Clark Capital Management Group

Benchmark Review & Monthly Recap

Trade Concerns Trip Up Markets

HIGHLIGHTS:

- The S&P 500 Index entered May near an all-time high, but a deterioration in trade negotiations with China sent stocks lower throughout the month.
- Global equity markets struggled as well, with both developed and emerging market equities moving lower.
- The yield on the 10-year U.S. Treasury dropped 37 basis points, ending the month at 2.14%— the lowest yield level since September 2017 and over a full percentage point below the 3.24% level seen just six months ago.
- As measured by the difference between 10-year U.S. Treasury and 3-month T-Bill yields, a brief and shallow yield curve inversion happened in late March. The yield curve inverted once again in May to a larger degree and ended the month in an inverted position.
- Economic data released in May was mixed. The unemployment rate dropped unexpectedly to 3.6%, but data covering the manufacturing and service industries were weaker than anticipated.

EQUITY MARKETS

After such a powerful start to 2019 with some equity indices hitting new record highs in April, it was not surprising to see markets take a break in May. However, equity market weakness was rather sharp during the month, driven by the deteriorating trade negotiations with China. Late in the month, a surprise tariff was announced on Mexico as well, which continued to keep broader trade concerns at the forefront of investors' minds.

On a relative basis, large-cap stocks continued to outperform small-caps in May, but in a shift of recent trend, developed international equities held up better than U.S. equities. Overall, it was a "risk-off" environment in May, with equities generally lower across the board.

The numbers for May were as follows: The S&P 500 declined -6.35%, the Dow Jones Industrial Average (DJIA) fell -6.32%, the NASDAQ Composite slumped -7.79%, and the Russell 2000 Index, a measure of small-cap stocks, declined -7.78%. Style was not that impactful to results in May as large-cap growth stocks, as measured by the Russell 1000 Growth Index, declined -6.32% and large-cap value stocks, as measured by the Russell 1000 Value Index, fell -6.43%. However, to keep these monthly declines in context, the S&P 500, Russell 3000, Russell 2000, and NASDAQ Composite are up 10.74%, 10.92%, 9.26%, and 12.85%, respectively, on a year-to-date basis.

The U.S. dollar remained elevated in May with some back and forth movement throughout the month. Often, developments in trade issues can lead to swings in currencies depending on the potential expected outcomes. However, we continue to believe the headwinds faced by international equities in 2018, driven in large part by U.S. dollar strength, will be less intense in 2019.

The Fed increased the Fed Funds interest rate target four times in 2018, and it appears they will at least be on hold for the balance of the year with expectations mounting that a rate cut might be the next move. With this backdrop, emerging market equities, as measured by the MSCI Emerging Markets Index, fell -7.26% in May and the MSCI ACWI ex USA Index, a broad measure of international equities, declined -5.37% for the month. Again, to keep these monthly declines in perspective, the MSCI Emerging Markets and the MSCI ACWI ex USA indices gained 4.09% and 7.15%, respectively, through the first five months of 2019.

FIXED INCOME

The 10-year U.S. Treasury yield dropped dramatically in May to its lowest level since September 2017. After ending April at 2.51%, the yield fell to 2.14% to close out May. Some likely contributors to the decline in yield were expectations that trade tensions could slow economic growth, lower inflation concerns, and rising expectations that the Fed might cut rates later this year.

As the month came to an end, ongoing trade concerns resulted in a correction in risk assets and a flight to safer asset classes. While high yield bonds have remained firm in the face of the correction, it's worth noting that the pronounced strength of U.S. Treasuries resulted in the Fixed Income Total Return strategy shifting its allocation away from high yield bonds and into U.S. Treasuries on June 3rd. Given the negative tone of the trade situation, it appears that investors have begun assuming a risk-off bias, and we expect this to continue as long as these tensions remain unresolved.

The short-lived yield-curve inversion at the end of March (comparing 10-year U.S. Treasury Note and 3-month T-bill yields) reemerged in mid-May, but to a larger degree. At its widest point, the inversion in March was a 5 basis point or 0.05% difference. To close out May, the difference between 10-year U.S. Treasury and 3-month T-bill yields stood at 21 basis points, meaning the 3-month T-bill was yielding 0.21% more than the 10-year U.S. Treasury. One difference between this yield curve inversion and some prior periods of inversion is that the Fed has clearly signaled it will be on hold for some time in the current environment.

In some prior inverted yield curve situations, the Fed continued to raise rates, which further exacerbated the inversion and that appears highly unlikely this time around. In fact, the Fed Funds Futures market is indicating the potential for two rate cuts by the end of the year. We are continuing to monitor developments in the yield curve closely.

