ClarkCapital MANAGEMENT GROUP

Portfolio Commentary

Navigator® Taxable Fixed Income

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A Possible Warning of Higher Rates and Questions Heading into Q4

Market Review

A low volatility range bound market prevailed for most of the third quarter on the 10-year Treasury bond, which traded mostly between 1.25% and 1.35%. On September 23rd, the range was broken to the upside at 1.43%, and it peaked at 1.53% on September 28th before rallying to close the quarter at 1.48%.

The Jackson Hole Symposium on August 27th was watched closely for new signals from the Fed. Chairman Powel talked of an uneven economy. Tapering could possibly start in 2021 and does not signal that rate hikes are imminent. The Fed is dealing with sustaining an elevated stock market, commodity prices on the rise, rents rising, and a lack of new, affordable homes to name a few.

As they say in economics, "the cure for higher prices is higher prices." Perhaps this is the new Fed blueprint. Yes, commodities are up in price, but prices will police themselves eventually. To give you a personal example, a friend of mine built an 885 square foot deck at the peak lumber prices in May. The price estimate was $65,000. The carpenter told the customer to wait, and in September, the same deck was built for $28,000 with lumber prices down two-thirds from their peak.

Silicon appears to be another commodity wreaking havoc in the supply chain. Silicon had been trading in the $1,200-$2,200 range until it spiked to close to $7,000 a ton as China cut back on production. Silicon is a readily available resource, and although it isn't exactly ecofriendly in production, it's used in a myriad of products from car parts to paints, bricks, ceramics, semiconductors, and more.

For the quarter, the Bloomberg Barclays U.S. Aggregate Bond Index was up 10 basis points. The Bloomberg Barclays Intermediate Corporate Total Return Index was up 14 basis points.

Third Quarter Performance Highlights

- Duration remained just short of the benchmark at 4 years. BB holdings continued to be called away during the whole quarter.
- One of our single B high yield credits in the food processing industry was the best performing holding in the Consumer Staples sector. Quant selling created the opportunity, and bonds rallied when the selling was completed.
- Our holding in a cloud computing company was the biggest underperformer for Q3. An investment firm took a 10% stake in the company and announced it will explore potential buyers for the firm. This news could be positive or negative, but with rates low and spreads tight the reaction was to sell.
- Rates stayed range bound for most of the summer, which turned into the "coupon clipping" summer of flat returns.

Past performance is not indicative of future results.
This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

Positioning and Outlook

We watched range bound markets in the quarter and on September 23rd, we saw a break of 1.40% on 10-year Treasuries and a break of 2% on 30-year Treasuries as a possible warning of higher rates. In the context of the lower for longer interest rate theme, the move just appears to be towards the upper end of the rate move in March for now.

In 2016 when the Fed began to raise rates, we were an early adopter of the barbell strategy, buying long and short bonds and avoiding the middle part of the yield curve. That may be the next adjustment made in the portfolio. We had started the process of selling the 2025-2026 parts of the yield curve that appears vulnerable if the curve steepens during Q4.

There are several questions and challenges heading into Q4. The Fed is in some turmoil with a second and possible third person resigning over personal trading issues. China is dealing with Evergrande and the liquidity issues it presents. There are power issues looming with coal shortages, and the global demand of natural gas for the winter heating season. Domestically, Congress is dealing with debt ceiling and infrastructure negotiations. Supply chain disruptions continue, and there is the possibility of an extended commodities rally.

I have focused some on commodity issues in my Q1 and Q2 commentaries. In 1980, the world population was 4.4 billion, and in 2021 it is at 7.9 billion. Green initiatives and the raw demand for water, clean air, protein, copper, etc. may be just a function of technology advancements using materials and population growth. I am not sure how raising interest rates fixes those issues.

Considering this, we will continue to adhere to the strategy that has served us well. We plan to stay slightly neutral to the benchmark duration of 4 years, buy investment grade bonds longer than 6 years in case the yield curve flattens, and buy short call BB bonds that that keep the duration to the 4-year level. Going forward, we will look to add to commodity and Material companies that are subject to credit upgrades. We will possibly reduce bank subordinated debt that is trading, in our opinion, at spreads that are too tight to benchmarks.