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

First Quarter 2019 — Portfolio Commentary

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It certainly has been a bit of a wild ride for the markets over the past six months, as the S&P 500 swung from its worst quarter in over seven years, to its best quarter in almost ten years! Concerns over trade negotiations with China, a Federal Reserve that seemed to lack any perception of how their messaging affects the market, and slowing economic growth resulted in all risk assets heading lower in the fourth quarter.

However, as the calendar changed, it appears that progress on the trade front may be at hand. In addition, the Federal Reserve did an about-face, going from an expectation of three rate hikes and "autopilot" on the balance sheet roll off to now zero rate hikes and ending the balance sheet roll off by September. After this remarkable about-face, the market cheered. Risk assets rebounded sharply and now stand at new highs, as is the case with high yield bonds, or at the precipice of new highs, with the S&P 500 just a stone's throw away from a record high.

First Quarter Attribution

After a brief stint in a defensive position holding cash equivalents and U.S. Treasuries between mid-November and early January, the Fixed Income Total Return (FITR) portfolio returned to a fully invested position in high yield bonds on January 10th. FITR's allocation away from high yield in November enabled the portfolio to reduce risk and helped us avoid the dramatic market volatility we saw in December.

Worries over deteriorating credit conditions and market fears dropped dramatically when Federal Reserve Chairman Jay Powell reversed course on the direction of future monetary policy on January 4th. High yield bonds and Treasuries both responded sharply, with high yield bonds rising and Treasuries fading. As a result, the models that drive FITR's allocations responded accordingly, shifting away from favoring U.S. Treasuries and shifting back to favoring high yield bonds, where the strategy remained for the balance of the quarter.

For the quarter, the FITR portfolio underperformed the Bloomberg Barclays Corporate High Yield Bond Index on both a gross and net basis, but outperformed the Bloomberg Barclays Aggregate Bond Index on a gross basis. Net of 3.00%, the strategy was in line with the Bloomberg Barclays Aggregate Bond Index, but trailed slightly. We believe that tactical strategies that can avoid high risk downside environments, like we experienced in the fourth quarter, can help deliver superior long-term risk adjusted returns.

K. Sean Clark, CFA®
EVP, 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 Investment Team and the Executive Team. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean holds the Chartered Financial Analyst® designation and is 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.

Here are some additional developments during the quarter:

- All high yield sectors were up at least 4% on the quarter, with energy lagging despite a surge in oil prices and health care and telecommunications services leading. The Bloomberg Barclays Corporate High Yield Bond index gained 7.26%, more than recovering from the fourth quarter 4.53% loss. It was the biggest quarterly gain for index since the third quarter of 2009.

- It has been a volatile six months in the high yield market. For example, yield to worst and option-adjusted credit spreads were at 6.27% and 3.03%, respectively at the market top on October 3rd. By December 24th, they had risen to 8.07% and 5.30%. By the time the strategy allocated back into high yield on January 10th, they had fallen to 7.23% and 4.45%. As of the end of the quarter, they have fallen even further to 6.43% and 3.91%.

- Companies continue to add leverage to fund growth and buybacks. This means that one day there could be a glut of supply in the high yield markets. Approximately 50% of the U.S. investment grade corporate market is BBB, with a downgrade moving them into the high yield category. We believe that FITR is well positioned to capitalize on these trends as they affect the markets.

Outlook

The S&P 500 had its best start in 21 years, gaining 13.65% in the first quarter! When the S&P 500 has gained at least 10% in the first quarter, it has risen the last nine months of the year 85% of the time by a median of 7.0% since 1926. This suggests that risk assets have a fair amount of momentum on their side, which bodes well for continued appreciation. Strength in risk assets is an encouraging sign for high yield bonds and continued spread narrowing suggests that credit conditions remain firm and supportive of continued economic growth.

The Treasury yield curve (10-year Treasury yield – 3-month T-bill yield) did invert briefly during the quarter. This was a warning shot across the bow as every recession since 1962 has been preceded by an inversion. However, it's important to note that not every inversion has been followed by a recession. We look at many economic indicators in our analysis, and so far, only the yield curve has warned caution on the economic front.

However, inversions usually happen 12-24 months before a recession. At this time, we believe there are no obvious warning signs that signal that the economy has meaningfully deteriorated. Recent economic reports including payroll growth, falling initial jobless claims, and the Atlanta Fed's GDPNow Forecast, which is tracking toward 2.2% economic growth in the first quarter, support this conclusion. Our outlook remains favorable for the markets and economy based on these solid economic fundamentals.

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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