Clark Capital Management Group

Portfolio Commentary

Navigator® Taxable Fixed Income

Portfolio Manager

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Strong Finish to a Weak Year

Market Review

While inflation remained elevated throughout the quarter, there were signs that it was easing. Core CPI fell to 7.1% in December, 0.2% lower than expectations. The Federal Reserve continued to raise rates during the quarter; however, these positive signs of inflation easing resulted in the Fed raising rates by only 50 basis points in December.

The Fed is still expected to raise rates a few more times in 2023, but the market is anticipating rate hikes to end in the first quarter or early second quarter now. Interest rates rose during the first half of the quarter to levels not seen since early 2008. The 10-year Treasury peaked at 4.24% before rallying and closing the year at 3.88% as inflation and Fed hiking expectations fell. The fall in inflation also led to a rally in credit spreads to close out the year.

Corporate credit spreads tightened during the quarter on the positive economic news with the Option-Adjusted Spread (OAS) ending the year at 130 basis points, the tightest level of the year since April. The combined move in both Treasury rates and credit spreads resulted in a positive total return for the market. The Bloomberg Barclays US Aggregate Bond Index returned 1.87% for the quarter, bringing the year-to-date return to -13.01%, while the Bloomberg Barclays Intermediate Corporate Index returned 2.72% for the quarter and -9.40% for the year. Even with the move lower in rates, investment grade corporate credit yields, as measured by the Bloomberg Barclays US Corporate Investment Grade Index, closed the year at higher than 5% for the first time since 2009.

Fourth Quarter Portfolio Highlights

- The duration of the portfolio rose during the quarter as longer bonds were added when interest rates rose above 4%. The portfolio now has a duration slightly over 4 years and is in line with the index.
- The pace of companies issuing new debt continued to be slow throughout the quarter. Earnings also continued to disappoint in some sectors, especially in Technology, as companies began to announce layoffs. This weaking of fundamentals in the more volatile sectors led to the pace of upgrades continuing to slow as the market moves away from a pure upgrade cycle, and is more name and sector specific in ratings actions.
- The best-performing sectors on a total return basis during the quarter were metals and mining and Telecommunications. Most of the outperformance from these sectors was due to the longer duration in these names, which was a reversal of their performance of the last few quarters. The worst-performing sectors were retailers and REITs as the market began to price in a weaking of the consumer going forward.
- Utilities and Financials added the most value during the quarter, as the portfolio was overweight these sectors in the longer end of the

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credit curve. Energy was the biggest detractor, reversing its outperformance from earlier this year. The majority of this underperformance from the quarter occurred in the first half as the price of oil fell more than 10%.

Positioning and Outlook

The main theme of the portfolio was moving further out the curve into higher quality names. Adding duration in 10-year bonds as interest rates crossed 4% was the prevailing view as the portfolio looked to take advantage of an expected peak in both rates and credit spreads. Higher yielding shorter bonds continued to be added in the front end of the yield curve as a barbell between short maturities (1-3 years to maturity) and longer maturities (7-10 years to maturity) grew. Agency mortgages were also added as a high-quality alternative to corporate bonds. These bonds offer yields that are comparable to lower quality corporate bonds while having the implicit backing of the U.S. Government.

The portfolio is positioned to take advantage of the expectation that inflation has peaked and the Federal Reserve is close to ending the hiking cycle. While expectations are still for rates to stay higher for longer, the added yield and carry in the portfolio should enable it to perform well in a market that continues to trade in an elevated range in both spreads and interest rates.

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 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 U.S. Treasury index is based on the recent auctions of U.S. Treasury bills. Occasionally it is based on the U.S. Treasury's daily yield curve.

The Core Consumer Price Index (CPI) measures the changes in the price of goods and services, excluding food and energy. The CPI measures price change from the perspective of the consumer. It is a key way to measure changes in purchasing trends and inflation.

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 option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate.

The 10-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 years.