ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Taxable Fixed Income

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In Bonds, No One Can Hear You Scream: The Sequel

The third quarter fixed income themes were dominated by positive macro data in July, accommodative Fed commentary in August, and heightened political uncertainty in September. During the quarter, COVID-related news returned to the front burner as both Europe and the U.S. experienced a significant uptick in new cases. At the beginning of the quarter, the yield on the 10-year U.S. Treasury bond was 0.66%; it finished the quarter on September 30th with a slightly higher reading of 0.69%.

Investment grade credit spreads compressed by 14 basis points and high yield spreads declined by 109 basis points during the quarter as both markets experienced positive fund flows with investors adding over $110.4 billion to investment grade funds and over $5.6 billion to high yield funds. Fund flows contributed to the positive performance for the corporate bond credit markets during the third quarter.

The Bloomberg Barclays Intermediate Corporate Bond Index finished the quarter up 1.33%. Municipal bonds finished the third quarter slightly higher. Using the Bloomberg Barclays Municipal Bond Total Return Index as a reference, the muni market appreciated 1.23% on a total return basis during the quarter.

The 5-year MMD scale experienced a 17 basis point drop during the quarter ending on September 30th with a reading of 0.26% as positive fund flows for the asset class drove municipal bonds yields lower during the third quarter. According to the Investment Company Institute (ICI), the municipal bond asset class experienced positive fund flows totaling over $26.2 billion during the third quarter (as of 09/23/2020), continuing a positive inflow trend from the prior quarter.

Below is a monthly recap of the third quarter:

July

In July, a tailwind from Central Bank policy, coronavirus vaccine optimism, positive expectations surrounding a fifth coronavirus relief package, and positive earnings surprises, were all cited as factors supporting optimistic investor sentiment during the month. The U.S. Central Bank responded to the coronavirus pandemic by proposing a financial asset purchase program, increasing its balance sheet by over $3.0 trillion from February to July to sustain market liquidity. This unprecedented policy response has suppressed interest rates, compressed corporate bond spreads, dampened volatility, and smothered bearish positioning. Bond yields continued to fall during July as the U.S. 10-year Treasury bond yield dropped by over 0.12% finishing the month with a yield of 0.53%.

Muni yields followed suit, decreasing by 18 basis points and finished the month with a 0.23% yield on July 31st, using the 5-year MMD scale. The muni market finished July with an impressive 1.16% positive performance as referenced by the Bloomberg Barclays 5-year Municipal Bond Index. The corporate bond market experienced a noteworthy positive performance of 1.50% during the month, as referenced by the

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Bloomberg Barclays Intermediate Corporate Bond Index.

August

The risk-on rally continued in August as investors continued to push equity markets higher. U.S. Treasuries finished lower as the yield curve steepened during the month. The 10-year U.S. Treasury began August at 53 basis points and finished the month higher with a yield of 71 basis points. The primary performance driver in August was attributed to continued massive monetary and fiscal stimulus implemented as a result of the of the coronavirus outbreak, with many investment strategists predicting the Fed's balance sheet could eventually exceed $20 trillion.

The FOMC announced at the end of month its intention to implement further policy accommodation if inflation continues to fall short of expectations. The corporate bond market performance was flat with the Bloomberg Barclays Intermediate Corporate Bond Index returning 0.00% in August. Municipal bonds performance was negative during the month following the sell-off in the U.S. Treasury market.

The 5-year MMD scale finished up 3 basis points in August, finishing the month with a yield of 0.26%; the Bloomberg Barclays 5-year Municipal Bond Index declined by 0.04% during the month. Despite investor worry over the inability of the White House and Congress to reach a deal on a fifth coronavirus relief package, municipal bond mutual fund flows remained positive in August as investors added over $10.5 billion into the asset class during the month, according to ICI, continuing a positive trend from the spring.

September

U.S. Treasury yields were mostly stable during September. The 10-year U.S. Treasury started the month yielding 71 basis points and finished the month relatively flat with a yield of 69 basis points. The coronavirus pandemic remained an overhang during the month as many European countries observed a significant increase in positive cases and the U.S. death toll eclipsed 200,000. The White House and Congress continued to differ on the size and scope of a possible fifth round of coronavirus fiscal stimulus.

The September FOMC meeting minutes indicated that the Fed has no intention to raise rates until at least 2023, and reiterated their August guidance towards a flexible inflation target. Election and political uncertainty were consistent throughout the month. The death of Supreme Court Justice Ruth Bader Ginsburg increased political uncertainty as Democrats resist President Trump's Supreme Court nominee, potentially lowering the likelihood of a Congressional agreement towards an additional round of coronavirus stimulus. At the end of the month, the presidential candidates squared off an in raucous debate that was filled largely with more interruptions than policy positions, leaving investors unclear on the candidates' plans as we march into the November election.

