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December 2018

MONTHLY COMMENTARIES

Monthly Commentaries Overview

November is officially in the books with the 2018 calendar year quickly drawing to a close. And because 'tis the gift giving (and receiving) season, global equity investors will likely be asking 'Ole Saint Nick for more monthly returns like November's (S&P 500 SPX +1.8%, MSCI ACWX All Country ex-USA Index +1.4%, Emerging Markets EEM ETF +4.9%) in the new year. However, 'tis also the season for introspection and reflection on the year that was. But for many investors, reflecting back on the markets in 2018 might require several more cups of Christmas cheer (eggnog) before doing so.

As of mid-Dec'18, year-to-date total returns for just about all asset classes are in the red: SPX ~-4% ; ACWX ~-14% ; EEM ~-17% ; EMB EM debt ETF ~-6% ; LQD Corp Bond IG ETF ~-4% ; HYG Corp HY ETF ~-2% ; and TLT 20+ Yr UST ETF ~-2%. Aside from the US Dollar (~+5% on a trade-weighted basis YTD), really the only major asset class consistently above levels at the start of 2018 worldwide, is volatility (both implied and realized). The VIX Index, for example, in early 2018 closed below the 10-handle a total of 7-times prior to Jan 11th. Through mid-Dec'18, the VIX Index hasn't closed below 10 on a daily basis since; it currently sits above the 20-handle. For perspective, the VIX closed sub-10 a record 52 out of ~250 trading days in 2017. Foreign exchange, commodity, equity, and bond volatility globally have all told similar stories with most still well above levels at the start of 2018.

Pretty much all commodities prices (energy, agriculture, livestock, and precious and industrial metals) are lower on the year in USD-terms with the exception of Corn, Wheat, US Natural Gas, and Palladium. Out of all of this, perhaps the most concerning development is in fact the quick and precipitous drop in crude oil prices. WTI crude oil was down almost 22% in November, and as of mid-Dec'18 is down almost 22% and 38% YTD/since Oct. 3rd, respectively. Unsurprisingly then, inflation expectations have also fallen. 5-year breakeven inflation rates have dropped more than >50 bps from a multi-month high of 2.1% on Oct 3rd to 1.8% by end of Nov'18, and to 1.55% as of mid-Dec'18 (see Municipal Commentary in the following pages for more details on the significance of the Oct. 3rd date on market prices).

Many market pundits, Federal Reserve economists, and a certain US President are often too hasty, especially given such a quick and precipitous drop in crude prices, to promote the narrative that lower oil prices are a stimulus to the economy given an actual or perceived boost it provides to consumers via lower gasoline prices. While things can and often have played out that way, what is often forgotten is the enormous role that crude oil plays in today's global funding markets.

Crude oil transactions (priced in the global reserve currency, $USD/barrel, i.e., petrodollars) make-up one of the largest consistent global sources of USD-denominated trade between countries. These dealings are crucial in facilitating global liquidity via the availability of USDs and offshore Eurodollars in collateral and short-term funding markets. Sharp, precipitous drops in crude oil prices, especially in today's marketplace, can more often than not have a dramatic net negative effect on global liquidity, financial conditions, and therefore the real economy.

And this crucial consideration is irrespective of the effect that sharp drops in crude oil have on the profitability and capex investment plans of energy, chemical, and overall industrial manufacturing companies. This not only affects US GDP but also oil-producing nations' and therefore global GDP growth. Lastly, the narrative that increased consumer spending more than offsets the above dynamics may not be as guaranteed as many imply, especially in the short term. Mid '14-'16 is a good example as to why. One would have expected a more robust pickup in US consumer spending given a more than 75% drop in oil prices over the same period. This suggests there could be a non-linear relationship between the effects of an equivalent sharp price drop/increase on consumer spending decisions in the near term.

As always, you can find the unabridged copies of our November monthly commentaries from each of our portfolio managers in the pages that follow. Until next Year!

Taxable Fixed Commentary

Our taxable portfolios have benefitted throughout 2018 from the more conservative positioning that consists of higher quality bonds, increased cash flow for the portfolio and a reduced sensitivity to interest rate movements. In a rising rate environment, this strategy was beneficial and allowed our models to outperform their comparable indices. As the Federal Reserve continued to speak of additional rate hikes in 2018 and 2019, we saw the US 10yr treasury note hit a closing high yield of 3.24% for the year towards the beginning of November. And as the saying goes, it was all downhill from there.

As we wrap up the first week of December, we have seen the yield on the US 10yr Treasury note drop about 32 basis points from that high back on November 8th. Has the outlook truly changed over the last few weeks to cause such a change of direction? In our opinion, the answer to that question is no. However, the market is discounting many factors as we head into the end of the year. First, the markets believe the Federal Reserve is more dovish than they have been previously as Powell recognized headwinds in coming quarters and sees the Feds Fund rate as "just below" the neutral level. We also have uncertainty as to how the tariff and trade issues will work out with China as we kick the can down the road for 90 days giving a slight reprieve to investors. In addition to the Fed and trade, oil has taken a roughly 30% hit since the beginning of October reducing expectations for future inflation.

