CROSSMARK GLOBAL INVESTMENTS

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June 2018

MONTHLY COMMENTARIES

Monthly Commentaries Overview

While the month of May failed to produce an NBA Final appearance for Crossmark Global Investments' hometown Houston Rockets (who lost to the Golden State Warriors in game 7 of the Western Conference Finals), what it did produce was yet another excellent compilation of monthly commentaries from our finest portfolio managers.

Given that the word count for "Fed" in each of our portfolio manager commentaries is materially higher than usual, we'll start this overview with a look at U.S. Government rates in May, which will then be followed by a brief synopsis of each of our managers' monthly commentaries.

What some may find a little surprising was that 10-year US Treasury yield started the month around 2.95% and ended the month around 2.88%. How is that surprising? Well, the 30 days between May 1 and May 31, the 10-year US Treasury yield: 1) broke then spent a few days above its 30-year-long technical trend line (around 3.00-3.05%), 2) then peaked at 3.11%, above its decade-high, 3) but then fell sharply to ~2.78%, 4) before rallying to ~2.88% to end the month. For those that don't closely monitor fixed income markets, that is a lot of intra-month volatility, but something that may not get noticed if looking at monthly data.

On that note, for those that are interested in fixed income environments exhibiting characteristics from a decade or more ago, then you'll find some good reading in our **Municipal Bond Commentary.** Our Muni Portfolio Manager put out an excellent white-paper last month [*view here*] , and this month's commentary is an extension of that piece. This month, he provides an excellent example of the "junk…coming to market at a faster pace", highlighting a new-issue $400mm municipal bond maturing in 2056 at the miniscule yield premium to investment grade munis of just 1.71%.

In our **Taxable Bond Commentary**, we reiterate that in all of our taxable fixed income portfolios, we are still in a short duration posture and we are still outperforming our benchmark indices YTD, despite giving up "a little…YTD outperformance" ground in May. For those that absolutely cannot wait until her next appearance on CNBC, Bloomberg, or Fox Business (we can't!), then feel free to peruse more of her thoughts on interest rate markets and Crossmark taxable fixed income portfolio positioning in her commentary on the following pages.

On the equities piece of the puzzle, those looking to get our thoughts on equity volatility should take a look at **Covered Call Income Commentary**. With the re-emergence of populism and nationalist governments continuing to win elections, there will likely be more political instability to come. And "as long as there are ongoing political issues surrounding the markets, volatility is not going anywhere". Moving on to our last monthly commentary, **Large Cap Core Growth**, highlights how equity markets, proxied by the S&P 500, have been range-bound -5% to -10% off its all-time high of 2872 set in January of this year. Will continued "very strong corporate profits" be the catalyst that get us out above this range?

As always, you can find the unabridged copies of our May monthly commentaries from each of our portfolio managers in the pages below. Until next Month!

Covered Call Income Commentary

Covered Call Income: May in Review

Volatility continued to plague the markets in May due in large part to heightened political risk. Global trade issues and the off again on again summit with North Korea still caused uncertainties within the global markets. Italy's new populist government added to more market concerns towards the end of the month. Despite the significant intra-month swings, the ongoing strength of global growth was evident in corporate earnings. The positive effects of tax cuts contributed to a strong Q1 earnings season in the U.S. and fears about a more aggressive pace of Fed tightening eased over the month May. The Fed is still expected to increase interest rates by a quarter of a percentage point at its June meeting, however the recent rhetoric has been more along the dovish side of expectations, a considerable change from prior communications.

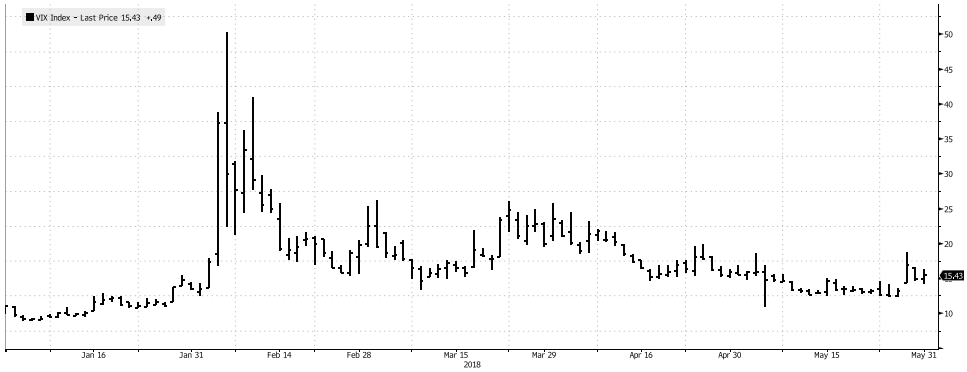
The markets in May were paced again by the technology sector and followed by the industrial and energy sectors. Consumer Staples, Utilities and Financials lagged for the month.

