Clark Capital Management Group

Navigator® Tax-Free Fixed Income

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Fourth Quarter 2018 — Portfolio Commentary

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FIXED INCOME UNDERDOGS ARE THE CHAMPS OF 2018

As equity investors slowly put their Dow 25,000 hats in their bottom desk drawer, let's take a second to talk about the biggest underdogs of 2018…bonds. Look, we get it. It is so easy to be seduced by a multi-year long bull market constantly hitting new highs. And let's face it— even in our last quarter's market review, we were focused on the high probability of a December rate hike and analyst expectations of several more in 2019.

But all that has changed in the fourth quarter. Whether it was the more dovish tone of the Fed, the stock market sell-off, a newly minted Democratic House of Representatives, weak oil pricing, continued tariff talk, or any combination of the above, the fact remains that fixed income got up off the mat in September and has been punching its way to a surprise quarter-long rally.

Every (Under)Dog Has His Day

At the start of 2018, the pews in the church of fixed income were empty to say the least. The mega-congregation of equities continued to find new believers with each new high that was hit, filling even the cheap seats in the back. Bonds, on the other hand, suffered a multi-quarter affliction as U.S. Treasury yields hit their highest levels since 2011, creating a double-edged sword of price loss at the expense of higher reinvestment yields.

But what goes up must come down, right? And as equities hit the skids from October to December, bonds finally had their time in the sun, with the rush to safe haven assets helping to fuel the Q4 rally.

To illustrate how far we have come, at the end of Q3, the Bloomberg Barclays U.S. Aggregate Bond Index was down -1.60% and finished the year at 0.01%. Over in tax-exempt land, the Bloomberg Barclays Municipal Bond Index had declined -0.40% through 9/30/18 and finished the year with returns of 1.28%.

Will the Champs Repeat in 2019?

Top of mind for investors and market participants is how long the Fed tightening cycle will last. Based on the more dovish language we've seen from the Fed, the answer may be not very long at all. Based upon the latest Fed models which focus on U.S. Treasury spreads, the probability of a recession may not be that far off.

Data dating back to the late 1960s shows us that the yield curve normally inverts 12-24 months prior to the start of the recession. While we have still not yet seen an inversion in the 10-Year/3-Month curve, it is getting close, with the spread at only 31 basis points at year end, which is the flattest it has been since September 2007.

Past performance is not indicative of future results.

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

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We are not economists, nor fortune tellers; however, we cannot completely discount what the data is saying…and for now, it points to the likelihood of lower rates.

When the curve inverts this cycle (and we're getting close), we will surely pay attention and start the clock speculating the timing of the next recession. While the credit impacts of an economic slowdown or a recession would point us to seek the safety of higher rated entities, the portfolio management impacts would direct us to remain fully invested to take advantage of price appreciation should rates head lower.

Tax-Free Portfolio

The fourth quarter rally in municipals was a welcome respite to the previous three quarters of negative performance, helping to push 2018 muni returns to 1.69% for the Bloomberg Barclays 5-Year Municipal Index. While there tends to be a bit of seasonality for municipal performance in December, the late innings of 2018 helped amplify returns for tax-free investors and firmly establish municipal bonds as one of the best performing fixed income asset classes last year.

As uncertainty regarding the future path of the Fed and continued U.S./China trade jarring weighed on investors, the 10-Year U.S. Treasury preceded to rally almost 42 basis points in the fourth quarter, while tax-free bonds followed along with the 10-Year AAA muni yield dropping by 32 basis points.

The final issuance numbers are in, and as expected, the loss of advanced refundings and overhang from 2017 implementation of tax reform contributed to a decline in municipal issuance of almost 22% year-over-year. Had it not been for a strong uptick in new money issuance, this figure would have sagged even further.

We anticipate that the demand patterns for municipals will remain somewhat fractured in 2019, with an expected uptick in the retail/SMA space and continued absence of a strong institutional appetite. The reduction in the corporate tax rate from 35% to 21% decreased the overall demand of financial institutions, such as banks and insurance companies, that were previous buyers of tax-exempts.

We continue to believe that these buyers are content to let existing bonds mature, and absent of an unforeseen credit event, will not be large sellers of munis in 2019. Further, we anticipate consistent and strong demand for municipals from the retail market/individual investors, especially from those buyers in higher tax states who are heading into the first full tax filing period, post tax-reform, for which the outcomes are highly uncertain.

While we expect the trend of new money issuance to continue to be net positive in 2019, our view is that total municipal issuance will still remain below longer-term averages with a projection of $330 billion for 2019.

Future tax-free returns will be dependent upon a combination of U.S. Treasury rate movements and the pace of municipal new issue supply. With the implementation of tax reform in the rear-view mirror, municipals should be free to feel the full impact of the January effect to start 2019.

Our focus in the tax-exempt fixed income strategy continues to center on current income, managing duration, and prudent credit selection. Focus on essential service issuers, as well as solidly capitalized healthcare and higher education names, provides portfolio diversification away from public pension and fixed cost ratio risk that are growing trends in the tax-backed sector. As we continue to monitor the indicators of a recession on the horizon, this could place even more pressure on the ad valorem tax backed sector.

Source: Bloomberg, Ned Davis Research

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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.

The Bloomberg Barclays 10-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.

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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