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GLOBAL INVESTMENTS

BALANCED CORE

Balanced Core is a separately managed account investment strategy

Commentary – 6/30/2019

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- In late June, the S&P 500 made a new all-time high, gaining 4.30% in the quarter.
- Large Cap Core Growth strategy awarded a PSN "Top Guns" distinction for five year performance.
- We are bullish on stocks and our current price target for the S&P 500 is 3100 based on $172 in earnings and a PE ratio of 18.

First, we are pleased to announce that our Large Cap Core Growth strategy has been awarded a PSN "Top Guns" distinction by Informa Financial Intelligence's PSN manager database, North America's longest running database of investment managers. The strategy was awarded a five- and six-star award, six indicating PSN's top performance for five year performance.

That said, the second quarter was a tough one for our Large Cap Core Growth strategy. Our model underperformed the Russell 1000 Growth Index, our benchmark, by 158 basis points as the growthier and higher PE stocks continued to do quite well. Additionally, our healthcare holdings underperformed under these conditions, the "core" component of the portfolio held us back a bit. Our top performing sector was Industrials followed by Staples, an interesting mix as one is cyclical and the other is more insulated from economic forces. Conversely, our lagging sectors were Healthcare followed by Technology. Again, one is cyclical while the other is not. As for individual names, L3Harris won the top spot. L3Harris is the new name for Harris Corp. after the just completed merger between Harris Corp. and L3 Technologies. The stock boosted second quarter performance by 37 basis points versus our Russell 1000 Growth benchmark. Also boosting results was CDW Corp., a provider of computer systems and services to business and government. CDW boosted our performance by 36 basis points for the quarter. On the flip side, stragglers like Palo Alto, an IT security company that suffered from a weaker than expected cloud business and acquisition integration issues, cost us 48 basis points. Additionally, Eli Lilly subtracted 32 basis points from our performance as an FDA trial on its Trulicity product was not as positive as hoped. Adjustments to the model included the sale of Square due to disappointing results, sale of Citrix Systems, and the purchase of additional McDonalds. Additionally we reduced our positions in Deere and 3M and purchased Take-Two Interactive and Intel.

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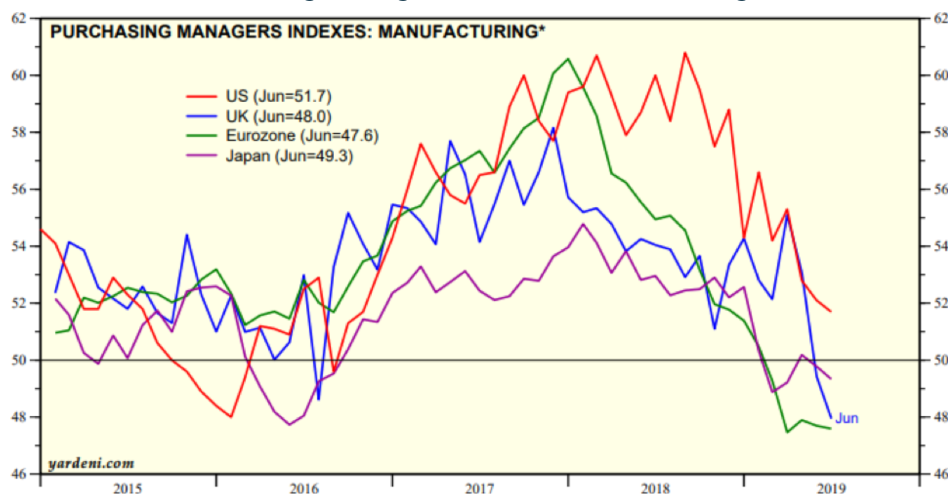
Second quarter was quite a rollercoaster ride for equity investors. We started climbing toward the top of the ride in April and peaked; plunged through May and early June and then resumed our climb for the continuation of June. In late June, the S&P 500 made a new all-time high, gaining 4.30% in the quarter. Year-to-date, the S&P 500 numbers were stellar as the index posted a total return of 18.54%, the best first-half results since 1997. Total return for the month of June was also quite impressive, resulting in 7.05%, the best for a June since 1955. As for the Dow Jones Industrials, it had its best June since 1938! The breadth exhibited for June was also excellent. There were 458 S&P 500 stocks posting gains for the month and all 30 stocks in the Dow Industrial Index were up. The S&P 500 index posted another all-time high in late June which, along with an all-time high in the advance-decline line, is considered quite bullish, especially given that other indexes followed suit. Through it all, the markets climbed the proverbial "Wall of Worry." The first brick in the wall is the inversion of the yield curve, a worrisome development that may signal an upcoming recession somewhere down the road. Typically, it would take over a year after a yield curve inversion for a recession to form, so we will be watching this closely. The administration continued its feud with China over trade and the status of that seems to change daily. As of June 30, Trump and Xi had agreed to a trade truce, which means there will be no additional tariffs while talks resume. Additionally, the purchasing manager index (PMI) has been in a downtrend for several months here in the US, although it has stayed above 50 so we are still in an expansion mode.

