Clark Capital MANAGEMENT GROUP

Navigator® Fixed Income SMA

Jamie Mullen, Senior Portfolio Manager
Eric Kazatsky, Portfolio Manager

First Quarter 2019 — Portfolio Commentary

Jamie Mullen
Senior Portfolio Manager

Eric Kazatsky
Portfolio Manager

WINTER IS COMING FOR GAME OF THRONES FANS, BUT IS IT SPRING FOR FIXED INCOME?

If the health of the U.S. economy remains on solid ground, then the speed and direction of the Fed policy change this year is quite interesting. We could chalk up the change to the Fed's actions as either meeting the market on rate expectations or that the Fed sees something frightening "beyond the wall" and is trying to prime the market for further easing.

Being optimists, we choose to believe the former and not lose sleep over an invasion of economic White Walkers. When the Federal Open Market Committee (FOMC) met in December 2018, they not only hiked the Fed rate, but also signaled further hikes throughout 2019. Fast forward to several weeks later, and the Fed indicated it would be pausing its hikes for the remainder of 2019 and suspending any balance sheet unwinding. This sharp dovish turn lit a fire under the prices for both fixed income assets and equities, helping create solid returns to start the new year.

If the end of 2018 and start to 2019 have been a euphoric summer for bonds, then Winter is most likely due to come to the fixed income markets. Much like the intentions of Game of Thrones creator George R.R. Martin, bonds should heed the sentiment that even if things are good now, we must always remain vigilant for a darker period. Imagining a catalyst that could prolong the bond rally is difficult given the level of absolute rates in the corporate and, especially, tax-free markets. Yet, several headwinds remain.

Night Gathers, and Now Our Watch Begins...

Based on the positioning of the latest Fed dot plot, 11 members see the target federal funds rate in the range of 2.25% to 2.50% at the end of 2019; four members see a target range of 2.50% to 2.75%, which would indicate one rate hike; and two members see a target range of 2.75% to 3%, which would indicate two rate hikes. The sentiment of a majority eyeing no change through the year was communicated by Chairman Powell at their March 2019 meeting.

Despite Fed dot plot outlooks, our role as the "Night's Watch of rates" remains one of high alert and unwavering vigilance. The continued rallying in bonds created a universe which favors sliding farther out the duration curve to help lock in more attractive spreads, relative to associated risk profiles. The flattening of the yield curve in tandem with the Fed's expectation to pause hikes for the year, helped to ensure that longer dated assets would perform better relative to shorter dated counterparts. We believe that this trend may have run its course.

Part of our preparedness for a bond Winter comes with a continued focus on barbell structuring in the SMA program. We use this structure in an effort to provide protection against higher rates in the front end of the curve and take advantage of more attractive ratios on the longer end of the barbell.

Past performance is not indicative of future results.

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While duration was one component of positive return in the first quarter, the other part of the success story was credit selection. Credit selection and continued negative screening within the portfolios continue to be a differentiating factor as spreads within investment grade corporates and municipal bonds continue to tighten. In our taxable portfolio, we remain focused on sectors that are less sensitive to interest rate volatility, while on the tax-free side, we find additional value in revenue sectors such as healthcare and higher education.

Is the Bond Market Overbought?

There is no denying that the bond market moved fast and furious during February and March. Following the laws of physics, what goes up must come down, right? Even though there seems to be some support to even higher bond prices as the market is implying odds of a cut in the fed funds rate later this year, we remain skeptical of such a move higher from already lofty valuations.

On our immediate radar are early April economic indicators such as payrolls and manufacturing, which, when combined with stabilizing inflation figures, could prove to be headwinds for the persistent rally in U.S. Treasuries.

Source: Bloomberg, Ned Davis Research

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