Clark Capital MANAGEMENT GROUP

Navigator® Taxable Fixed Income

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First Quarter 2019 — Portfolio Commentary

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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

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longer end of the barbell.

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.

Taxable Bond Portfolio

Fixed income returns were robust during the quarter based on the Fed's change in messaging to a dovish stance. The 10-year Treasury bond mostly traded in a range in January and February of a 2.60 to 2.80 yield. March 1st saw an aggressive rally from 2.755% to a close the month at 2.406% according to Bloomberg data.

By the end of the quarter, it was reported that $10.6 trillion of global debt was trading at negative yields. The combination of negative yields, a dovish tone from the Fed, a global economic slowdown, and just plain old positive yields in the U.S.A. really lit the fire for a bond grabfest.

Returns were pervasive and, in no particular order, were driven by:

- Oversold fixed income markets in the fourth quarter of 2018
- U.S. Treasury rally
- Flattening yield curve
- A barbell strategy that improved returns in the longer end of our duration buckets
- Spread compression in investment grade and high yield bonds

As you can see, the market has responded to a complete change of stance by the Fed, but that is in the rearview mirror now, and we need to look at the road straight ahead through the windshield.

The end of the Mueller investigation and possible trade agreement with China have reduced volatility for equity markets. A rising equity market should keep high yield spreads contained as yield starved investors will continue to add money to the asset class. A dovish tone from the Fed should keep investment grade corporate spreads range bound. The combination of these events and an upcoming election in 2020 will possibly mean the talk of an infrastructure bill supported by both parties. This supports the growth of the low employment story for the economy and signals tailwinds for equities.

An alarming part of the December sell-off was that it did not appear that the bond and the stock market can withstand a 3% 2-year Treasury interest rate without selling off. At 3%, state tax-free U.S. Treasuries appear to be a real competitor for capital especially after a 10-year bull market in equities.

The negative feedback loop is: Fed tries to tighten, stocks sell off, Fed needs to abruptly reverse course, etc… The forward asking question then becomes: are "lower for longer" interest rates back? With that question a looming possibility, we have been proponents of a barbell strategy and will continue on that path for now.

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.

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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.

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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.

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