ClarkCapital MANAGEMENT GROUP

Navigator®
Fixed Income Total Return
K. Sean Clark, CFA®, Chief Investment Officer

Third Quarter 2018 — Portfolio Commentary

K. Sean Clark, CFA®
Chief Investment Officer

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.

FULL STEAM AHEAD

It was a tale of two different risk markets during the third quarter. It was full steam ahead for U.S. markets and credit, but the rest of the world languished in the choppy waters of the U.S. wake. The S&P 500 gained 7.71% in the third quarter while the MSCI AC World ex-US index gained only 0.71%, and the MSCI Emerging Markets index actually lost 1.09% during the third quarter. The strong economic landscape in the U.S., rising dollar, higher interest rates, and diminishing impact from the tariff spats have resulted in strong demand and flows for U.S. domiciles assets.

Broad based fixed income struggled with interest rate headwinds. High yield was the bright spot with the Bloomberg Barclays Corporate High Yield Index up 2.40%. Meanwhile the Bloomberg Barclays Aggregate Bond Index gained only 0.02%, and the Bloomberg Barclays US Treasury 7-10 Year Index lost 0.79% during the quarter.

We continued to see interest rates rising and the entire yield curve has recently reached new highs in yields. After the Brexit vote in the summer of 2016, the 10-year treasury yield bottomed at 1.37%. It has more than doubled since then, ending the third quarter at 3.06%. U.S. risk assets have not only coped well with the rising rates, but have surged as higher rates are a reflection of stronger economic activity. Stocks and high yield bonds, both being levered to the health of the economy, have performed exceptionally well.

Third Quarter Attribution

The Fixed Income Total Return (FITR) portfolio remained fully invested in high yield bonds during the third quarter. The strategy has been fully committed to high yield for thirty-one consecutive months. For the third quarter, the Fixed Income Total Return portfolio outperformed both the Bloomberg Barclays Corporate High Yield Bond Index and Bloomberg Barclays Aggregate Bond Index on a gross basis and underperformed on a net basis. At the risk of sounding like a broken record, the alpha of the strategy is driven by disciplined and quantitative top down relative strength research process that determines the strategy's sector exposure within fixed income.

Thirty-one consecutive months allocated to high yield is a remarkably long period, and we presently see no evidence of the strength in high yield bonds fading. Since the strategy allocated to high yield debt on 2/29/16 through the end of the third quarter, high yield bonds have significantly outperformed other fixed income sectors. Over that period, the Bloomberg Barclays Corporate High Yield Index has gained 30.52%, the Bloomberg Barclays Aggregate Bond Index has advanced just 2.44%, and the Bloomberg Barclays US Treasury 7-10 Year Index has lost 3.73%.

Except for high yield, bonds weren't such a great place to be during the third quarter as interest rates continued their grind higher. The 10-year U.S. Treasury Note yield rose, ending the quarter at 3.06% — its highest quarterly close since June 2011. In fact, as the fourth quarter began, yields across the curve have broken into new highs, which has heightened concerns over continued rising interest rates.

In terms of excess returns, high yield bonds posted their fourth consecutive month of gains and the Bloomberg Barclays Corporate High Yield Index outpaced the Bloomberg Barclays Aggregate Bond Index in each of the past four months. Finally, the lower credit quality spectrum of the high yield market performed slightly worse than higher credits. For example, according to ICE BofAML Indices, BB rated bonds gained 2.34%, B rated gained 2.39%, and CCC and lower rated bonds gained 2.82% in the third quarter.

Solid performance in high yield bonds and rising treasury yields resulted in continued credit spread compression and a relative new all-time high in the performance of high yield bonds compared to both U.S. Treasuries and T-bills. Of particular note is that credit spreads also fell to their lowest level since July 2007. While that is an indication that high yield is likely expensive, we know from past history that an asset class can stay expensive for an extended time and that credit spreads can stay low for long periods. One such period was between 2004 and 2007, with strong and stable economic growth and rising interest rates, which seems similar to today's environment.

Outlook

Our outlook has remained consistently favorable for the markets and economy based on solid economic fundamentals. Economic growth in the U.S. continues to surprise. The 10-year U.S. Treasury Note is trading above 3.0%, the unemployment rate sits at a 48-year low, recent comments from Federal Reserve officials signaled more rate hikes are on the horizon, and the economy is expected to continue on its growth trajectory through 2019. Those trends all favor continued outperformance of risk assets, and within fixed income, favoring credit risk over duration risk.

We have discussed mid-term election years statistics in past commentaries and with the election just around the quarter, we wanted to highlight one particular statistic around market performance. The worst two quarters of the four-year Presidential Cycle are the second and third quarters of the mid-term year.

We are now in the part of the calendar where the presidential cycle transitions from its two worst quarters to its two best, historically. Dating back to 1946, the S&P 500 has advanced by an average of 7.51% and 6.61% during the fourth quarter of the mid-term year and the first quarter of the following year respectively.

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.

Gross performance shown is presented gross of investment advisory fees and includes the reinvestment of all income. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net performance includes the deduction of a 3.0% annual wrap fee, which is the highest anticipated wrap fee charged by any sponsor. Management and performance of individual accounts will vary due to differences such as the availability of securities, trading implementation or client objectives, and market conditions. For a fee schedule, please contact your financial advisor. If you enter into an agreement directly with Clark Capital, refer to Clark Capital's Form ADV Part 2A.

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