ClarkCapital MANAGEMENT GROUP

# Navigator® Fixed Income

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Second Quarter 2017 — Portfolio Commentary

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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.

## DO IT AGAIN

*"And now we're back where we started"*

*"Here we go around again"*

As I begin to pen the second quarter review, a song from the Rock and Roll Hall of Fame band The Kinks keeps rolling through my head. "Do It Again" is artistry at its best by the British band. Unlike when it came out in 1984, I can now listen to it on my iPhone, go to YouTube and watch the video on my phone, or turn on Roku on my TV and watch on it on the larger screen all without getting out of my chair.

Fast forward to 1994, when Amazon launched. Hard to remember, but it was a little bit ignored at first, with people thinking, "What's so great about buying books online?" Facebook followed in 2004, Uber in 2009, Bitcoin in 2009, Instagram in 2010. The common thread that makes all these technologies work? The iPhone, celebrating its 10th anniversary this year.

The iPhone and cell phone technology created a demand for faster and faster internet service, along with ever increasing data plans. Sharing information, connecting with others personally and professionally, seeking and/or creating entertainment… the list goes on and on showing how intertwined we are with our cell phones. It is a disruptive technology and has changed socialization patterns and how we live our lives. The speed of change is startling.

But for our purposes here, let's slow things down and look at few important dates for the Fed:

- 1987 Stock Market Crash
- 1997 Thailand Baht Starts the Asian Crisis
- 2007 Financial Crisis
- 2017????

So far this year: in June the Fed increased the Federal funds target for the fourth time in this tightening cycle. They also announced a plan to pare back their balance sheet during their process of "normalization." The Fed can read the government-supplied numbers but does that really illustrate the fundamental changes in consumer behavior caused by the internet companies mentioned above? So what is the Fed model's reaction? The same reaction as they always have to the data. But despite that reaction, the economy is behaving differently this time. We can't get a sustained growth in GDP that will help alleviate the deficits being created at the federal, state and local levels of government.

### Amazon Buys Whole Foods

Fed Chair Yellen insists when growth slows it is "transitory," and inflation below target is "transitory." Do you think Amazon buying Whole Foods is inflationary? Food delivery at home is one more reason not to use your car or, for that matter, not buy a car at all. The Whole Foods stores will also be places to pick up goods bought through Amazon Prime. This purchase is a part of Jeff Bezos vision of how the consumer will live in the future. Amazon can compress margins in the food industry and continue to drive retail purchases away from malls.

The day the deal was announced, Walmart, Costco, and Kroger shares were pummeled.

The Amazon purchase of Whole Foods is probably deflationary. But since everything the Fed looks at is "transitory," the question really becomes: Is this purchase by Amazon "transitory" or truly "transformational"? The low interest rates that persist in the bond market seem to contrast with the Fed's models on growth and inflation. The result of each transitory change made by technology drives transformational changes in the world.

Let's talk about another technology that will be transformational and that is the development of driverless cars. I have to assume that is deflationary as well, all the way down to the local government level. Think about your local municipality losing revenue from parking and speeding tickets and DUI offenses. Millennials don't find having driver's licenses or owning cars a priority now. Maybe the baby boomers as they downsize will also decide to get rid of a car and lower our car insurance as well. The tentacles of deflation will spread far and wide when driverless technology hits the masses. Will driverless cars be transitory or transformational?

For the Fed "Transitory" is a term used to say that the economic models will get back in sync. "Normalization" in Fed speak says, "Let's go back where we started, where unicorns run free in the fields and candy is growing from trees." But what date do we go back to? 1987? 1997? 2007? The central banks saved the world in 2007. But the economic patient has been sedated for 10 years and I doubt when it wakes up it will agree that the economy of Apple, Amazon, Google, YouTube, Facebook etc. is anything like an economy they have seen before.

The Fed is in an interest rate tightening mode. The initial hikes in the economic expansion don't mean a whole lot until suddenly they do. With no history of unwinding a balance sheet of this size, the Fed will monitor if this in itself magnifies the rate hikes so far. Back where we started?

No, its 2017 and the adage "Don't fight the Fed" is back because here we go around again.

## Navigator Taxable Bond Portfolio

As the quarter closed, the European Central Bank and the Bank of England hinted that as economies continued to recover "some removal of monetary stimulus is likely to become necessary." Now all major central banks seem to be in sync with moving away from easing with our Federal reserve leading the way, already four interest rate hikes into this cycle.

During this quarter, we noticed a large amount of selling going on in the front end of the yield curve. My supposition is that this has been the banks clearing the decks to be "requested" by the Fed to buy some of the debt off their balance sheet. So far, so good, as the market volatility has been low and liquidity firm.

With the front end of the yield curve finally providing some incremental yield, we have been barbelling the portfolio. Taking positions with durations in the 1-3 year range, and adding durations in the 6-8 year range could be a benefit if the yield curve continues to flatten.

Our percentage of investment grade corporate holdings increased during the quarter. We had a few of our high yield bonds mature and called during the quarter, reducing our exposure to this sector. If and when high yield sells off, providing a better risk/reward scenario, we will look to increase our exposure again.

## Navigator Tax-Free Portfolio

The highlight of the quarter was the anticipated re-investment of the June through August coupon interest and maturing bonds coming due. This positive seasonality in munis coupled with 10-year Treasury bond rallying to the 2017 low point of 2.12% on June 14th has led to it being a seller's market.

We have taken the opportunity during this positive market tone to reduce 3% coupons, as well as some 4% coupons, and reduce duration. We liked a couple of note deals that were priced during the quarter as a place to put some cash to work in the one year area of the curve.

On the credit side of things, Puerto Rico Government Development Bank (GDB) reached a deal with its bondholders. Generally investors would receive 55 to 60 cents on the dollar. This will set a tone for further negotiation with the general obligation bonds going forward.

By the end of the quarter, Illinois debt was being threatened by the rating agencies with a downgrade to junk bond status. Illinois has not had a state budget passed in two years and the credit agencies are putting pressure on the state through the downgrade warning. Yield spreads widened out but interestingly AGM and BAM municipal insurers were willing to quote insurance for various Chicago credits and the state's general obligation bonds. We have taken a couple of positions in selective Illinois credits that we felt offered extra yield versus the general market.

Not to be outdone by Illinois, New Jersey was looking at a government shutdown as the July 4th weekend approached. As with Illinois, New Jersey is failing to pass a state budget as law makers cannot agree on much. With a lame duck governor, the New Jersey issue will continue to be in the headlines.

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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.

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