Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

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

Rates Driven Market

Market Review

After the worst first half of the year since 1970, the third quarter started out giving investors something to feel good about with the S&P 500 rallying 17.7% from its June 16th low to its August 16th high. However, markets peaked in mid-August and declined relentlessly thereafter, with many equity indices domestic and abroad, and fixed income making new yearly lows. The declines were widespread as inflation fears remained persistent.

At the Fed's Jackson Hole Economic Symposium in August, Chairman Powell said "Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses."

In an attempt to bring down inflation and inflict some "pain," the Fed has hiked rates five times so far this year, delivering several outsized rate increases, and in the process, they have lifted the overnight rate by 300 bps to a range of 3.0% - 3.25%. The Fed said they are committed to hiking rates aggressively through year-end, and there is a growing concern the Fed actions will cause a recession and financial instability.

There was no place to hide during the third quarter except cash equivalents and the U.S. Dollar. Asset classes across the board suffered widespread declines, with many major indices hitting fresh lows to end the quarter. Year to date, the S&P 500 has lost 23.9%, and the MSCI ACWI ex-U.S. has declined 26.5%. As an asset class, fixed income hasn't offered any relief with year-to-date losses across the board. The Bloomberg Barclays U.S. Corporate High Yield Index lost 14.7%, the Bloomberg Barclays 7-10 Year U.S. Treasury Index declined 15.7%, and Bloomberg Barclays Aggregate Bond Index sank 14.6%.

For the first time on record, there were three consecutive quarters of declines for both the S&P 500 and Aggregate Bond Index, a streak that has never happened going back to 1976. In addition, it is only the second time that the Aggregate Bond Index has been down three quarters in a row; the last time was Q3 1979 – Q1 1980.

Third Quarter Portfolio Highlights

The primary driver of Fixed Income Total Return over time is its macro allocations that are driven by our relative strength credit risk management models. Those models dictate the strategy's allocation to high yield bonds, U.S. Treasuries, and cash equivalents. During the third quarter, the models shifted allocations three times, with the strategy owning each of the three fixed income sectors, as the credit markets remained very volatile.

- As we mentioned last quarter, credit and rates have been positively correlated and that continued through the third quarter. Equities, credit, and U.S. Treasuries all declined on continued Fed rate hikes.
- The main contribution to return during the quarter was an allocation to risk-off cash equivalent investments from 8/30 through the end of the quarter. During that period when the strategy was defensively positioned, the Bloomberg Barclays High Yield Index lost 4.39%, the Bloomberg Barclays Aggregate Bond Index declined 4.639%, and the 7-10 Year Treasury Index lost 4.69%.
- The main detractor from performance during the quarter was an allocation to U.S. Treasuries from 7/1 – 7/20. During that period the Bloomberg Barclays 7-10 Year Treasury Index declined by 1.01%.
- The strategy ended the month in cash equivalents. With interest rates up significantly this year, cash equivalents now provide both a modest yield as well as capital preservation.
- During the second quarter, duration held up better than credit. That trend reversed in the third quarter, with credit performing better on a relative basis compared to duration as inflation fears and a very hawkish Fed drove interest rates higher. The 10-year Treasury Note yield surged to its highest level in over a decade. The 10-year yield ended the quarter at 3.80%.

Positioning and Outlook

The market is now clearly in the retest phase of the mid-June lows. If there is a silver lining, it is that investor sentiment is very pessimistic, internals are washed out, and seasonality turns positive for the markets, especially in mid-term election years. The further we get into the month of October, we believe the seasonal tailwinds will be stronger. Investor sentiment is very pessimistic and according to the Bank of America Investment Manager survey, asset managers have one of their largest underweight equity positions ever. That represents a lot of potential buying pressure if we get the normal mid-term election year rally into year-end.

As far as the Fed and rate hikes go, which has been a major driver of market losses and volatility this year, the market is now pricing in another 75 basis point hike in November, a 50 basis point hike in December, another 25 basis point hike in early 2023. A question we are seeking to answer is "Is the Fed fighting yesterday's inflation battle?" Inflation has peaked and inflation expectations have remained well anchored. The Fed was too optimistic regarding inflation last year, and now they may be too pessimistic. Our main concern with the economy is that the Fed is hiking rates aggressively into falling inflation and a slowing economy. In our opinion the window for the Fed to engineer a soft landing is closing rapidly.

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. There is no guarantee of the future performance of any Clark Capital investments portfolio. Material presented has been derived from sources considered to be reliable, but the accuracy and completeness cannot be guaranteed. Nothing herein should be construed as a solicitation, recommendation or an offer to buy, sell or hold any securities, other investments or to adopt any investment strategy or strategies. For educational use only. This information is not intended to serve as investment advice. This material is not intended to be relied upon as a forecast or research. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Past performance does not guarantee future results.

This document may contain certain information that constitutes forward-looking statements which can be identified by the use of forward-looking terminology such as "may," "expect," "will," "hope," "forecast," "intend," "target," "believe," and/or comparable terminology (or the negative thereof). Forward looking statements cannot be guaranteed. No assurance, representation, or warranty is made by any person that any of Clark Capital's assumptions, expectations, objectives, and/or goals will be achieved. Nothing contained in this document may be relied upon as a guarantee, promise, assurance, or representation as to the future.

The manager utilizes a proprietary investment model to assist with the construction of the strategy and to assist the manager with making investment decisions. Investments selected using this process may perform differently than expected as a result of the factors used in the model, the weight placed on each factor, and changes from the factors' historical trends. There is no guarantee that Clark Capital's use of a model will result in effective investment decisions.

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

The Treasury General Account is used for U.S. government disbursements, where tax payments are deposited, and where funds from the sale of Treasury debt is collected.

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.

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.

Clark Capital Management Group, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about Clark Capital's advisory services and fees can be found in its Form ADV which is available upon request. CCM-508