CROSSMARK GLOBAL INVESTMENTS™

ECONOMIC AND STRATEGY COMMENTARIES

4Q 2019

Economic Market Commentary

The 2010's sure went out with a bang! In the fourth quarter of 2019 the S&P 500 was up 8.71% while the full year increased a remarkable 31.92%, despite plenty of scary headlines along the way. After a big decline in the fourth quarter of 2018 it seemed that 2019 might bring more of the same. However, when 2018's year-end tax selling came to a halt, the selling pressure was relieved. Add to that the Fed's new, softer tone (after some tough talk in 2018) which helped propel stocks higher in 2019. After some sideways action in the third quarter, stocks went up relentlessly in the fourth quarter. It was a steady move, with the S&P 500 showing no moves of one percent or more in November or December. Of course, the markets did climb the proverbial "wall of worry" as always seems to be the case. Talk of trade wars with various countries, especially China, slowed the rally from time to time. Also, economies worldwide were somewhat wobbly, especially in the third quarter. The elephant in the room, of course, was the impeachment of President Donald Trump. As far as the markets have been concerned, this has been a big "nothingburger." Stocks have done well throughout this period because with the Senate in Republican hands, it is highly unlikely that Trump will actually be removed from office. The US remained the strongest of the major economies, despite some slippage in manufacturing, and is the only G7 country likely to show growth above 2% for 2019 (source: Wall Street Journal). Fortunately, manufacturing is only about 15% of our GDP while services make up the rest. The services PMI was signaling expansion with readings above 50 (55 in December) while the manufacturing PMI was posting numbers in the upper 40's (PMIs are a measure of the strength of the economy). Markit, which publishes an alternative PMI, showed both manufacturing and service sectors above 50. Additionally, employment statistics continue to look quite good. For months now, there have been more jobs available than people looking for work and the unemployment rate remains at a 50 year low at 3.5%. This has helped consumer spending and that, in turn, has helped growth. So the US economy looks pretty solid as we enter 2020.

This all seems fitting given that we are now at 127 months in the longest economic recovery on record. While the expansion is surely getting long in the tooth we believe that periods of growth do not die of old age. More likely they are ended by the Federal Reserve when they commit a policy error and the Fed's actions have indicated that they will do what it takes to keep the good times rolling. However, if inflation heats up the Fed might become more hawkish.

As we enter 2020 near all-time highs, valuation concerns obviously come to mind, especially with the PE on the S&P 500 currently at about 18.3x 2020 earnings. That puts it is above its five and ten year averages by two to three points. But don't fear the strong returns from 2019. In the last 70 years, there were 18 years with 20%+ returns. In 15 of the following years, returns were positive with and average return of 11% (source: MKM Partners). However, we think this valuation is reasonable and even offers the potential for a decent upside rally. Note that a study by Ned Davis Research showed that, in periods of low inflation between 1%-3%, the PE of the S&P 500 has averaged around 21x since 1984. So with a friendly Fed, a good economy and an expected increase in corporate profits, the path of least resistance for the markets could be up.

GLOBAL EQUITY INCOME
Commentary

Global Equity Income is a separately managed account investment strategy

Performance
The global equity markets for the fourth quarter posted substantial positive overall returns. The Global Equity Income benchmarks of the S&P Global 1200 and the S&P 500 ended the quarter with returns of +8.91% and +9.07% respectively. For global dividend index comparison purposes, the MSCI World High Dividend Yield Index returned +7.10%.

Factors Affecting Performance
The Global Equity Income strategy underperformed the S&P Global 1200 and the MSCI World High Dividend Yield Index for the fourth quarter following a quarter of significant outperformance. The portfolio equity allocation at the end of the period was 60% U.S. and 40% international. Positive relative performance was led once again by Taiwan Semiconductor Manufacturing Co., Ltd. +25.70%. Shares of the company continued to climb on strong sales with Q4 on track with forecast guidance. The rapid progression of 5G technology now appears to be the catalyst for strong growth in 2020. Mobile customers Qualcomm and particularly Apple should spur growth as the 5G iPhone rolls out across its various models. High performance computing also is experiencing strong growth as the company increases its market share. Lloyds Banking Group PLC +25.38% shares jumped on Brexit optimism when the election of Boris Johnson confirmed that the U.K. would exit the European Union. This sent the British pound and U.K. bank stocks sharply higher. Lloyds is also favorably positioned versus other U.K. banks as it has demonstrated robust credit growth in the third quarter and it isn't mired down by weaker performing divisions that plague many of its competitors. Shares of Leggett & Platt, Inc. +25.11% rose on solid reported earnings that came in 13% ahead of consensus analyst estimates. These results were driven by increased sales, improved consolidated margins along with a lower tax rate. Details included a return to strong growth in the automotive division as well as continued excellent mattress product sales gains. Management earnings guidance for 2019 was raised and sales appear to be hitting the previously reported estimates.