Positive fund flows continued in September as investors seemed to ignore the political uncertainty during September by adding over $6.2 billion (as of 09/23/2020) to municipal bond mutual funds during according ICI. The 5-year MMD scale finished September relatively flat, yielding 0.26%. The municipal bond market logged a modest rise in September as the Bloomberg Barclays 5-year Municipal Bond Index improved slightly by 0.16%. Corporate bonds posted a modest decline during the month as the Bloomberg Barclays Intermediate Corporate Bond Index declined 0.18%.

Navigator® Taxable Fixed Income Strategy

"In Bonds, No One Can Hear You Scream," was an article I penned in the 3rd quarter of 2016. It was about low rates and the dilemma bond investors face investing in this asset class. Four years later, the same discussion is taking place. The Fed has promised to keep rates low through 2023, and so the conundrum to investors continues. Here is how the third quarter 2020 unfolded:

Q3 in the Taxable Blond portfolio started off with a strong July, followed by a slight re-trace of yields in August and a step backwards in September as investors braced for the possibility of a volatile fall in equity markets. Overall, the Bloomberg Barclays US Aggregate Bond Index returned 0.57% for Q3 and the Bloomberg Barclays Intermediate Corporate Total Return Index was up 1.33%.

Investment grade supply and liquidity were the themes for the quarter. September 2020 investment grade supply came in at $174 billion, a record for the month of September. September 2020 ended the busiest Q3 of investment grade supply on record at $387 billion. Supply is running up 66% on a year-over-year basis. The growth in supply was met with relative calm in the markets as the ICE BofA Move Index made a new yearly low on September 29th, showing relative calm in the markets.

The week of September 25th was the worst week for high yield since March 2020, when the Bloomberg Barclays U.S. Corporate High Yield Index finally seemed to have a buyer strike. However, this proved to be just a little hiccup for the market as the Index edged higher moving into quarter end. For high yield issuers, it is positive that the economy is recovering from the COVID-19 lockdown and that the Fed has promised to keep rates pinned near zero into 2023. This is reflected in a statement from Moody's Investors Service, which says that the U.S. corporate default rate fell from 3.8% at midyear to 3.3% in September.

Negative macro news piled up by quarter end. Hopes of a second stimulus package seemed to be fading with the summer sun. The passing of Ruth Bader Ginsburg creating a new appointment for SCOTUS. Despite the initial bluster, there is very little the Democrats can do to block an appointment by the Republican held Senate. COVID cases appear to be ticking up in Europe and new hot spots in the U.S. as the flu season approaches.

All of this seemed to weigh on the market, causing stocks, as reference by the S&P 500, to lose 3.80%, followed by the Bloomberg Barclays US Corporate High Yield Bond Index dropping 1.04% and the Bloomberg Barclays Intermediate Corporate Total Return Index declining by 0.18%.

With these macro events taking place, we are subtly shifting the portfolio's weightings after years of promoting a barbell strategy. We have moved out the curve and are buying very little 1-year paper. As a result, the portfolio is structured a bit more bell shaped, with some additions to the investment grade space in 7-10-year bonds. We continue to find short call high yield bonds attractive. We have had some BB credits called at the make whole call level, which is usually attributed to investment grade corporations. Rates at these historically low levels have enabled many high yield companies to refinance and extend bond maturities out to 7-10 years.

The yield curve remained static in the quarter. 2-year Treasury bonds rallied from 15 basis points to 12.9 basis points and 10-year bonds rose slightly. Beginning the quarter at 0.657%, the market rallied and hit a new low on August 4th of 0.508%. From August 4th, the 10-year sold off and closed at 0.685%. Not really much to talk about overall, but for the quarter, the 2-10-year Treasury curve steepened a couple a couple of basis points. Overall, this was not a dramatic shift to affect the Taxable Fixed Income strategy.

From a sector perspective, our themes have been Housing, Technology, and areas of the market we feel could benefit from a stimulus bill and separately from an infrastructure bill. If the unemployment rate cannot move back to the pre-COVID levels of 3%, we believe there would probably be more pressure for an infrastructure package from both parties. We mostly avoided Banking and Finance sector names during the quarter, but did find a few names where spreads slightly widened and valuations seemed more attractive by quarter end.

Macro risks are still present, but we will stay the course with our disciplined investment approach. We will look to provide current income, credit protection, and diversified security selection in our portfolio implementation process.

In fixed income, we refer to almost all purchases at the time of the buy as having "relative value". With the Fed suppressing volatility and keeping rates low, we need to look at each purchase as having relative "relative value". I am not sure if that is a double negative or a double positive. As an active manager, we believe increased volatility and higher rates are an opportunity in the fixed income market. However, at the moment, it seems that the Fed has other plans.

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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.

The Bloomberg Barclays 5-Year U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market.

The Bloomberg Barclays US Treasury: 10-Year Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years to maturity.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

The S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

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