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February 2019

MONTHLY COMMENTARIES

Monthly Commentaries Overview

Using the S&P 500 as a proxy, January 2019 was the best start of the year for US equity investors since January 1987. The S&P 500 Index gained +7.9% on a price percentage basis, a stark contrast to the previous month of December's -9.2%, one of the worst December's on record. However, for many of those invested in US equities over the previous 2 months, this January's "V"-shaped recovery (described in the commentaries below as the "January Effect") may not have been as positive an outcome for investors as one might imagine. The reason being a widely used portfolio management tool toward the end of the tax year known as tax-loss harvesting.

The rationale behind tax-loss harvesting is to reduce an investor's capital gains tax bill. One does this by closing out of losing trades at a realized loss in order to offset or lower the capital gains realized on winning trades, thus lowering one's tax bill. Furthermore, you can buy the same security or securities back in 31 days without incurring a penalty while alleviating some of the pain in the process. Seems like a win-win, right?

On occasion, however, investors in the same losing trades see the same opportunity to harvest tax-losses. As stated in the Large Cap Core Growth commentary: "often these stocks are driven down to attractive valuations causing a buying surge after the new year starts". Does this sound like the environment we saw in December? And then again in January as this reversed?

The risk for tax-loss harvesters, however, is one of opportunity cost. Will the tax loss benefits realized in December outweigh the potential January Effect rebound in prices over the following 31 days? Let's explore this with a scenario.

Let's say you bought an equal USD amount of every stock in the S&P 500 on the first day of trading in December 2018. Exactly 3-weeks later, as the markets continued to slide lower, let's also say you decided to sell all of your stocks that had declined by 20% or more over that period (161 stocks by the way). Assuming a capital gains tax of 20%, the estimated tax benefit as a % of original cost for those 161 stocks would have been ~5%. Not too bad – down 15%+ certainly feels better than down 20%+ for a month.

But let's also assume you waited the exact 31-day period (as to not incur any tax penalties) before buying back each of the 161 stocks that were sold for tax-losses (each in proportion to the capital received from their respective sales). How do you think you would have fared over the 31-day waiting period? As you might have guessed, not so well. The foregone price appreciation after adjusting for tax loss benefits would have been a whopping ~16% on those 161 stocks.

The January Effect is very real, but obviously not the only driver of US stocks in January. For more thoughts on this topic and on the other factors driving the markets in January, please find the unabridged copies of our monthly commentaries from each of our portfolio managers in the pages that follow. Until next month!

Taxable Fixed Commentary

What a difference a new year makes! After one of the worst performing months in December of last year, the markets rallied and we had the strongest January in decades. The uncertainties in the markets continued in the new year, but with the shutdown ending and a potential solution to the China trade issue capturing the headlines, the markets recovered much of the downturn from the end of 2018. As the equity markets rallied, the fixed income markets became mostly range-bound between 2.60%-2.70% for the US 10yr treasury note.

Treasury yields were maintaining a cautious approach to the market gyrations. We began January 1st with a 2.68% on the US 10yr treasury yield and although there were movements along the way, we began the month of February at the exact same level. In that environment, the yield curve placement of holdings and the overweight allocation to investment-grade corporates were the two largest positive contributors to outperformance versus the index for the Core Fixed and Intermediate Fixed strategies during the month of January. For the Current Income Product and Income Opportunities strategies, the fixed-rate preferred allocation and the accompanying income generation were large positive contributors to their outperformance versus their respective indices as well. Although generating a strong positive performance for the month, the Corporate strategy slightly underperformed its index due to having a significantly lower exposure to interest rate risk via shorter duration.

As uncertainties continue through the rest of the 1st quarter of 2019, we maintain a duration shorter than respective indices although working to shift that duration longer as many of the strategy holdings are maturing over the next 12 months. Our four step investment process of determining duration targets, yield curve positioning, sector and security selection remains steadfast in all market environments, shaping our strategy over the longer term. As always, we are here to answer any of your questions and help you navigate the markets through these uncertain times.

