ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Fixed Income Total Return

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The Pivot is Almost Complete

"Don't fight the Fed" is a common axiom among investors that has relevance in today's market environment. After a brief trade related scare in May, markets continued to push higher during the second quarter. The major stock indices are trading at or near new highs, corporate credit has remained firm, and U.S. Treasuries have rallied on expectations of rate cuts in the second half of the year.

The seemingly insatiable appetite for U.S. Treasuries has resulted in a steep drop in yields as the market discounts Fed rate cuts. Yields on the 10-Year Treasury Note sank to 2.0%. At the June FOMC meeting, the Fed left interest rates unchanged but prepared the market for future rate cuts. The prospect of a policy error and rising trade tensions with China have gotten the Fed's attention, and the Fed's bias has turned dovish given the uncertainties surrounding the economic outlook and muted inflation pressures. The Fed is now expected to cut rates at the July FOMC meeting. It seems strange to cut rates with stocks trading at or near record highs, full employment, 3.1% real GDP in the first quarter, tight credit spreads, and the moral hazard of cutting rates.

The current economic expansion has been very resilient and at the end of June, it became the longest economic expansion on record, tying the expansion from 1991–2000. At 120 months, this expansion has more than doubled the median length of past expansions. Data we look at suggests continued economic growth through year-end, but there are some concerns given the late cycle nature of the advance. For example, global manufacturing has been in decline for over a year and the yield curve is inverted, signaling potential trouble for the economy down the road.

Second Quarter Attribution

The Fixed Income Total Return (FITR) portfolio was invested in high yield bonds from January 10th until June 3rd, when the portfolio moved into U.S. Treasuries. During the second quarter, trade tensions with China turned into a full-blown trade war between the world's two largest economies. The escalation of the trade war, breakdown in negotiations, and trade tensions with Europe and Mexico resulted in fears of a deeper global economic slowdown.

These fears caused a correction in risk assets and a flight to safer asset classes with the models that guide the FITR strategy showing pronounced strength in U.S. Treasuries. This strength in U.S. Treasuries resulted in the strategy shifting its allocation away from high yield bonds and into U.S. Treasuries in early June.

De-risking added value in the portfolio both in terms of return and reduced risk during 2018. While it has reduced risk in the portfolio, unfortunately that same de-risking has also been a net detractor from return so far this year. For the quarter, the FITR portfolio underperformed both the Bloomberg Barclays Corporate High Yield Bond Index and the Bloomberg Barclays Aggregate Bond Index on a gross and net basis.

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Credit spreads have remained tame most of this year and have come in substantially from their peak in the 4th quarter. Given that our economic outlook remains positive, we expect credit spreads to stay mostly contained until economic conditions worsen.

Since the Great Recession ended, there have been several bouts of credit weakness where spreads spiked higher, including those in 2011, 2015, and 2018. Each one of those weak periods was primarily due to growth scares that proved to be temporary. As we move deeper into the late stages of this economic expansion, we should anticipate similar episodes of volatility.

Outlook

We came into the year with a bullish outlook and expected continuing, but slowing economic growth. The U.S. markets have delivered solid gains, and we expect further gains in the second half of the year. We believe the range of possible outcomes is wider than usual over the next six months given uncertainty on the trade front, Fed policy actions, and slowing U.S. economic activity.

Economic indicators suggest continued economic growth, but at a slower pace. In our opinion, the risk of recession remains low as Leading Indicators and labor market statistics are strong, but the yield curve is beginning to flash warning signs.

There are many risks to the outlook that could roil the markets. Top on the list is the trade war with China. Anything can happen, and even a tweet can send the market into a buying frenzy or selling panic. That adds a level of uncomfortable uncertainty into the equation. The Fed's pivot to a more dovish bias is almost complete. As of quarter end, the market was discounting 100 basis points of rate cuts over the next 12 months. We expect the Fed to cut rates, but in our opinion, the market's expectation is too aggressive.

High yield investors may need to downgrade their return expectations over the intermediate-term given the recent strength in credit and decline in yields. The yield on the Bloomberg Barclays Corporate High Yield Index dropped below 6.0% in June. Total returns for the index's 6 and 12 month forward averaged just 1.19% and 2.4%, respectively.

3 month	6 month	12 month	18 month
0.69%	1.19%	2.40%	3.70%

Source: Bloomberg Intelligence. For illustrative purposes only.

There has been a deterioration in credit quality over the past couple of years. Over 50% of both the U.S. and European investment grade corporate bonds are trading at the bottom rung of investment grade ratings. The amount of debt rated BBB is currently larger than the entire high yield market.

As a result, many people are concerned about the spillover effect on the high yield market if a large share of these BBB bonds are downgraded to junk status. Our view is that this would present a tremendous opportunity should it occur, and we believe we are well positioned to capitalize on this opportunity with our active and tactical approaches to managing fixed income.

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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.

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