ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Fixed Income Total Return

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The Pivot is Now Complete

Global markets and investor sentiment have been pushed around by news events and concerns over a deteriorating global economic landscape. The major influences affecting the markets have been tweets and trade tensions, a potential policy error by the Federal Reserve, and geopolitical concerns both in the U.S. and abroad.

In an effort to avoid a major policy error, the Federal Reserve is in the processes of taking back the rate hikes from 2018. After hiking rates four times in 2018, the Fed has cut rates twice during the quarter and appears set to cut rates again at least once, maybe even twice, before the year is over. The Fed's pivot to a more dovish bias is now complete as they look to keep the current economic expansion on solid ground.

For the quarter, risk assets and U.S. Treasuries advanced, but there was some volatility as a result of rising trade tensions. The S&P 500 suffered through a 6.1% intra-quarter drawdown, made a new all-time high in July, and settled the quarter with a 1.70% gain, logging its best first nine months since 1997.

Treasuries outperformed stocks with the Bloomberg Barclays 7-10 Year Treasury Index up 2.73% for the quarter, the Bloomberg Barclays Aggregate Bond Index advanced 2.27%, and the Bloomberg Barclays U.S. Corporate High Yield Index gained 1.33%. The 10-year U.S. Treasury yield fell as low as 1.47% in early September, bounced sharply in September, and settled at 1.68% at quarter end.

Over $17 trillion in negative yielding bonds globally and mounting evidence of sluggish economic growth contributed to lower Treasury yields but by Labor Day, much of the bad news was priced in, which set the stage for a violent reversal. Parts of the yield curve inverted, with the 2-year Treasury yield falling below the 10-year in late August for the first time since June 2007.

Third Quarter Attribution

The Fixed Income Total Return (FITR) portfolio had several allocation changes during the third quarter as volatility became elevated in the fixed income markets. The strategy was invested in U.S. Treasuries from June 3rd until September 13th at which point it shifted from U.S. Treasuries to high yield bonds. For the quarter, the Fixed Income Total Return portfolio underperformed the Bloomberg Barclays Corporate High Yield Bond Index and the Bloomberg Barclays Aggregate Bond Index on both a gross and net basis.

Credit remained firm, supported by high yield finishing the quarter less than 0.50% below its all-time high. However, the real story was the strength and volatility in U.S. Treasuries. The 10-year U.S. Treasury yield sank to its lowest level since July 2016 as deflationary pressures continued to build across the globe. A record amount of debt trading at negative yields (over $17 trillion) has acted as an anchor to U.S. yields and contributed to the lower for longer interest rate environment.

As Treasury yields have fallen, volatility in the Treasury market has risen. For example, at the end of the quarter the six-month daily realized volatility was twice as high for the Bloomberg Barclays 7-10 Year Treasury Index than it was for the Bloomberg Barclays U.S. Corporate High Yield Index. In the upside-down world we live in with negative interest rates, 95% of corporate investment grade debt with positive yields is coming out of the U.S.

One of the benefits of the FITR strategy's relative strength approach is its ability to stay with trends as long as they persist and become more sensitive as volatility increases. High yield strength persisted for an extended period from early 2016 until the fourth quarter of 2018. During that time, the strategy rode that strength with an allocation to high yield. More recently however, the credit and Treasury markets have become more volatile and as such, the strategy has had several reallocations that gave up some upside, but served to reduce risk during uncertain periods.

Outlook

The global credit markets slumped in 4Q 2018 as central banks moved from quantitative easing to a quantitative tightening mode. As we begin the 4th quarter this year, there is a different feel as major central banks are back in easing mode. The European Central Bank is set to restart net purchases of corporate bonds and the Federal Reserve has already reversed the hiking cycle that was in full swing last year.

Investors are questioning whether or not the Fed will be able to successfully maneuver a soft landing. The bond market echoes this sentiment and is now pricing in a 70% chance of a third rate cut at the Fed's late October meeting. That should begin to help ease investors' worries about the state of the global economy.

In addition, hard economic data has continued to exceed expectations despite a spat of disappointing survey data with solid employment gains, near record-low unemployment claims, and elevated consumer confidence. Moving forward, we believe the outlook is largely dependent on what happens with trade tensions, whether the global manufacturing slowdown encroaches into the service sector, and political developments here in the U.S.