Municipal Fixed Income Commentary

There was a January Effect to begin 2019 as fewer municipal bonds were issued than what matured, called, plus interest paid to investors made for a rush of investors looking to get cash invested. After 13 weeks of municipal bond mutual fund net redemptions, inventory was initially solid and prices were a bargain. As the month progressed, inventory shrunk rapidly, bond dealers marked their inventory prices higher daily and the money flow for purchases increased as investors attempted to buy prior to the next markup in price. In short form definition, there were "more buyers than sellers" and that drove pricing higher in January. Crossmark Global Investments is anticipating trading in the municipal bond portfolios entrusted to us at a slower pace to begin the year, allow some cash to build coupled with selective purchases in the best portion of the yield curve, then aggressively purchase when volatility peaks and most individuals are selling.

The Federal Open Market Committee (FOMC) signaled that if financial conditions deteriorate nationally or globally then they might not raise rates in 2019. However, the FOMC base case guidance at year end was to raise rates twice in 2019 and once in 2020 dependent upon various factors. This guidance also included the possibility of a pause in the sequence should economic factors weakened further. Granted, the equity market declined in December 2018 and the government shutdown might have been partial factors in the FOMC dovish statement but growth has slowed, not declined into negative territory, which may provide the opportunity for the FOMC to pause with quarterly hikes. Financial commentators were quick to announce that not only would the FOMC pause further rate hikes but would cut rates sometime in 2019. Such a quick change of course by commentators might signal a desire to be the first to deliver a change of news rather than reporting actual news. Without a catalyst for a recession in 2019, there would be little reason to cut rates in the United States this year. The short-term economic news may be challenged with the longest government shutdown in history as well as some nasty cold weather extending across densely populated areas. This weakened economic data will support the financial commentators narrative that rate cuts are on the horizon but don't be surprised if the slower growth in 1Q19 reestablishes itself in 2Q19. If the FOMC pauses rate hike activity in March, which is highly expected, and there is a resurgence of positive economic data in 2Q19 resulting in a potential rate hike in either June or September, then the fixed income markets could be in for a volatile period of time. The FOMC may not be done with rate hikes in 2019.

One portion of the Tax Reform Act that is getting increased attention is the State and Local Tax deduction that is capped at $10,000. Tax reporting season is affecting everyone but especially those in high income tax states. SALT may shock high net worth individuals as their tax liability may be more than anticipated. This could guide more fixed income investors to municipal bonds in search of tax exempt returns. With tax-exempt municipal bond yields higher than previous years and inflation remaining subdued, real returns with very little risk will become very appealing. This could push prices higher and yields lower until a catalyst changes the fixed income market dynamics.

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 5 to 12 year range with a call feature between 2021 and 2025. 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

The fourth quarter was a disaster for the stock market, culminating in the worst December performance for the S&P 500 (-9.18%) since 1931. Fortunately, January was almost a mirror image of the previous month, rebounding 8.01% on a total return basis. The Russell 1000 Growth Index, our benchmark, did even better, gaining 8.99% for the period. We had anticipated that some of the worst performers would come back strong in what is known as the "January Effect." This happens because some stocks with losses are relentlessly sold before year end to lock in tax losses which can be used to lower an investor's tax bill. Often these stocks are driven down to attractive valuations causing a buying surge after in the new year starts. It will be interesting to see if January was mainly the reversal of tax selling or if this new rally has legs.

Despite the tariff issue, the US economy continues to do well versus the rest of the world. The PMI numbers, both for the manufacturing and service sectors, continue to post nicely above 50. Numbers over 50 indicate an expanding economy. Employment numbers are also strong. Nonfarm payrolls surged by 304 thousand in January, beating forecasts by a wide margin. The unemployment rate ticked up to 4% but that was due to more people entering the workforce, a good sign. In November, the rate fell to 3.7%, the lowest number in almost 50 years. So, for the foreseeable future, it appears to be clear sailing, especially with the Federal Reserve talking more dovishly now.