Negative contributors to relative performance included McDonald's Corp. –7.37%. The company reported a third quarter miss of both revenue and earnings that weighed on the stock however an unplanned leadership transition added additional uncertainty. After leading a strong turnaround of McDonald's since 2015, president and CEO Steve Easterbrook departed the company. He has been replaced by Chris Kempczinski who successfully headed up U.S. operations. No material changes in near term strategies are expected. Shares of Infosys Ltd. –8.20% dropped after anonymous allegations of the company taking unethical steps to boost short term revenue and profits. The complaint is being investigated by the company's Audit Committee as well as an independent law firm. No evidence supporting the allegations have been uncovered to date. The company continues to maintain above average revenue growth at an attractive valuation. While the Global Equity Income strategy underperformed its benchmarks for the quarter, its methodology and strategy continues to be effective and has proven to perform well over the longer term.

COVERED CALL INCOME
Commentary

Covered Call Income is a separately managed account investment strategy

U.S. equity markets continued to post impressive gains during the fourth quarter of 2019 buoyed by solid economic data and trade optimism between the U.S. and China as a phase-one trade detail was confirmed in December. Strong consumer sentiment and a recovering housing market also attributed to the markets hitting record highs during the quarter. At the S&P 500 sector level, where the Covered Call Income strategy employs a sector neutral approach, performance was led by healthcare, technology and financial sectors. The Covered Call Income strategy outperformed the primary benchmark of the BXM by 175bp for the fourth quarter. The option overlay for the strategy also added to performance as the trading team was able to execute several different option spread trades over the course of the quarter that generated additional income. A few underlying names worth mentioning that performed well for the quarter include Activision, Qualcomm and Charles Schwab.

The coming weeks of January will see many companies begin to release earnings and forward guidance. Corporate earnings for 2019 were fairly tepid, so much of the attention will be placed on whether investors believe companies have turned things around. Look for consumer confidence to continue to rise if there is a pickup in earnings growth. The Crossmark trading team continues to monitor volatility with the intent to methodically place option spread trades in order to maximize income as well as reduce as much market risk as possible.

LARGE CAP CORE GROWTH
Commentary

Large Cap Core Growth is a separately managed account investment strategy

After a stellar third quarter where Large Cap Core Growth outperformed by 285 basis points, it's not surprising that we gave some of that back by underperforming the Russell 1000 Growth by 181 basis points in the fourth quarter. Our best individual performers were UnitedHealth at 35.8% and Apple at 31.5%. Apple has multiple growth drivers including an upcoming 5G upgrade "supercycle" and valuation rerating higher as it shifts from a low-multiple hardware company to a high-multiple services company. UnitedHealth recovered after lagging for the first part of the year. Our underperformers were YUM Brands falling 10.8% and McDonald's falling 7.4%, both of which missed expectations for third quarter earnings. In addition, being underweight the Technology sector cost us 33 basis points.

With an eye towards continued growth in the US economy and stock market, during the third quarter we increased our exposure to growth companies and growth sectors. We bought three new companies, Amazon, Comcast, and Mastercard. Amazon has generated strong revenue growth for years, however this year it has also started to show in profitability as well. We expect that to accelerate going forward. We purchased Comcast on an expected ramp in profitability as their investment in network infrastructure has slowed and they are trading low margin video subscribers for much higher margin internet subscribers. We also purchased Mastercard as it fits perfectly with our focus on high quality companies with high margins, strong balance sheets, and strong growth. Mastercard benefits from the steady double-digit growth of credit card transactions without taking on the credit risk that the issuing banks have to bare. We trimmed less growth-oriented companies like Cisco, O'Reilly, and Texas Instruments and eliminated Schlumberger to fund these purchases.

In addition, we reduced our overall exposure to Healthcare, which is a more defensive sector. Celgene was acquired by Bristol-Myers Squib and we trimmed our position in Baxter after they reported both a weaker sales quarter and an accounting issue related to foreign exchange rates. We did increase our exposure to growth within Healthcare by moving some of the proceeds into Intuitive Surgical, the surgical robot maker.

TAXABLE FIXED INCOME
Commentary

Core Fixed Income, Current Income Portfolio, Intermediate Fixed Income and Income Opportunities are separately managed account investment strategies

In a quarter that saw the US 10yr treasury yield move higher by roughly 30 basis points, it is no surprise that for all of our taxable fixed income models, where we are positioned to reduce interest rate sensitivity, that duration was a positive impact for performance as compared to the comparable indices. We had a pretty steady move higher with yields moving from a quarter low of 1.53% at the beginning of October to end the quarter at a 1.92%. Along with duration, the other positive contributors to performance across all models were our positioning on the yield curve and our focus on income generation. The corporate sector allocation was the best performing sector for the strategies while the fixed-rate preferred allocation was a drag for the Current Income Portfolio, mostly due to the Pitney Bowes holding that had a volatile quarter.

