TARIFFS, GEOPOLITICAL RISKS, AND THE FED

The S&P 500, and in fact the overall market, is in the midst of its fourth longest pullback since the market bottomed in March 2009. The market peaked on January 26th and has yet to eclipse that high-water mark. Geopolitical risks, tariff negotiations, trade war fears, and Fed rate hikes have all taken steam out of the market. Nonetheless, the major U.S. indices remain within striking distance of the old highs, a sign that the long-term trends should be respected and risk-on remains the appropriate bias.

Regardless of any extraneous fear, long-term fundamentals are firmly skewed in favor of a bull market. On the economic front, growth is accelerating and supported by a healthy labor market. The U.S. economic expansion is now nine years old, making it one of the longest expansions in U.S. history. In fact, the only post WWII expansion that lasted longer than the current one was 10 years long, from 1991 to 2001. We believe this is a late cycle expansion, but unlike typical late cycle expansions, this one seems to be accelerating with a considerable amount of momentum.

The Fed has now hiked interest rates seven times this cycle and recently highlighted a desire to hike rates two more times this year, three times in 2019, and once in 2020. The market doesn't believe the Fed will hike rates five more times between now and the end of 2019. The overnight swap market suggests the Fed will hike two or three more times through next year.

Second Quarter Attribution

The Fixed Income Total Return (FITR) portfolio remained fully invested in high yield bonds during the second quarter, and it has now been allocated fully to high yield for twenty-eight consecutive months. For the quarter and first six months of 2018, the strategy slightly underperformed the Bloomberg Barclays Corporate High Yield Bond Index and outperformed the Bloomberg Barclays Aggregate Bond Index. For the quarter, the Fixed Income Total Return portfolio gained 0.58% (-0.17% net of fees) in comparison to the Bloomberg Barclays Corporate High Yield Bond Index, which gained 1.03%, and the Bloomberg Barclays Aggregate Bond Index, which lost -0.16%. We have often said that the true alpha and value of the strategy is the sector exposure within fixed income. Since the FITR strategy allocated to high yield debt on February 29, 2016 through the end of the second quarter, high yield has significantly outperformed other fixed income sectors. Over that period the Bloomberg Barclays High Yield Index has gained 27.45%, the Bloomberg Barclays Aggregate Bond Index

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As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Board of Directors, the Investment Committee and the Management Committee. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

is up just 2.42%, and the Bloomberg Barclays 7-10 Year Treasury Index has lost 2.96%.

Credit spreads ended 2017 at 331 bps. Spreads remain low and well behaved, despite the equity market volatility we experienced in the first quarter. Spreads rose to a high of 365 bps as volatility spiked higher and tariffs and other geopolitical news rattled the market. As the market recovered, spreads have fallen back down and ended last week at 331 bps, exactly where they began the year.

We still don't expect to see the same surge in credit as we saw over the past couple of years, as spreads are already below their long-term average of 492 bps. At the risk of sounding like a broken record, history shows spreads can remain tight for long periods of time without an economic downturn. While risks have risen given the tight spreads, we are comfortable remaining allocated to credit as the economic outlook remains supportive. In addition, Moody's predicts default rates over the next twelve months will be historically low — around 2%.

However, there are risks that we are mindful of. In particular, rollover risk is high. According to Moody's, maturities for high yield debt will jump to $104 billion in 2019 from $36 billion in 2018 and will rise to $182 billion in 2020. That is likely to put pressure on the high yield debt market at a time of potential economic weakness. That is definitely a concern, but we believe it would also be an environment that the tactical nature of active fixed income management and the fixed income total return portfolio in particular is well positioned to manage through.

Outlook

Mark Twain said, "History never repeats itself exactly but it often times rhymes." We say that to highlight the fact that we are in a mid-term election year and those years have historically been subpar leading up to the early autumn elections. We are currently in the midst of what has historically been the weakest six-month period of the Presidential Cycle, the second and third quarters of the mid-term year. However, that weakness historically has given way to the market's best six-month period for the four-year cycle. There is a chance that we already have had the normal mid-term election year correction this time around. Nonetheless, it wouldn't surprise us to see some more correction or consolidation ahead of the mid-term elections.

Source: Bloomberg, FactSet, Moody's Corporation

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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 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 free float adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization.

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 CBOE Volatility Index (VIX) is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

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 one year.

The Bloomberg Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The BofA Merrill Lynch U.S. High Yield Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Bloomberg Barclays 7-10 Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities between seven and ten years.

The Bloomberg Barclays 20+ Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities greater than twenty years.

The Bloomberg Barclays Long-Term Treasury Index tracks the performance of the long-term U.S. government bond market.

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 U.S. Treasury Bond Index is an issuances-weighted index measuring the performance of the U.S. Treasury bond market, one of the largest and most liquid government bond markets in the world.

Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

MSCI All Country World Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley and is comprised of stocks from both developed and emerging markets.

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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