Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

K. Sean Clark, CFA®
EVP, Chief Investment Officer

Volatility Continues to Challenge the Bond Markets

Market Review

A volatile second quarter capped off the worst first six months to start a year in a very long time across many asset classes. It has been an extraordinarily difficult period for fixed income investments over the past six months as inflation pressure and recession concerns have led markets lower. The May Consumer Price Index (CPI) surprised to the upside, hitting a 40-year high of 8.6% year-over-year. As a result, the Federal Reserve amped up its policy response to fight inflation. During the quarter they hiked rates twice, 50 basis points in May and 75 basis points in June, and began quantitative tightening by letting bonds on their balance sheet mature off. Equity and fixed income suffered in a general risk-off environment that was marked by several failed rally attempts.

During the quarter, stocks declined broadly with sharp losses. The S&P 500 fell 16.11%, its worst quarter since the COVID pandemic-induced decline in Q1 2020. The small-cap Russell 2000 fell 17.21%, its 11th worst quarter since data began in 1979, and the MSCI ACWI Ex-U.S. declined 13.73%. It was the worst start to a year for the S&P 500 since 1970.

The 10-year U.S. Treasury Note ended the quarter with a 2.97% yield, up from 1.51% to start the year. During the quarter, however, the yield spiked to as high as 3.48% before settling back in. Fixed income provided no place to hide again as bonds declined alongside stocks. For the quarter, the Bloomberg Barclays Aggregate Bond Index lost 4.69%, the Bloomberg Barclays 7-10 Year U.S. Treasury Index declined 4.46%, and the Bloomberg Barclays U.S. Corporate High Yield Index sank 9.83%. In contrast to the first quarter, duration outperformed credit as the market's focus shifted from inflation to recession fears. To put into perspective the historical significance of this year's revaluation in the bond market, the Bloomberg Barclays Aggregate Bond Index declined by 10.35% through the first six months, its worst start to the year on record. In fact, it is also its second largest drawdown in two successive quarters on record. Only one other period in history showed greater declines – the three quarters from June 1979 – March 1980 when the index declined 12.63%.

Second Quarter Performance Highlights

- For the second quarter and year-to-date periods, Fixed Income Total Return outperformed the Bloomberg Barclays U.S. Corporate High Yield Index and underperformed the Bloomberg Barclays U.S. Aggregate Bond Index.
- Fixed Income Total Return came into the quarter allocated to 50% high yield bonds and 50% cash equivalents. The strategy had several allocation changes during the quarter between cash equivalents and high yield bond exposures. The strategy had an unsuccessful allocation to high yield bonds between the end of May and mid-June, which resulted in losses. The strategy then

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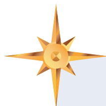

moved out of high yield bonds and back into cash equivalents. Since then, high yield spreads have surged to their highest level since 2016, excluding the COVID meltdown.

- The primary driver of the strategy's return over time is its macro allocations that are driven by our relative strength credit-based risk management models. The models had several unsuccessful allocation shifts during the quarter.
- Credit and rates have been positively correlated this year, in contrast to normal times when they are inversely correlated. Risk-on and risk-off assets both declined as inflation spiked with the CPI hitting a 40-year high of 8.6% year-over-year.
- The Federal Reserve has hiked interest rates by 150 basis points already this year and is expected to hike again by at least 75 basis points at the end of July. A lot of financial tightening has already occurred with the Fed rate hikes, higher mortgage rates, declining stocks, and a surging U.S. Dollar.
- On a relative basis, duration held up better than credit during the quarter as recession fears overtook inflation as the primary concern. The lower end of high yield bond credit ratings was hit particularly hard as evidence mounted of slowing economic growth. CCC bonds lost over 13% during the quarter.

Positioning and Outlook

Overall credit fundamentals have improved during the post COVID economic recovery. Companies have decreased their leverage to the lowest level since pre-2000, and interest coverage ratios have surged to their highest level in over 50 years.

High yield has become more attractive recently, with the yield on the high yield index ending the quarter at 8.89%. Apart from the COVID collapse in March 2020, those are the highest yields since 2016. While there are short-term risks given the downside momentum, we believe high yield looks to be attractive once credit spreads start coming back in.

This year has been very challenging and frustrating for investors. We expected a decent correction in the first half of the year, and also expect a stronger second half of the year. Inflation has been persistently higher than policymakers have expected, and therefore the Fed is taking a hawkish stance. However, there are signs that we may have reached or are near peak inflation, which may take some pressure off of the Fed rate hikes. Some of those signs include sharp declines in commodity prices, easing supply chains, moderating wage growth, and declining market-based inflation expectations.

The probability of a recession has increased following the first quarter's 1.6% contraction in GDP as well as softer economic data points seen in the second quarter. If this is just a growth scare, or even if a mild recession ensues, then the market may have already discounted a large amount of the economic slowdown, which we believe will set it up for a better second half of the year.

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Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.

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 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 Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

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 MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 26 Emerging Markets (EM) countries*. With 2,206 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

Gross domestic product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. GDP provides an economic snapshot of a country, used to estimate the size of an economy and growth rate.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a representative basket of consumer goods and services. The CPI measures inflation as experienced by consumers in their day-to-day living expenses. Indexes are available for the United States and various geographic areas.

The 3-Month Treasury bill is a short-term U.S. government security with a constant maturity period of 3 months. The Federal Reserve calculates yields for "constant maturities" by interpolating points along a treasury curve comprised of actively traded issues of term (e.g., 1 month) maturities.

A credit rating used by the S&P and Fitch credit agencies for long-term bonds and some other investments. It is equivalent to the CAA rating used by Moody's. A CCC rating represents an extremely high risk bond or investment; banks are not allowed to invest in CCC rated bonds. CCC bonds are junk bonds.

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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