Clark Capital Management Group

Portfolio Commentary

Navigator® Taxable Fixed Income

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How Can You Just Leave Us Standing? Alone in a World with Rates So Low...

If Jerome Powell and the Fed took a more dovish position in the first quarter of 2019, then the June 2019 meeting signaled the return of "lower for longer" in terms of U.S. interest rates. While the line was held on key interest rate levels in the June meeting, most notable was the Fed dropping the word "patient" in its approach to policy, which in essence, propped the door wide open for the possibility of additional rate cuts for the duration of 2019 and into next year.

In fact, some market participants had viewed the word "patient" as having a bias towards rate hikes in the past. While the market appears to be pricing in four rates cuts over the next 12 months, the views from our Chief Investment Officer Sean Clark state that this may be a bit overzealous. Instead, we believe the odds are better for one or two cuts over the coming months, which are somewhat in line with where Fed officials' opinions have fallen in the latest dot plot projections.

Regardless of the amount of rate cuts, the Fed's softened language and a renewed pledge to keep the economic expansion train running have given the market a sense of comfort that a reversal in the direction of rates is of little concern at the moment. To give this most recent interest rate cycle some context, 10-Year U.S. Treasury rates are 70 basis points lower than January 1, 2019 and are on the cusp of dropping below 2% for the first time since 2016.

But the Fed is not the only factor weighing on the markets, as both domestic and international pressures have factored into investor sentiment. Since the last Fed meeting, the President has renewed his long running trade war with China, threatened tariffs on Mexico, and placed additional trade pressure on Europe and Japan.

Further, certain portions of the yield curve have actually inverted, meaning longer-term rates are lower than shorter-term options. Historically, when the U.S. Treasury yield curve has inverted, it has been a signal that the economy is slowing or that a recession may be on the horizon. The argument can be made that the Fed is going to act well in advance of any material slowdown with a view on keeping the expansion in place.

Maybe We're Just Too Demanding...Thinking That Rates Won't Remain Here So Low...

While the market has priced in their anticipated rate cuts, there still seems to be some slight divergence from those actually making the decisions. Based on the positioning of the latest Fed dot plot, eight members see the target federal funds rate in the range of 2.25%-2.50% at the end of 2019; one member see a target range of 2.50%-2.75%, which would indicate one rate hike; and the additional members see a target range of 1.75-2.25%, which would indicate slight easing.

The consensus forecast remains in place into 2021 and 2022, demonstrating the central bank's view that the market may be getting ahead of itself in anticipation. The fact of the matter is that despite what the rates markets actually do, our role as Portfolio Managers is to navigate the current interest rate environment while keeping income high and focusing on principal preservation.

This is What it Sounds Like...When Rates Cry...

Interest rate environments like the one we're in today make a case for active management as we look to keep the current yield of the portfolio at above market level and focus on relative value opportunities that present themselves in both credit and duration management.

Our portfolios on both the taxable and tax-exempt side continue to utilize a barbell approach, which may provide investors with the best defense should the Fed decide to sharply reverse course at any stage along the way.

While duration was one component of positive return in Q2, 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 the taxable portfolio, we remain focused on sectors that are less sensitive to interest rate volatility, while on the tax-free side, we remain committed to finding additional value in revenue sectors such as healthcare and higher education.

Taxable Fixed Income Portfolio

Fixed income returns continued their robust rally in the second quarter as the 10-year Treasury bond rallied from 2.406% at the end of Q1 to close Q2 at 2.026% according to Bloomberg data. The bond rally resulted in the Bloomberg Barclays U.S. Aggregate Bond Index returning 3.01% for the quarter and the Bloomberg Barclays Intermediate U.S. Corp Intermediate Index up 3.13%.

By the end of the quarter, it was reported that over $13 trillion of global debt was trading at negative yields. Bond markets around the globe appear to be signaling a slowdown in growth or even a flashing the possibility of recessionary forces coming to light. A small 7% correction in equities while they trade close to all-time highs appears to have the Fed concerned about the U.S. economy. The Fed has jawboned the market into believing that they will continue to give support to the market so the expansion from the Great Recession of 2008 can continue.

Returns during the quarter were pervasive and driven largely by:

1) Treasury rally
2) A barbell strategy that improved returns in the longer end of our duration buckets
3) Spread compression in investment grade and high yield bonds

In examining the yields in the U.S. versus global rates, it is a bit astonishing to see the yield levels we trade at. Just when you thought the rally would slow down, Treasury bonds continued their march toward lower yields and corporate bonds yields followed. The market closed the quarter near 2% and a break below, which brings in the prospect of a possible move to 1.5%

We have been proponents of utilizing a barbell strategy and will continue on that path as returns are in line with our benchmarks. A slight inversion on the front end of the yield curve has made for difficult area to invest over 2.5%. The long end of the barbell is benefiting the most from the drive to lower rates. Last quarter, we ended with a question are "lower for longer" interest rates back? It appears so. It was a quick two years of the Fed trying to normalize rates. Debt appears to be deflationary and acting as a tailwind to keep the bond bull market alive and well.

Source: Bloomberg, Ned Davis Research

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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.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity.

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