Clark Capital Management Group

Portfolio Commentary

Navigator® Fixed Income Total Return

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Good News for the Economy Has Turned Into Bad News for the Markets

Market Review

The third quarter can be described as a period of consolidation for the broad markets at a time in which the economy continued to exceed expectations, inflation moderated, and interest rates surged higher. The quarter started strong with most risk assets rallying into a peak near July 31st. For the rest of the quarter, the broad markets declined during what is the weakest seasonal period of the year. The correction began as the 10-year Treasury yield broke above the 4.0% range, eventually heading toward 4.60% by the end of the quarter.

The broad equity markets gained about 30% from their October 2022 bear market lows to the recent highs. The market had and still has a lot to contend with including rising yields, higher oil prices, labor strikes, the threat of government shutdown, and U.S. sovereign debt downgrades. Even so, the markets have been very resilient as the trend of inflation has been on a glidepath lower.

However, the calm in the markets suddenly changed after the September FOMC meeting and risk assets gave way to sharply higher interest rates. The tone of the markets shifted from trading around the declining inflation narrative to concern over the federal debt, increased Treasury supply, and the future burden of servicing the debt at higher interest rates. The economy has surprised to the upside and recession calls have been pushed into the future; nominal and real interest rates across the Treasury curve have surged to multi-year highs. For example, the 10-year U.S. Treasury yield hit its highest level since July 2007. Good news for the economy has turned into bad news for the markets.

The broad equity markets suffered their first quarterly decline since the third quarter of 2022, snapping a streak of gains that recouped about three-quarters of the prior bear market losses. For the quarter, the S&P 500 lost 3.27% and the MSCI ACWI ex-US Index declined 3.77%. Fixed income markets didn't fare much better. The Aggregate Bond Index lost 3.23% and the 7-10 Year Treasury Index shed 4.42%. The bright spot was the High Yield Index gained 0.46%. The S&P 500 followed a similar year-to-date trend up 13.06% and international stocks were up 5.34%. Fixed Income was mixed with the Aggregate Bond Index down 1.21% and 7 to 10-year Treasuries off by 2.87%, while high yield bonds were up 5.86%.

Third Quarter Portfolio Highlights

- The primary drivers of Fixed Income Total Return over time are its macro allocations that are driven by our relative strength credit management models. Those models dictate the strategy's allocation to high yield bonds, U.S. Treasuries, and cash equivalents. Fixed Income Total Return has been allocated to high yield bonds since mid-April, for over five and half months. During that period, credit remained firm even as higher interest rates pressured other areas of fixed income.
- The strategy came into the second quarter allocated to high yield bonds and remained there the entire quarter. For the quarter, high yield bonds outperformed both Treasuries and the Aggregate Bond Index. The strategy picked up a fair amount of relative outperformance compared to U.S. Treasuries.
- A big driver of performance during the quarter was the increase in interest rates. Credit remained firm even in the face of higher interest rates. This was evidenced by credit spreads. The high yield credit spread began the quarter at 390 basis points and ended the quarter higher by only 4 basis points at 394 basis points. Cracks began to show as the quarter ended with some credit weakness.
- For the second quarter in a row, CCC and below rated high yield bonds outperformed higher quality high yield bonds, investment grade corporate bonds, and U.S. Treasuries. The outperformance of lower-quality debt highlighted the strength of the economy and the negative impact of duration in higher quality bonds.
- Yields across the U.S. Treasury curve continued their relentless move higher. 2-year and 10-year Treasury yields hit their highest levels since 2006 and 2007, respectively, before the Global Financial Crisis.

Positioning and Outlook

Just as the fourth quarter was getting started, the House of Representatives fell into chaos by ousting the Speaker of the House. In the 234-year history of the House of Representatives, its members had never voted to fire their leader in the middle of a term. What happens next with the ongoing uncertainty of funding and keeping the government open is a big risk. Increased dysfunction in Washington DC only adds to an already challenging fiscal outlook. In addition, the credit rating agencies have previously expressed concern over the political landscape in DC. This certainly adds another level of risk at a time when the market is growing increasingly uncomfortable with higher amounts of Treasury supply, hence the higher interest rates as inflation continues to moderate.

The good news is the markets are now oversold, investor pessimism is setting in, and as we move into the fourth quarter, the seasonal headwinds should turn into tailwinds for the market. Recession expectations keep getting pushed further into the future. Third quarter GDP is expected to come in around 3.0%. Thereafter, we expect the economy to continue growing into 2024, but at a more moderate pace as the long and variable lags of the Fed's 525 basis point rate hikes to date continue to filter through the economy.

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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.

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 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.

A CCC bond rating is considered to be speculative or junk grade, indicating that the issuer has a high risk of defaulting on its debt obligations. CCC credit ratings are often given to companies that are experiencing financial difficulties or have a high level of debt.

The US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada.

A Leading Economic Indicator is a measurable set of data that may help to forecast future economic activity.

A Treasury yield is how much investors can earn when they purchase one of those government debt obligations.

The ICE U.S. Treasury 7-10 Year Bond Index is part of a series of indices intended to assess the U.S. Treasury market. The Index is market value weighted and is designed to measure the performanceof U.S. dollar-denominated, fixed rate securities with minimum term to maturity greater than seven years and less than or equal to ten years

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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