 2.62%. After the rate hike, yields rallied and by weeks' end yields were lower — 2-year yields were down six basis points, 5- and 10-year yields by 12 basis points.

Can you imagine calling your retail client, fearful of higher rates, and explaining to them that the Fed hiked rates yet the yield on the bonds we can buy went down? This is the message of the market: bond bears hope for higher yields which still has not happened.

With the rate hike, borrowers with revolving debt or adjustable rate mortgages will get hit with increased payments. However, bond investors had to be invested before the rate hike to participate in the price rally. When the 2.60% yield level on 10-year Treasury bonds held on March 13th, bonds subsequently rallied to 2.40% giving the bond bulls confidence the rally could continue. The result is that new investors aren't likely to get the benefit of higher rates in this rally that is occurring into the end of the first quarter.

You Can Call It Another Lonely Day

Since Obamacare was put into place, the House of Representatives during the last administration wanted to "repeal and replace" the bill. The current President wanted to make it his first agenda item under his administration. The Freedom Caucus and moderate Republicans in the House could not reach agreement. Washington rhetoric started flying. Some pundits said a 1000 point drop in the Dow was possible if the bill did not pass. Predictions of large layoffs in the healthcare sector probably spooked some in Congress as well.

Trump called for the House to vote on March 24th, but as the day wore on it became apparent there were not enough votes to pass and Paul Ryan pulled the bill. The result was stocks opened down on Monday, March 27th but closed up on the day.

The election brought anticipation of fiscal policy changes. Specifically, up next are:

- Corporate and individual tax reform
- Regulatory reform
- Infrastructure spending program

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The Disconnect

Stocks have spent the last weeks of March consolidating the fourth quarter 2016 gains. Bonds have rallied after the Fed rate hike. What gives? Who is right? Past efforts to stimulate the economy á la QE1 and QE2 from the Great Recession have produced a low growth recovery. Stocks have favorably anticipated tax reform as being able to re-price the S&P 500 multiple higher in 2018. However, the Atlanta Fed reduced fourth quarter GDP projections to below 1%. Fed Chair Janet Yellen was more dovish in her minutes after the rate hike than hoped for by bond bears. So bonds and stocks appear to be predicting different outcomes to the next round of fiscal stimulus that will be negotiated in Washington.

How can I ever change things that I feel?

The Structure of Debt — Impediment to Growth

At the household level, debt is just treated as a line item in a checkbook. Low interest rates make it difficult to pay back debt because the monthly payment is skewed towards the principal side. For the same payment, people take on more debt at lower rates. Simply put, if I have mortgages at 3% and at 6% that both have $1000 monthly payments, it is easier to pay down the mortgage at 6% because I have less debt. We believe that because of the low interest rate environment, moderate tightening by the Fed is a much more powerful tool in restraining economic growth when rates begin to rise because of this imbalance of principal debt on the household balance sheet.

The federal deficit gets even trickier. I am not going into a PhD level dissertation on this but let's assume rates go to 5% on a $20 trillion deficit (and growing). That is a $1 trillion interest expense the good old USA would be paying. That really starts to dwarf a $1 trillion dollar infrastructure plan.

The bottom line is debt is deflationary. We have a ton of it everywhere and that is what bonds may be predicting. Deficits, debt, more low growth, and maybe a Fed that is further along this rate hike cycle than in past cycles — all are certainly part of a discussion to have about how high can rates really go.

We believe one thing is apparent. Bond bulls and bond bears after a 36 year bull market are splitting. And they can **go their own way**.

More Comments on Fixed Income

The taxable bond portfolios have been the benefactor of the rally in Treasury prices. Keep in mind bonds are meant to be held and not traded. If higher yields occur, we are re-investing at higher rates. Demographic changes tend to change spending and investing habits in an aging population. Throw in pension funds and insurance companies starved for yield after eight years of ZIRP and demand for bonds may keep overall rates in this Fed hiking cycle lower than bond bears would like.

Municipal bonds in a seasonally weak time period have benefited from reduced new issue supply. Changes to the ACA have kept hospitals from the market as they try to assess the financial implications. An infrastructure program and regulatory reform have kept issuers from roads and bridges to clean water agencies on the sideline as they wait to see the changes that will take place.

The lack of supply in munis plus the threat of higher rates have pushed investors into purchasing shorter bonds in the 3- to 5-year maturity range. The percentages of Treasuries are in the upper 70 to low 80% range and in our opinion don't appear to be of much value. Purchasing investment grade corporates in the 3- to 5-year range seems a more compelling value.

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CCM-655