Clark Capital Management Group

Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

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Good Riddance!

Market Review

Good riddance to 2022! The major equity indices peaked on the first trading day of 2022, and the positive correlations between stocks and bonds provided no place to hide. For the first time on record, both stocks and bonds fell by more than 10%.

In fact, 2022 was the worst year for the traditional 60% / 40% balanced portfolio since the 1930's. The S&P 500 declined by 18.13%, its seventh worst year since 1926. Bonds didn't fare much better. The Bloomberg Barclays U.S. Aggregate Bond Index lost 13.01%, its worst year on record, and the Bloomberg Barclays High Yield Index dropped 11.19%, its second largest decline ever. Drivers of the market weakness included the highest inflation and most aggressive tightening cycle by the Federal Reserve in 40 years, as well as supply chain issues that were exacerbated by the Russia/Ukraine war.

The Federal Reserve embarked on its most aggressive rate hike cycle in 40 years to combat inflation. In 2021, the Fed was too complacent about surging inflation, and they spent all of 2022 playing catch-up, potentially hiking rates too much into peaking inflation. For perspective, on 12/31/21, the Fed Funds rate was 0.25% and the 10-Year Treasuries Note yield was just 1.51%. One year later, the Fed Funds rate is 4.50% and the 10-Year Treasury Note yield is 3.88%. Assets across the board suffered due to repricing the cost of money.

It wasn't long ago that a topic many were talking about was the potential for negative nominal rates in the U.S. That is not a consideration now with the backup in yields we saw in 2022, and the accompanying losses across the fixed income asset class. By many accounts, it was the worst bond market in history. Duration underperformed credit with Treasuries and investment grade corporate credit suffering the worst of the losses.

Fourth 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-based risk management models. Those models dictate the strategy's allocation to high yield bonds, U.S. Treasuries, and cash equivalents. The strategy began the quarter defensively positioned in cash equivalents, then reallocated into high yield bonds at the end of October, where it spend the remainder of the quarter.

- The main contribution to return during the quarter was an allocation to risk-off cash equivalent investments from the beginning of the quarter to 10/28/22. During that period when the strategy was defensively positioned, the Bloomberg Barclays High Yield Index gained 3.03%, the Bloomberg Barclays Aggregate Bond Index declined 0.88%, and the Bloomberg Barclays US 7-10 Year Treasury Index lost 0.99%.

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- Risk assets in general spent the majority of the quarter in rally mode until the Federal Reserve FOMC meeting on 12/14/22, when the Fed hiked rates an addition 50 basis points and Chairman Powell gave very hawkish comments at the press conference. Risk assets, and the Fixed Income Total Return strategy, peaked around that time and spent the remainder of the quarter treading water.
- While bonds posted gains for the quarter, interest rate volatility was extreme. The 10-Year Treasury yield soared from 2.6% in July to 4.2% in October, but then fell back to 3.4% in early December, only to retrace to 3.9% to end the year.
- The strategy ended the year allocated to high yield bonds as credit performed in line with duration into year end.

Positioning and Outlook

As we enter 2023, consensus expectations are calling for a recession and more pain for the markets. A lot of the macro headwinds still exist today, but as the year progresses, those headwinds could turn into tailwinds. Therefore, we have a bit more of an optimistic view of the potential for the markets in 2023.

The economy did end 2022 on a strong note with solid second half growth. That momentum is likely to carry over into 2023, but growth should continue moderating with the prospect of recession near the middle of the year. Economic indicators including Leading Indicators, the inverted yield curves, manufacturing indices, housing weakness, and the cumulative effect of monetary tightening suggest the odds of at least a mild recession are increasing. We expect the economy to grow by only 0.5% in 2023. In our opinion, if there is a recession in 2023 it would be mild given the strength of the labor market and lack of excesses that have built up in the system.

Inflation is set to continue moderating and could well be near the Fed's target in the second half of the year. CPI year-over-year should fall to 3% with the potential for a downside surprise. Base effects, slowing housing data, and commodity round-trip supports the moderation of inflation. With inflation set to continue falling, the Federal Reserve is in the late innings of rate hikes. We expect the final rate hikes to occur in Q1, then pause. We also expect the 10-Year Treasury Note yield to digest gains with the 2022 high of 4.2% likely capping yields.

As always, there are risks to the outlook for the year ahead. The major risks we see include a Fed policy error by overtightening into decelerating inflation, the growing potential of a recession, negative earnings growth, and geopolitical issues including the ongoing war in Ukraine, China/Taiwan tensions, and China's COVID policy. Any of these risks could impact investor sentiment and market conditions.

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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.

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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 Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

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 note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

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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