ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Fixed Income Total Return

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Credit Remains Resilient Despite Market Headwinds

Market Review

The market certainly has been dealing with many headwinds including the Delta wave, China's increasingly hostile actions, the Federal Reserve announcing their intention to taper bond purchases, the Evergrande debt default, the U.S. debt ceiling, looming tax policy changes, inflation, supply chain problems, and peak economic and earnings growth.

As such, we feel September lived up to its reputation as being the weakest month for the market, with the S&P 500 declining -4.7%, posting only eight positive trading days. The broad market has been in consolidation mode for the past several months, while the large-cap S&P 500 Index continued to hit record highs until September 2nd. The Index just suffered its first 5% correction in 226 trading days, the 13th longest stretch without a pullback on record. During the quarter, the S&P 500 Index gained 0.58%, the Bloomberg Barclays U.S. Corporate High Yield Index gained 0.89%, the Blomberg Barclays U.S. Aggregate Bond Index gained 0.05% and the U.S. Treasury 7-10 Year Index slipped 0.02%.

At the September 22nd FOMC meeting, the Federal Reserve signaled that they would begin tapering bond purchases soon. Those comments caused an instant change in market character, as interest rates spiked by 20 basis points. We expect the Fed to start tapering in November, at a pace of $15 billion per month through June 2022. Even with that pace of tapering, the Fed's balance sheet will still grow by $400 billion over that period, which is supportive of risk assets.

As the quarter came to a close, the debt ceiling and infrastructure plans working their way through Congress took center stage. In fact, Treasury Secretary Yellen penned an opinion commentary in the Wall Street Journal and said that "failing to raise the debt limit would produce widespread economic catastrophe. We would emerge from this crisis a permanently weaker nation. For about a century, America's creditworthiness has been a major advantage over our economic competitors. We can borrow more cheaply than almost any other country, and defaulting would jeopardize this enviable fiscal position."

Congress has raised or suspended the country's debt ceiling about 80 times since 1960. It is inevitable that the debt ceiling would be either suspended or raised. However, both sides of Congress played political games and while a temporary deal was struck in the first week of October that relieves the immediate pressure, the topic will be revisited in early December.

Third Quarter Performance Highlights

For the quarter, Fixed Income Total Return underperformed the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees) and slightly underperformed the Index (net of fees). For the year to date, Fixed Income Total Return is slightly underperforming the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and outperforming the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees and net of fees).

- The strategy was invested with a risk-on bias throughout the quarter and remained fully invested in high yield bonds. In fact, it has remained allocated to high yield bonds for 14 consecutive months.
- Credit has remained very resilient in the face of many headwinds including rising interest rates. For example, the 10-year U.S. Treasury yield bottomed on August 2nd at 1.17%. It ended the quarter with a 1.53% yield. During that time, the Bloomberg Barclays 7-10 Year Treasury Index declined 2.39%, the Bloomberg Barclays Aggregate Bond Index slipped 1.29%, and the Bloomberg Barclays U.S. Corporate High Yield Index rose 0.49%.
- Despite the Delta surge, the economy continues to re-open, which we think provides a favorable macro backdrop to credit. Continued economic re-opening has led to improved credit outlooks and an upgrade cycle that appears set to extend into 2022.
- Duration across many sectors of fixed income is out to record highs given the low interest rate environment and record issuance of bonds with longer maturities. Below investment grade credit, however, has much lower duration than investment grade and Treasuries. The lower duration has allowed high yield debt to be a little more defensive as rates have risen.
- Credit quality within the high yield space was not a large driver of returns during the quarter as BB bonds slightly outperformed CCC and below bonds.

Positioning and Outlook

The market was due for a correction, and it arrived during the normal seasonally weak period of the year. Now we enter what we believe to be the best three-month stretch of the year for risk assets from October through December. During the September correction, our credit risk models continued to favor risk-on asset classes, and as such, the portfolio remained fully invested. Corporate credit has remained extremely firm as the 10-year Treasury yield eclipsed 1.5%.

The economy is still in the midst of a strong economic recovery with above-trend growth as the economy continues to re-open. We believe above-trend growth is likely to persist into the middle of 2022, when the economy will settle back into the pre-COVID growth rates of about 2.00%.

A large reason for the stronger growth is the very favorable monetary conditions with over $400 billion expected to be added to the Fed's balance sheet before tapering concludes. Inflation is front and center and the next couple of months will provide a lot of information on supply chain shortages and labor shortages. We expect that the inflation we are seeing now is more cyclical than structural, but this transitory period is taking longer than the Fed and many others anticipated.

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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 S&P 500 High Yield Corporate Bond Index, a subindex of the S&P 500 Bond Index, seeks to measure the performance of U.S. corporate debt issued by constituents in the S&P 500 with a high-yield rating. The S&P 500 Bond Index is designed to be a corporate-bond counterpart to the S&P 500, which is widely regarded as the best single gauge of large-cap U.S. equities.

The Bloomberg Barclays US Treasury: 7-10 Year Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.9999 years to maturity.

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 US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The 10 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10 year treasury yield is included on the longer end of the yield curve. Many analysts will use the 10 year yield as the "risk free" rate when valuing the markets or an individual security.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices. Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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