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ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Tax-Free Fixed Income

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2020: Time to Play the Stimulus Music

The fourth quarter of 2019 and last year of the decade ended in a bullish froth in both equities and bonds. The S&P 500 closed the year up 31.48%. The Bloomberg Barclays Aggregate Bond Index finished up 8.72% and the Municipal Bond 5 Year Index was up 5.45%.

Fearful of an economic slowdown and flattening yield curve in the third quarter, the Fed cut interest rates on August 1st and September 19th. Entering the fourth quarter of the year, the bond market appeared to be pricing in a third rate cut of 25 basis points depending on the October economic data.

Then rumors started to surface of liquidity problems in the repo market. The Fed announced on October 11th that it would begin buying Treasury bills resulting in several hundred billion dollars pumped into the system for liquidity in the quarter. In addition, on October 11th the President announced a Phase One trade deal with China. Finally, as October closed, the Fed cut rates for a third time during the year by an additional 25 basis points.

There was Dancin'... and Singin'... and Movin' to the Stimulus...

The October events of liquidity in the repo markets, a Fed rate cut and the possibility of the de-escalation of the tariff war with China paved the way for the "risk-on" rally into year-end:

- The yield curve steepened, which is a positive sign for now in averting a potential economic slowdown
- Investment grade corporate bond spreads tightened
- High yields continued to be refinanced with ease
- BB high yield credits continued to rally in spread versus Treasuries
- And of course, the S&P 500 broke out to new highs

Now first it wasn't easy...

The fixed income rally that we saw in 2019 began during the 4th quarter of 2018. As we entered 2019, we said, "*We are not economists, nor fortune tellers; however, we cannot completely discount what the data is saying...and for now, it points to the likelihood of lower rates.*"

That seemed to be a prescient statement as 2019 turned out to be a pretty good year for fixed income. We really saw the benefits of using a barbell structure to construct our portfolios when the Fed became accommodative.

Perhaps the Fed is building another bubble or perhaps inflation surprises to the upside. In my opinion, as a long time tactical fixed income manager, I would go with Fed bubble. In either scenario, we believe an actively managed bond SMA can adjust to market forces whether its credit or interest rate risk.

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The continued decline in Treasury rates added to a third quarter of positive returns for municipal bonds. The Bloomberg Barclays Aggregate Bond Index posted a return of 8.72% through the end of 2019. The Bloomberg 5-year Municipal Bond Index returned 5.45% for the year. Investors took notice and poured $90 billion into municipal bond mutual funds versus $4 billion in 2018.

The quarter began with the Bloomberg Municipal AAA curve at 1.45% and ending at 1.47%, just two basis points higher. The muni yield curve steepened during the quarter. As you will see, the real steepening was in the first five years of the curve where investors pushed ratios to 60-70% of Treasuries. Here are the Bloomberg AAA yield curve changes during the quarter.

Years	Quarter Ending 9/30/19	Quarter Ending 12/31/19	BPS Changes
1 YR	1.24%	1.03%	- 21 BPS
5 YR	1.24%	1.11%	- 13 BPS
10 YR	1.45%	1.47%	+ 2 BPS
20 YR	1.83%	1.88%	+ 5 BPS
30 YR	2.02%	2.10%	+ 8 BPS

Source: Bloomberg

As the curve steepened in October and November, the strategy underperformed its benchmark. December was in line as the portfolio benefited from the yield curve roll that happens every January as the optional call feature which premium bonds are priced to moves down the yield curve.

In our view, munis provide some of the best credits in the global fixed income arena. Munis react more to macro events such as tax law changes and yield curve shifts for example rather than to specific credit events. This year is a good example as Illinois and New Jersey, the states with the biggest headline risk, provided some of the best returns in the municipal market. The reason for this is that higher equity prices helped tamp down the talk of pension liabilities and low rates had investors looking for the highest yields available.

Tailwinds are still prevalent in munis although these should be more muted in 2020 as we are starting from overall lower Treasury yields than at the start of 2019. Credit quality deterioration should be minimal with full employment and a slow growth economy. Tax advantages will continue to keep individual demand strong.

Taxable new issue supply is a credit positive in our view. Municipalities continued to issue 5% coupons in the tax-free market for decades, not really taking advantage of lower interest rates. A shift to taxable issuance with current coupon structures should lower overall true interest costs to issuers. Lastly, the Fed appears to be accommodative.

As we enter 2020, we will continue our barbell approach to investing our SMA accounts and we believe this strategy is in line with our CIO Sean Clark's interest rate outlook of a 10-year Treasury range of 1.50% -2.50%. 2.50% is cheap money, but it doesn't feel that way when you move from 1.50% to 2.50%. Therefore, we believe active management versus a passive strategy warrants consideration.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Barclays Capital 5 Year GO Municipal Bond Index represents the performance of long-term, investment grade tax-exempt bonds with maturities ranging from four (4) to six (6) years.

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 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

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