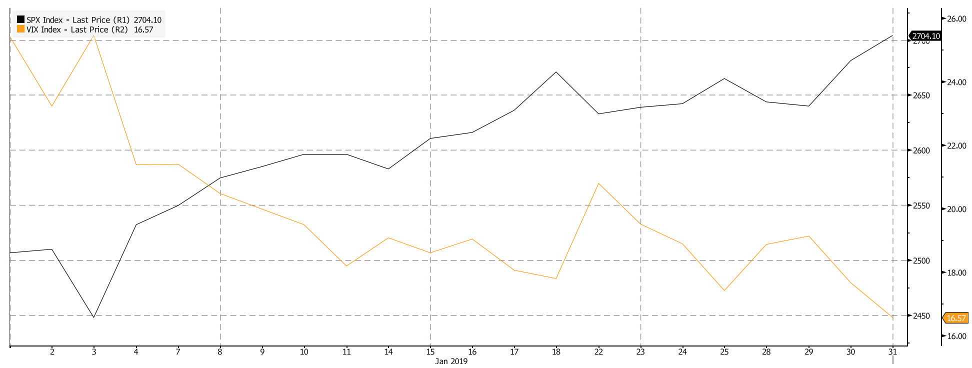
It was a tough January for the Large Cap Core Growth model. We had a very strong performance in the fourth quarter of 2018 but the big rally in some of the high growth technology stocks in January caused it to lose some ground versus the index. Our top performing sectors were Energy, which was driven by a significant rebound in oil prices, and Industrials, which also rebounded strongly from the fourth quarter sell off. Our top performing stock in January was Celgene, up 38.02%, after Bristol Myers Squibb agreed to acquire the company for $102.43 in cash and stock. Coming in at the number two spot was Square, Inc., one of the victims of the tax selling in the fourth quarter. It jumped 27.21% for the month. Bringing up the rear were Consumer Staples and Healthcare, two of the more defensive sectors. Underperforming stocks included AbbVie, which had weaker than expected results, and Amdocs Limited, after lowering first quarter guidance. Adjustments to the model for January included the sale of our remaining Constellation holdings and the purchase of both Facebook and VMWare.

Covered Call Income Commentary

Covered Call Income: January in Review

U.S. stocks rebounded sharply in January after reaching lows in December as some of the worst fears hovering over the markets have subsided for now. Stocks were oversold from a technical standpoint in December and recovered substantially as monetary policy shifted in a more dovish direction with financial conditions also easing. As investors look to the future, several headwinds still remain prevalent. The March 1st deadline looms for additional tariffs coming into play with the U.S. and China if no agreement is in place. Brexit continues to be at the forefront from a global market perspective with a hard exit or resolution at the end of March. Let us not forget about the 180 degree turn the Fed made from their early Q4 2018 comments on rate hikes to now more of a dovish tone and likely standing pat. Earnings season kicked off with the financial names in mid-January to relatively mixed reviews, with the rhetoric appearing to be slow growth but with no fear of a recession. Even though volatility declined from the spikes we saw at the end of 2018, the levels are still higher than they were in 2017. Look for volatility to persist this year.

S&P 500 vs VIX



Source: Bloomberg

Covered Call Income: Looking Ahead to 2019

The month of January turned out to be one of the better Januarys in recent memory even though the core issues of slowing growth, what actions the Fed will take in 2019, U.S. and China trade and Brexit still continue to produce a high level of uncertainty in the markets which will in turn provide for more volatility. Earnings season will continue into February with several prominent companies still left to announce. 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. Mixed messages for the markets will continue to be the theme as we head into the middle month of the first quarter. Let us hope the government will remain open as well!

Large Cap Core Growth Top 10 Model Holdings [1]

Microsoft Corp.
Apple, Inc.
Alphabet Class C
Home Depot, Inc.
UnitedHealth Group, Inc.
Cisco Systems, Inc.
JP Morgan Chase & Co.
CDW Corp.
O'Reilly Automotive, Inc.
Texas Instruments, Inc.

% of Total Portfolio: 38%

Covered Call Income Top 10 Model Holdings [1]

Exxon Mobil Corp.
Abbott Labs
Visa, Inc.
Oracle Systems Corp.
Nike, Inc.
Coca Cola Co.
Exelon Corp.
Cisco Systems, Inc.
United Technologies Corp.
Intel Corp.

% of Total Portfolio: 36%

[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 1/31/2019.

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.

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