Most fixed income sectors advanced in May as yields declined, but high-yield bonds struggled during this more "risk-off" month. Overall, the Bloomberg Barclays U.S. Aggregate Bond Index gained 1.78%, the Bloomberg Barclays U.S. Credit Index advanced 1.47% and the Bloomberg Barclays U.S. High Yield Index fell by -1.19% in May. As would be expected during a period of elevated equity market volatility, U.S. Treasuries performed well during the month. The Bloomberg Barclays U.S. Treasury Index gained 2.35% for the month, with longer maturities outperforming shorter maturities. Muni bonds and TIPS enjoyed positive gains as well.

ECONOMIC DATA AND OUTLOOK

Economic data released in May was mixed. The Institute for Supply Management (ISM) manufacturing index was below expectations and lower than the prior month's mark coming in at 52.8 for April. At the same time, the ISM non-manufacturing index, which represents the much larger service industries in the U.S. economy, declined to 55.5 in April, which was below expectations of 57 and the prior month's reading of 56.1. (Recall that ISM readings above 50 indicate expansion, and both readings continued to reflect growth.)

However, housing starts and building permits were both ahead of expectations in April and were improved from March. Despite equity market weakness, consumer confidence readings remained elevated during the month. Furthermore, the Conference Board's Leading Economic Indicators Index (the Leading Index) increased by 0.2% in April as expected, although the improvement in the prior month's reading was reduced from 0.4% to 0.3%.

Job market data remained strong as well with non-farm payroll additions coming in at 263,000 for April, well ahead of expectations of 190,000. The unemployment rate dropped unexpectedly to 3.6% from 3.8%. Retail sales excluding autos and gas, however, disappointed with a month-over-month decline of -0.2% in April when an increase of 0.3% was anticipated. Finally, the second reading of first quarter GDP still reflected a rather robust start to the year.

The advanced reading of first quarter GDP released in April showed a surprisingly strong 3.2% annualized growth rate for the economy. The second reading of first quarter GDP was expected to drop to 3.0%, but instead it only dropped to 3.1%. While still somewhat mixed, we believe economic data continues to support the conclusion that the U.S. economy has more runway in front of it in 2019.

The dovish tone from the Fed continues to reverberate in 2019. The FOMC began a meeting on April 30, which concluded May 1. As expected, the Fed kept rates on hold at this latest meeting. Market expectations continue to mount that a rate cut, or cuts, might happen in 2019, which is now considered the most likely event this year. After "fighting the Fed" in 2018, the Fed seems to have at least moved out of the way of the market and could potentially become a tailwind if it begins to cut rates as the market expects. Expectations are for no change in rates at the Fed meeting in June and slightly higher than a 50% chance of a rate cut at the July meeting.

Event	Period	Estimate	Actual	Prior	Revised
ISM Manufacturing	Apr	55.0	52.8	55.3	—
ISM Non-Manf. Composite	Apr	57.0	55.5	56.1	—
Change in Nonfarm Payrolls	Apr	190k	263k	196k	189k
Unemployment Rate	Apr	3.8%	3.6%	3.8%	—
Average Hourly Earnings YoY	Apr	3.3%	3.2%	3.2%	—
JOLTS Job Openings	Mar	7350k	7488k	7087k	7142k
PPI Final Demand MoM	Apr	0.3%	0.2%	0.6%	—
PPI Final Demand YoY	Apr	2.3%	2.2%	2.2%	—
PPI Ex Food and Energy MoM	Apr	0.2%	0.1%	0.3%	—
PPI Ex Food and Energy YoY	Apr	2.5%	2.4%	2.4%	—
CPI MoM	Apr	0.4%	0.3%	0.4%	—
CPI YoY	Apr	2.1%	2.0%	1.9%	—
CPI Ex Food and Energy MoM	Apr	0.2%	0.1%	0.1%	—
CPI Ex Food and Energy YoY	Apr	2.1%	2.1%	2.0%	—

Event	Period	Estimate	Actual	Prior	Revised
Retail Sales Ex Auto and Gas	Apr	0.3%	-0.2%	0.9%	1.1%
Industrial Production MoM	Apr	0.0%	-0.5%	-0.1%	0.2%
Building Permits	Apr	1289k	1296k	1269k	1288k
Housing Starts	Apr	1209k	1235k	1139k	1168k
New Home Sales	Apr	675k	673k	692k	723k
Existing Home Sales	Apr	5.35m	5.19m	5.21m	—
Leading Index	Apr	0.2%	0.2%	0.4%	0.3%
Durable Goods Orders	Apr P	-2.0%	-2.1%	2.6%	1.7%
GDP Annualized QoQ	1QS	3.0%	3.1%	3.2%	—
U. of Mich. Sentiment	May F	101.5	100.0	102.4	—
Personal Income	Apr	0.3%	0.5%	0.1%	—
Personal Spending	Apr	0.2%	0.3%	0.9%	1.1%
S&P CoreLogic CS 20-City YoY NSA	Mar	2.50%	2.68%	3.00%	2.95%

Source: Bloomberg F = Final P=Preliminary S = Second