Purchasing Managers Indexes: Manufacturing*



* An index above 50 indicates an increase in manufacturing activity. An index below 50 indicates a decrease in manufacturing activity.

Source: Institute for Supply Management, CIPS, Markit, and Haver Analytics

Elsewhere around the world, we have seen the PMI dip below 50 into contraction. Currently, China's manufacturing PMI is 49.4 while the Eurozone's manufacturing PMI sits at 47.6, so they have entered a contraction mode. Lastly, corporate earnings have been slowing and we may see down quarters in the second and third quarter before returning to growth at the end of the year. Despite the headwinds, unemployment is near a fifty-year low at 3.7% and we still have more available jobs than we have people seeking work. At last count, the US had 7.45 million job openings versus 5.82 million job seekers, a record since these statistics have been kept. The payroll report for June was also strong. The US added 224,000 new jobs for the month, well ahead of the 165,000 consensus forecast. This was strong enough to ease worries that the US economy was weakening but also triggered concern that the Federal Reserve would postpone the rate cut Fed watchers were expecting in July. As for small businesses, the National Federation of Small Business, a group that has done a small-business survey for close to 50 years, says that the results of their survey have been setting record results for more than two years. Add to that, the US recovery since the 2008 market crash has now reached 11 years, making it the longest expansion in US history. As the saying on Wall Street goes "expansions don't die of old age—they are murdered by the Fed." Now, with the Federal Reserve "on board" with the White House and looking to possibly lower rates this month, there is not much to stop the expansion near term.

Taking a closer look at corporate profits, the current consensus from FactSet calls for an earnings decline of -2.6% for the second quarter on revenue growth of 3.8%. Compared to data from March 31, 9 sectors of 11 have lower earnings growth rates today due to downward revisions to EPS estimates. Also of note, FactSet determined that companies with sales that are more than 50% overseas were expected to post earnings down -9.3%. Companies with sales that are more than 50% domestic are expected to see sales increase 1.4%, so tariffs are definitely hurting business results.

Top 10 Model Holdings [1]

Microsoft Corp.
Apple, Inc.
Alphabet Class C
CDW Corp.
Home Depot, Inc.
Cisco Systems, Inc.
JP Morgan Chase & Co.
McDonald's Corp.
Harris Corp.
O'Reilly Automotive, Inc.

% of Total Portfolio: 40%

[1] Model Portfolios are based on a hypothetical account managed during the current quarter. Actual characteristics and income may differ materially from model. As of 6/30/2019.

That said, analysts have made smaller cuts to the S&P 500 companies than is typical. Over the last 5 years, the average reduction to earnings have been 3.3% versus 2.6% currently. Add to that, the typical pattern of managements talking down earnings only to then "beat" the lowered expectations. Sounds like managements are gaming the system to show an earnings beat. That is likely what we will see with 2Q earnings coming in stronger than the -2.6% consensus. For the third quarter, analysts are looking for an earnings decline of 0.5% and then a return to positive growth in the fourth quarter with growth of 6.3%.

As noted, the market had its ups and downs in the second quarter making a new all-time high near the end of June. Year-to-date stocks were up 18.5%. However, if we step back and look at the bigger picture since the market peaked in January, 2018 the S&P500 has only gained 2.9% on a price basis, so the recent strength is not quite as impressive as it seems. However, we may simply be building a base that will serve to launch the next leg up in an ongoing bull market. The current twelve month forward PE ratio stands at 16.9x, which we consider reasonable. The five-year average is 16.5x and with interest rates and inflation at subdued levels, history shows that we could easily gain a point or two on the PE, especially with the Fed ready to ease again. We are bullish on stocks and our current price target for the S&P 500 is 3100 based on $172 in earnings and a PE ratio of 18.

