Clark Capital Management Group

Portfolio Commentary

Navigator® Taxable Fixed Income

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Interest Rates Drive Total Returns Negative for the Quarter and Erase Most Gains from Earlier in the Year

Market Review

After pausing rate hikes in June, the Federal Reserve once again hiked interest rates in the third quarter. The federal funds rate rose a quarter point (25 basis points) in July and then held steady in September. While rates weren't hiked in September, the Federal Reserve remained hawkish and committed to keeping rates high until inflation hit their stated 2% target. Core PCE, the Fed's preferred measure of inflation, continued to trend lower, but remained elevated well above their target.

Due to elevated inflation, the strong comments from the Fed, and strong labor market, the market is now pricing in a 40% chance of one more hike with cuts not starting until the middle of 2024. This is a significant repricing of the magnitude and timing of cuts in 2024.

The move in market sentiment drove the 10-year Treasury to levels not seen since 2007. The 10-year rose 73 basis points to close the quarter at 4.57%. While the 2-year Treasury also rose, it moved much less than the 10-year as the interest rate curve began to normalize. The 2-year closed the quarter at 5.05%, a rise of only 15 basis points. These moves drove the spread between the 2-year and 10-year to 47 basis points, down from 106 basis points at the start of the quarter.

The market is now pricing in a positively sloped curve by the end of the first quarter 2024. While the rates market continued to price in hikes and higher rates, the credit market showed little signs of stress until the last two weeks of the quarter. Credit spread levels, as measured by the Bloomberg Barclays US Corporate Bond Index, closed the quarter 2 basis points lower than where they started; however, they rallied by 10 basis points during the quarter before the high rate environment began to put some stress on the market. The last two weeks saw a 5 basis point move wider.

Overall, the move in interest rates drove total returns negative for the quarter and erased most of the gains from earlier in the year. The Bloomberg Barclays US Corporate Bond Index has now returned 0.02% for the year while the Bloomberg Barclays US Intermediate Corporate Bond Index remained positive at 1.35% year to date, which was reflective of the normalization in the rates curve and the smaller move higher on shorter maturity bonds.

Third Quarter Portfolio Highlights

- The duration of the portfolio remained around 4 years, which is consistent with the position that it has been in all year and is slightly underweight the Index.
- The best performing sector on a total return basis was the Energy sector. The

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continued improvement in credit fundamentals, as witnessed by the trend higher in ratings and upgrades, was coupled with higher energy prices and the sector's ability to manage these moves more efficiently. The worst performing sector on a total return basis was the Telecommunications sector. While the sector in general continues to show improving fundamentals, names in the sector tend to issue longer maturity bonds than other sectors, thus pushing total returns lower as the rates on longer maturity Treasuries underperformed.

- The Energy sector also added the most value to the portfolio during the quarter. The portfolio benefited from the market value overweight in the sector combined with owning shorter duration bonds than what is reflected in the index. The Financial sector detracted the most from performance during the quarter. The sector continued to rebound from the mini banking crisis earlier in the year; however, the portfolio was slightly underweight the riskiest names and thus underperformed.

Positioning and Outlook

The main theme of the portfolio remained constant during the quarter. The majority of the credit risk continued to be taken in the very front end (0-3 years) of the portfolio in order to take advantage of the higher yields and income that these bonds provide. While increasing, the overall credit risk in the market remains low from an historical perspective and these securities continue to be priced too cheaply for this actual risk.

At the longer end of the portfolio (7-10 years), the strategy continued to add higher quality more stable credits. As rates approached 4.5%, this position was increased in order to increase the overall yield in the portfolio while still maintaining the 4-year duration profile and keeping the overall credit profile in line with previous quarters.

The portfolio is currently positioned to maximize yield and income in the front end while still owning what we believe are high quality names in the longer end. This helps us ensure that positive total return can be captured with any rally in interest rates and can potentially limit the impact on credit spreads from a weakening economy.