Clark Capital Management Group

Portfolio Commentary

Navigator® Taxable Fixed Income

Portfolio Manager

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Inflation Means Lower Rates?

Market Review

Inflation became the topic of the quarter. Is inflation transitory as a result of a disrupted supply chain from COVID, while demand returns to pre-COVID levels? How does the Fed deliver on its full employment mandate? In Q2, the Fed began to jawbone the need to increase rates because of the expanding economy. On the commodity front, lumber prices, which peaked at $1,686 per thousand board feet on May 7th, closed at $716 as of June 30. Crude oil futures rallied 27%.

The result was that interest rates continued to surprise in the second quarter and volatility remained muted. The 10-year U.S. Treasury yield peaked at 1.75% on March 31st and then began a rally to finish the quarter at 1.44%. The rally was flying in the face of inflationary talk. Inflation means higher interest rates to the retail investor, but that is exactly the opposite reaction in the bond market. The market interpreted this as a sign of a slowing economy sooner than expected. The yield curve flattened as 30-year bonds rallied to close the quarter at 2.08%.

For the quarter, the Bloomberg Barclays US Aggregate Bond Index was up 1.5%. The Bloomberg Barclays Intermediate Corporate Total Return Index was up 1.48%.

Second Quarter Performance Highlights

- The portfolio's duration remained just short of the benchmark at 4 years. BB bonds were being called away the whole quarter. The rally in rates and flattening yield curve drove returns for investment grade positions in names where we were positioned longer than the benchmark.
- As oil started to move above $60, we increased Energy exposure in the portfolio. We added a BB oil holding, and by quarter end, oil was over $70. The company declared a tender on $2.5 billion of its debt, which provided the strongest returns in the portfolio during the quarter. Financials acted as a drag on performance, and specifically our holdings in the 3 to 4-year duration range. Corporate credits were sound, and any laggards were a result of yield curve positioning.
- In high yield, one of our holdings in a mining company lagged versus the benchmark. We view this holding as a potential candidate for a credit upgrade, and believe it should correct itself in the future.

Positioning and Outlook

The lower for longer interest rate theme continues to drag on interminably. Volatility continues to be muted and the option-adjusted spread (OAS) continued to contract during the quarter. The portfolio's strategy will remain in place until there is some resolution to the ultimate direction in rates.

We continue to stay slightly neutral to the benchmark duration of 4 years. We are buying investment grade bonds longer than 4 years in case the yield curve continues to flatten. We are also buying short call BB bonds that that keep the portfolio's duration around the 4-year level.

As the lead Portfolio Manager, I consider the portfolio to be at its highest credit profile in the last ten years. Investment grade credits are very strong, and companies are cash flush. A possible negative to this outlook is leveraged buyouts (LBOs) in the investment grade space creating wider spreads. Our BB holdings are mostly upgrade candidates within the Housing, Energy, and Materials sectors.

During the quarter, we sold our last single B credits, and increased our exposure in Materials. We added to Energy and added new exposure in the Housing sector with two home builders. We also added to two vehicle manufacturers. We bought three high grade names and continue to add to our positions in the "Big 4" banks and regional banks when we can find them at attractive levels.

We believe there are some potential risks to the market: China continues rhetoric about unifying Taiwan. Does the Fed taper too early if the economy really overheats? The infrastructure deal falls apart and is not passed. Some unknown Fed speak that comes in August at Jackson Hole. Can the Fed ever extricate itself from the markets and not cause a tantrum in stocks and bonds?

As active managers, we will keep an eye on these conditions and adjust as needed.