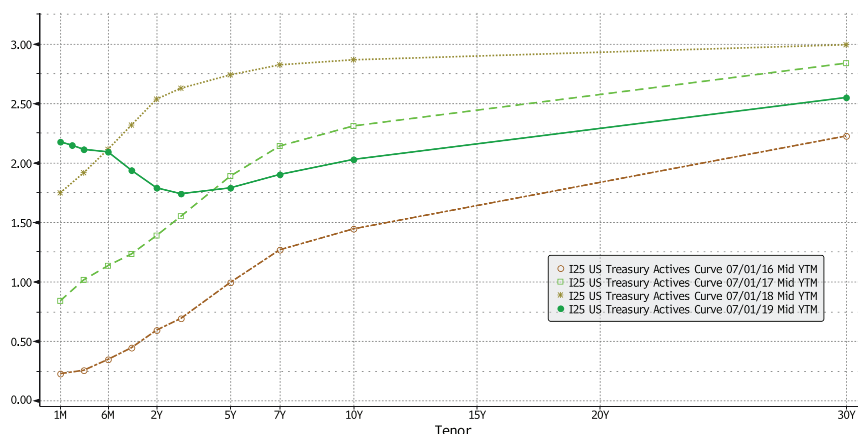
- We still have many uncertainties surrounding us including potential tariffs on products from the EU, Iran tensions, budget issues and the same issues that caused the breakdown in China/US talks previously still remain.
- With four weeks to go until the next FOMC meeting, investors should be cautious in assuming the rate cut is a done deal.
- As earnings season approaches, there are many variables that could shift the economic outlook and give the Federal Reserve reason to continue with their patient stance at the July meeting.

Taxable Fixed Income Commentary

We are through the first month of summer and the typical "summer doldrums" does not appear to be the case in 2019. Even with the pause in the trade issues between China and the US, we still have many uncertainties surrounding us including potential tariffs on products from the EU, Iran tensions, budget issues and the same issues that caused the breakdown in China/US talks previously still remain. One would assume these would make the markets nervous and yet the Dow, S&P and Nasdaq have hit record highs. The other side of the story if being told by the bond market where the US 10yr Treasury yield is reaching levels last seen in 2016.

The next Federal Open Market Committee (FOMC) meeting is at the end of July but futures are predicting a 25 bps cut with additional cuts at the remaining meetings of the year. With four weeks to go until the next meeting, investors should be cautious in assuming the rate cut is a done deal. Although growth is slowing, the economy is still pushing forward and the consumer continues to show elements of strength with improved household balance sheets, high savings rate levels and continued consumption. As earnings season approaches, there are many variables that could shift the economic outlook and give the Federal Reserve reason to continue with their patient stance at the July meeting.

US Treasury Yield Curve – 2016 - 2019



Source: Bloomberg

At Crossmark, we continue to use a more conservative approach to fixed income by positioning the portfolios with a shorter duration than the comparable index to reduce the sensitivity to interest rate movements while producing an elevated level of income generation. For 2Q 2019, the taxable fixed income portfolios produced positive performance although underperforming the comparable indices due to our conservative positioning. The positive contributors to performance include yield curve positioning, allocation and income effects with duration being the largest drag on performance. For the CIP and Income Opportunities models, income is the largest positive contributor to performance due to the preferred and high yield corporate allocations. Throughout the quarter we have worked to extend duration slightly as we approach the end of the rate hiking cycle and Fed futures are already pricing in rate cuts over the coming quarter.

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The upcoming FOMC meetings will be key events for the markets and we will be watching not only the statements but the press conferences closely to help determine the path of rates going forward. It may be summertime, but the markets are in full swing and we are here to help guide you through any volatility. As always, feel free to contact us to discuss our process, strategy or outlook on the markets. Enjoy your summer vacations but make sure and keep your eyes on the markets as we maneuver through these interesting times.

Our Firm

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All investments are subject to risk, including the possible loss of principal. Past performance does not guarantee future results.

Crossmark's Large Cap Core Growth strategy was named Top Gun 5-Star and 6-Star rating. The 5-star rating means that the strategy had an r-squared of 0.80 or greater relative to the style benchmark for the recent five- year period. Moreover, products must have returns greater than the style benchmark for the three latest three-year rolling periods. Products are then selected which have a standard deviation for the five-year period equal or less than the median standard deviation for the peer group. The top ten returns for the latest three- year period become the 5 Star Top Guns. The top ten information ratios for the latest five-year period then become the 6 Star Top Guns.

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