Combining the markets' expectations for a more dovish Fed, increased trade issues in 3 months and volatility in the oil and energy sectors, it is not a surprise that we have seen the yield curve flatten over the last couple of weeks. This drop in rates caused underperformance of our taxable portfolios versus their comparable indices for the month of November, although they are still outperforming on a year-to-date basis. A Fed hike in December is basically priced in to the market with at least another hike in the first half of 2019. With this outlook and following our 4 step investment strategy of duration targeting, yield curve placement, sector and security selection, we are looking for opportunities to extend our duration closer towards neutral but still maintaining a more conservative approach in regards to sensitivity of interest rate movements.

This could prove to be a bumpy ride as we approach the end of the year. Will the Santa Claus rally come to investors or will the Grinch arrive instead? We at Crossmark are here to help you ride through the remainder of 2018 with confidence. As always, feel free to reach out with any questions in regards to your portfolio or our outlook and we wish you a wonderful end to the year.

Municipal Fixed Income Commentary

Last month, Crossmark Global Investments municipal bond portfolio manager confirmed aggressive buying for the benefit of separate managed account clients as the municipal bond funds entered a ninth week of liquidations. The yields were very attractive and spreads favored purchases for called bonds, maturing bonds and deposits to existing or new accounts. The 10 year Treasury began the month close to its trading range high of 3.25 percent before the equity market volatility pushed investors towards risk off purchases of short term fixed income investments. Next came Federal Reserve Chairperson Jerome Powell speaking in New York City with a different assessment of how close the interest rates were to neutral. As a refresher, and without exact text, a statement made on October 3 stated the Federal Open Market Committee (FOMC) rates were "a long way" from neutral. Then this moths, the hawkish rhetoric turned dovish immediately with the phrase of "just below" neutral. The 10 year Treasury saw a rapid decent in yield to touch 3.00 percent and it would not be overly surprising to see the level in yield drop below 3.00 percent and test the area surrounding 2.85 percent in December. With the FOMC making it pretty clear that they will raise in December 2018, it will be interesting to see if investors get whiplash should yields rise on the rate increase news. Did the equity market volatility, Trump Tweets at Two or a combination of the two push Federal Reserve Chairperson Powell to turn dovish in his speech?

Also last month, Crossmark Global Investments stated the FOMC guidance included a rate hike in December 2018, three hikes in 2019 and two in 2020. Crossmark Global Investments stance was that the guidance may be aggressive in light of anticipated positive GDP growth, market volatility, economic reports and a changing political environment could derail FOMC guidance of five interest rate hikes through 2020. The hawkish to dovish comments by Powell just may be setting the stage for a pause in raising interest rates at some point in 2019. Either the FOMC keeps raising interest rates until something breaks, FOMC pauses either/or rate hikes and Federal bond portfolio runoff or the economy picks back up and inflation offsets the hikes. At this writing, the bond market is telling us that inflation and growth are slowing down faster than anticipated in order to support another seven rates hikes by FOMC through 2020. Installing seat belts on the investment decision seat may be advisable.

With a split Congress, infrastructure looks to be common ground for all parties involved. However, the political parties may wish to consult American municipalities as it appears they may resist the urge to go on a spending spree, even if infrastructure demand is off the chart. According to the National Association of State Budget Officers, state budgets have grown 3 percent in the current fiscal year that began July 1 of this year. Residents prepaid taxes before the new limitations on state and local deductions kicked in which added another 11.2 percent increase to local government coffers but states and local municipalities are holding most of this back to see how current year revenues adjust. Top line revenue is expected to benefit through fiscal year 2019-2020. States and municipalities in general continue to be conservative. Maybe politicians can persuade states to match funds to repair infrastructure as it is in desperate need of repair or replacement. Look for airports and roads to lead the spending initially for infrastructure.

Crossmark Global Investments continues to find value in the municipal secondary market with bonds rated A or better involved with essential services like water, sewer, power, streets, highways, school education and general obligations. The ideal maturities on the yield curve have moved to the 7 to 15 year range with a call feature between 2020 and 2023. Crossmark Global Investments continues to hold a shorter duration than the Barclay's Quality Municipal Index with a focus on higher quality municipalities. Crossmark Global Investments continues to use municipal bond market volatility to opportunistically manage the portfolios entrusted to us.

Large Cap Core Growth Commentary

After a harrowing decline in October, November saw the S&P 500 and other averages bounce back a bit. The S&P 500 gained 2.04% and the Russell 1000 Growth Index, our benchmark, gained 1.06%. Our Large Cap Core Growth model bested both indexes on a performance basis for the month. Trade issues, Trump issues and Brexit/EU issues impacted both indexes which started the month off strong and then gave back some of the early gains to finish the period.

