ClarkCapital MANAGEMENT GROUP

Navigator® Fixed Income

Jamie Mullen, Senior Portfolio Manager

Fourth Quarter 2017 — Portfolio Commentary

Jamie Mullen
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.

SWEET DREAMS

Who am I to disagree?

The volatility index of the stock market as measured by the VIX Index has told a story contrary to what seemed to be on most peoples' minds and that is politics and geopolitics. Whether it was North Korea testing intercontinental ballistic missiles, Russian election tampering allegations or just about anything else coming out of Washington, the VIX told a story of complacency as the U.S. markets moved higher for the year.

The Fed raised rates three times in 2017 for a total of five rate hikes in our current tightening cycle. Janet Yellen, the current Fed Chair, will be replaced in early 2018. The Fed began reducing its balance sheet by $10 billion per month and plans to gradually raise this amount over the foreseeable future. The U.S. yield curve flattened from over 120 basis points at the end of 2016 to 51 basis points at the end of 2017, based on 2- to 10-year U.S. Treasuries. A flattening yield curve typically has been a strong predictor of an upcoming recession. However, the U.S. economy is still strong and we see potentially 3% GDP growth seemingly on track for 2018.

I travel the world and the seven seas

Economic growth seems to be getting synchronized across the globe, including both developing and emerging economies. For now the European Central Bank (ECB) and the Japanese Development Bank (JGB) are still accommodative in their bond buying, making positive yielding U.S. interest rates relatively attractive. Two-year interest rates are still negative in eight European counties and Japan. Five-year rates closed the year negative in Germany, Sweden, Netherlands, Switzerland and Japan. Meanwhile U.S. interest rates out to three years are at their highest levels since 2008.

Some of them want to use you

Cryptoflation? Does the Fed need to be concerned about the cryptocurrencies? Cryptocurrencies came about as a result of the Financial Crisis when central banks aggressively lowered interest rates and people feared inflation and the collapse of the traditional monetary system. We get asked the question from time to time about Bitcoins' impact. For now, it is the true definition of a speculative investment. You can't use technical analysis to trade, it's just "pick a price" and hope it goes up. Fear of missing out isn't rampant yet, but it could get there. There is a limited supply of Bitcoin and people around the globe are trading it, so it could really move up in price. But is it destabilizing? Until a financial institution gets on the wrong side of a crypto trade, it won't have a major impact to the Fed. So for now, as a trader, it's a fantastic ride until it goes against you and, as with any other trading system, money management skills will determine your own outcome.

Past performance is not indicative of future results.

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Hold your head up

The Fed is five rate hikes into this current cycle. The FOMC is projecting three rate hikes in 2018. The new normal for the fed funds rate appears to be 2%. Until the fed funds rate gets above 2%, I don't see the Fed policy as being too restrictive. The curve probably will continue to stay flat although at a higher level than today's rates. As always, the New Year starts and it is up to us to navigate the markets looking for positive return. Because as the Eurythmics said it: "everybody is looking for something."

Navigator Taxable Bond Portfolio

There continued to be a large amount of short-term investment-grade paper available as the year came to a close. Corporations and banks sold into the yearend, looking to position themselves for the new tax law changes coming in 2018. Yields continued to rise in the front end of the curve as the flattening of the yield curve continued. For our portfolios, which have been slowly transitioning the allocation into a barbell strategy, the higher yield on the front end of the curve was welcome.

The tax law changes will certainly have an impact on fixed income in 2018 as will the Fed rate hikes. The reduction of the corporate tax rate from 35% to 21% will likely reduce the interest rate deduction on existing debt. In theory, this could change how corporations look at their capital structure resulting in issuance of more stock. This could be a slight tail wind against the Fed raising rates, as investment grade corporate bond supply could be reduced.

We believe the tax law will be negative for high yield as weaker credits will lose some deductibility of their interest payments. However, with volatility low and a strong stock market, high yield companies may continue to be able to refinance debt and issue stock to shore up their finances. The BB callable bonds we look to use in the portfolios still have the potential to help portfolio return moving forward. We will continue to focus on positioning the portfolio in a barbell strategy and adding select high yield credits in an effort to enhance income when appropriate.

Navigator Tax-Free Portfolio

December was a volatile month in the municipal market which was influenced by every rumor about the new tax law. At the beginning of December, bonds were a bit weaker but then were aggressively bought upon word that the tax law eliminated advance refundings. Advanced refundings enabled municipalities to issue a new series of bonds and invest the proceeds, typically in Treasuries, until they can call an older higher interest rate bond series. This pushed some issuance from the first quarter of 2018 into December 2017.

We talk of seasonality in these postings. At the end of the third quarter, we mentioned the unattractiveness of some bonds in the 5-year range because of the large reinvestment period in the June through August period. In retrospect, bonds traded to extremes during that period, leading to down months for the Bloomberg Barclays 5 Year Municipal Bond Index in September through November. We were able to avoid those potentially negative returns by prudent security selection and timing.

When a final version of the tax bill was passed, the new issue supply was quickly absorbed into the final holiday week. The month was volatile but closed on a positive tone.

While we anticipate consistent and strong demand for municipals from the retail market or individual investors, the reduction in the corporate tax rate from 35% to 21% will likely decrease the muni appetite of financial institutions, such as banks and insurance companies that hold these bonds. We don't think we'll see large scale selling from these institutions as they are most likely going to let existing bonds mature before reinvesting proceeds.

Overall, the effects of the new tax bill should prove to be challenging for many high tax states. Revenue raising ability will be limited with the SALT deduction limited to $10k. Any economic slowdown along with rising pension costs should reduce financial flexibility further. Our goal continues to be positioning the portfolio in what we view to be higher quality names that can withstand the financial challenges that lie ahead. We believe individuals will continue to buy in-state municipal bonds as out-of-state bond ownership will likely be reduced with the new limit on SALT. The reaction in the muni market is something we'll be actively monitoring in 2018.

Source: Bloomberg, Ned Davis Research

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The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

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 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.

The Bloomberg 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 Bloomberg 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 Bloomberg 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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The Bloomberg 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.

The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices and which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk. 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 Bloomberg Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury inflation-protected securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. The Bloomberg Barclays Capital Aggregate Bond Index is an intermediate term index.

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