For the quarter, all taxable fixed income models outperformed their respective index with the exception of the Current Income Portfolio that performed in line with its index, lagging by only 1 basis point. The shorter duration positioning and the focus on income were responsible for the majority of the outperformance. As we look at the year 2019, the same positioning worked against many of the models as yields fell from around 2.70% on the US 10yr treasury at the beginning of the year. For the year, the fixed rate preferreds were a positive contribution for both the Current Income Portfolio and the Income Opportunities models allowing them to outperform their respective indices while the shorter duration of the remaining taxable fixed income models caused them to lag the index. We anticipate that rates will continue to be volatile but move back up towards a 2.00% US 10yr treasury over the coming quarters. Utilizing our four-step investment process of determining duration, yield curve positioning, sector selection and security selection, we will maintain our current shorter duration positioning although we are moving slightly further out the yield curve as we see rates moving towards the top end of the expected trading range. As always, we will monitor earnings, economic reports and geopolitical events to determine any changes to our strategy in the coming quarter.

MUNICIPAL FIXED INCOME
Commentary

Municipal Fixed Income is a separately managed account investment strategy

The $3.8 trillion U.S. municipal bond market finished 2019 with the best performance for state and local government debt since 2014 due to record investor inflows and a dovish Federal Reserve. 2019 began with the 10 Year Treasury at 2.85 percent and was met head on with a FOMC message that Fed Fund rate cuts would be a leading story for the year. Three rate cuts later, the 10 Year Treasury would dip as low as 1.42 percent in August before abruptly rebounding 53 basis points to 1.95 percent in September. The 10 Year Treasury has since been range bound as it ended the year at 1.91 percent.

According to the Investment Company Institute, investors added an unprecedented $90 billion into municipal-bond mutual funds for 51 consecutive weeks of inflows, compared with only $4 billion in 2018. Bloomberg Barclays reports that riskier bonds, including investment grade rated BBB and debt with more than 22 years of maturity performed the best.

The Tax Reform Act affects everyone, but especially those in high income tax states, due to the State and Local Tax deduction that is capped at $10,000. High tax states have witnessed individual investors buying greater quantities of municipal bonds in an attempt to reduce the increase in tax liability. This concentration in the high tax states to purchase municipal bonds have driven prices to an extreme in 2019, resulting in lower yields.

The 10 highest income tax states for 2019:
California 13.3%
Hawaii 11%
Oregon 9.9%
Minnesota 9.85%
Iowa 8.98%
New Jersey 8.97%
Vermont 8.95%
District of Columbia 8.95%
New York 8.82%
Wisconsin 7.65%

The top 10 ranking of states that pay the most in property taxes for 2019:
1. New Jersey
2. Connecticut
3. New Hampshire
4. New York
5. Massachusetts
6. Illinois
7. Rhode Island
8. Vermont
9. Wisconsin
10. California

Crossmark Global Investments continues to find value in the municipal secondary market with bonds rated A or better by Moody's or Standard & Poors at time of purchase 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 10 to 20 year range with a call feature between 2022 and 2024. Crossmark Global Investments limits maturities to 20 years. Crossmark Global Investments continues to hold a shorter duration than the Barclay's Quality Intermediate 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.

Global Equity Income Top 10 Model Holdings [1]

Taiwan Semiconductor Mfg Co.
McDonald's Corp.
Accenture PLC
Intel Corp.
Raytheon Co.
Smith & Nephew PLC
Pepsico, Inc.
Medtronic PLC
Texas Instruments, Inc.
Unilever NV

% of Total Portfolio: 23%

Covered Call Income Top 10 Model Holdings [1]

Lowes, Inc.
Medtronic PLC
Nike, Inc.
Intel Corp.
Coca Cola Co.
Qualcomm, Inc.
Abbott Labs
Cisco Systems, Inc.
Citigroup, Inc.
Walmart, Inc.

% of Total Portfolio: 35%

Large Cap Core Growth Top 10 Model Holdings [1]

Apple, Inc.
Microsoft Corp.
Alphabet Class C
JP Morgan Chase & Co.
CDW Corp.
UnitedHealth Group, Inc.
L3 Harris Technologies, Inc.
Honeywell Intl, Inc.
McDonald's Corp.
Amazon.com, 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 12/31/2019.

Our Firm

Crossmark Global Investments is a boutique investment management firm that provides a full suite of investment strategies to institutional investors, financial advisors, and the clients they serve. For over 30 years we have delivered uniquely-constructed products based on our proprietary, disciplined, and repeatable process. We are especially known for helping our clients align their investments with their values by creating socially-conscious, responsible investment strategies. Founded in 1987, we are headquartered in Houston, Texas and manage approximately $5.1 billion in AUM as of December 31, 2019.

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