Looking at the economy, the US is still doing well as the rest of the world slows. Both the manufacturing and service sector PMIs are still well above the key 50 level that indicates expansion while major foreign economies appear to have peaked and are rolling over (although still above 50). Add to that the recent employment numbers where hiring surged and wages grew the most in almost a decade. At the same time, unemployment stayed at a multi-decade low of 3.7%. Even Fed Chairman Powell implied the economy was "almost too good to be true." If anything, such strong results has raised the specter of higher than expected interest rates and that may have scared markets, as well.

Turning to our Large Cap Core Model, we had another relatively strong month as the "FANG-type" stocks continued to lag the major indexes. The NYFANG Index fell 4.0% for the month after falling 7.2% in October. While the LCCG Model is fairly heavy in technology stocks, it is less so the very-high PE names. Our top performing sectors for November were Healthcare, up 8.77%, and Industrials, up 5.01%. AbbVie was the top performer in the portfolio, gaining an impressive 21.09% for the month after rebounding from a sharp decline in October. Number two in the performance derby was Deere & Co., up 14.35%, also on a snap-back rally after some positive trade news. At the other end of the spectrum, our worst performing sectors were Communications Services, down 7.27% and energy which fell 2.17% as the price of oil declined. Top losing stocks were Activision Blizzard, down 27.76% on growth concerns and product news and Apple, which fell 18.12%. We have a 5.29% position in Apple but are still underweight because the stock is such a large percentage of the R1000G. Therefore Apple's decline actually helped our "relative" performance versus the benchmark.

Adjustments for the month included the sale of FLIR Systems after it lowered earnings guidance and the sales of Garrett Motion and Resideo, both received in spin-offs. We also purchased Ulta, an operator of beauty stores.

Covered Call Income Commentary

Covered Call Income: November in Review

Geopolitical events continued to move the markets over most of the month of November. The U.S. mid-term elections produced an outcome that most everyone expected as the Democrats took control of the House of Representatives with the Republicans increasing their hold on the senate. Risk off sentiment within the markets prevailed through most of the month as the U.S. administrations approach to global trade continued to be quite hostile. The most important meeting at the G-20 event turned out to be a dinner between President Xi of China and President Trump as the two world leaders sat down to discuss quite a few topics but none more important than the issues surrounding trade. Any whisper of good news coming out of that dinner meeting would have the markets off to the races again. All one had to do was look at S&P futures on Sunday night to determine how global equity investors thought of how the meeting went between the leaders of the world's two largest economies.

As far as the Fed goes, the markets did not have to wait until the December meeting to receive some good news from Fed Chair Powell. Chairman Powell's comments indicated a more meaningful dovish tone which was drastically different than anything he had stated publically in the past several months. As with the Trump/Xi dinner, the markets again reacted favorably. Volatility was prevalent throughout November and doesn't look to dissipate any as we head into the final month of the year.

S&P 500 vs VIX

Source: Bloomberg

Covered Call Income: Looking Ahead

As the end of 2018 approaches, there are several hot button topics to digest as we head into December. The results from the Xi-Trump meeting need to be contemplated as well as the upcoming Fed monetary policy meeting set for December 18th. A December rate hike seems to be completely priced into the markets. Continued uncertainty surrounding the markets will provide for more volatility. Look for the Crossmark Covered Call Income team to strategically place trades in order to generate additional income while using volatility to the strategies advantage. The final month of 2018 is shaping up to be quite an end to a very eventful year.

Large Cap Core Growth

Top 10 Model Holdings [1]	Weight
1. Microsoft Corp.	6.21%
2. Apple, Inc.	4.82%
3. UnitedHealth Group, Inc.	3.55%
4. JP Morgan Chase & Co.	3.52%
5. CDW Corp.	3.51%
6. Home Depot, Inc.	3.38%
7. Cisco Systems, Inc.	3.34%
8. O'Reilly Automotive, Inc.	3.17%
9. Honeywell Intl, Inc.	2.83%
10. Texas Instruments, Inc.	2.83%
Total of Portfolio	37.16%

Covered Call Income

Top 10 Model Holdings [1]	Weight
1. Abbott Labs	4.18%
2. Visa, Inc.	4.00%
3. Coca Cola Co	3.56%
4. Intel Corp.	3.48%
5. Oracle Systems Corp.	3.44%
6. Delta Air Lines, Inc.	3.43%
7. Cisco Systems, Inc.	3.38%
8. Exelon Corp.	3.27%
9. Nike, Inc.	3.18%
10. Microsoft Corp.	3.13%
Total of Portfolio	35.05%

[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 11/30/2018.

About Crossmark's 30 Year History

Crossmark Global Investments is an innovative investment management firm. We provide a full suite of investment management solutions to institutional investors, financial advisors and the clients we serve. We have a multi-decade legacy of specializing in values based investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas and manages approximately $5.2 billion in AUM.

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