As long as there are ongoing political issues surrounding the markets, volatility is not going anywhere. Volatility is healthy for the markets and advantageous to covered call strategies. The Covered Call Income team took advantage of the intra month swings in the markets in May by strategically placing option trades to enhance income as well as resetting the hedge ratio or delta of the portfolio. The last four months have proven to be very beneficial for selling covered calls.

Covered Call Income: Looking Ahead

Several news worthy events are on the horizon as we look ahead to June. The off again on again North Korea-U.S. summit is now slated for June 12th in Singapore. It is anyone's guess as to what comes out of this historic meeting. Another Fed meeting is scheduled for June, and many consider another interest rate hike to be a foregone conclusion. Coming off another strong earnings season, surveys of investors still suggest plenty of optimism surrounding the markets as we head into the summer months. Continue to look for the Covered Call Income team to look for trading opportunities as they present themselves over the next month.

VIX YTD 2018



Source: Bloomberg

Large Cap Core Growth Commentary

In May, the S&P 500 continued trading in a range bounded by approximately 2600 and 2750. The Russell 1000 Growth Index, our benchmark, traded in a stronger pattern, breaking out through the top of its range. With the Russell Indexes' heavier weighting of the "FANG" stocks of Facebook, Apple, Netflix and Google, it has been a very strong performer, both in May and all of 2018 to date. For May, the S&P 500 gained 2.41% while the R1000G jumped 4.38%. Our Large Cap Core Growth model lagged both indexes for May. So far, the S&P 500 has traded well short of the all-time high it established in January of 2872. We believe the market could break through this level on the basis of very strong corporate profits that are being reported.

Turning to our Large Cap Core model, our best performing sectors were Technology, up 7.22%, and Energy, up 3.98%. The price of oil was strong, rising to about $72 by late May but weakened into the upper $60's by month's end. Lagging sectors for May were Consumer Discretionary and Telecom. Among individual names, Microchip Technology, up 16.86% on positive guidance and CDW Corp, up 12.58% on strong sales and guidance. On the flip side, lagging stocks included Tapestry, which lowered guidance and Thor Industries, which is feeling the impact of the Trump tariffs. Adjustments to the LCCG model included adding to our Baxter International position and the sale of our remaining Lennar Class A&B shares.

Taxable Fixed Commentary

The month of May was driven by headlines, and let's face it, who doesn't love a good headline! The markets are not fond of uncertainty and headlines this month fed into concerns regarding tariffs and trade, geopolitical issues, global growth and mid-term elections, to name a few. In this environment, we saw the treasury curve continue a flattening trend although with bouts of steepness as the U.S. 10yr treasury note moved from a 2.96% to start the month, up to a multi-year high of 3.11% on May 17th, and then falling back down to a 2.85% to end the month.

For the year 2018, we have experienced an upward move of about 45 basis points on the U.S. 10yr treasury note through the end of May. This obviously did not transition in a straight line, but the overall trend higher in rates is the type of environment that the Crossmark taxable fixed income portfolios are positioned for. Although the portfolios gave a little of their YTD outperformance vs the comparable indices back during the month of May due to the swift move higher to 3.11% during the middle of the month, all taxable fixed income products are still outperforming the indices YTD through the end of May. With an outlook of potential continued upside movement across the yield curve, our strategy did not significantly change during the past month.

By utilizing a short duration positioning to reduce our exposure to interest rate volatility and combining that with an elevated level of income as compared to comparable indices, the Crossmark taxable fixed income portfolios are prepared for rates moving higher and use this strategy to help buffer market value volatility. The shorter duration positioning served as a drag on performance during the month of May, but was the largest single positive contributor to the YTD outperformance across the models. The income component also served as a positive contributor and provides the client with a steady income stream throughout differing market cycles. As we await the next Federal Open Market Committtee (FOMC) meeting in mid-June, along with a summit with North Korea and decisions from the European Central Bank and the Bank of Japan, we will continually monitor our inputs to our investment process, adjust our outlook as necessary and look for opportunistic trades for the portfolios.

Municipal Fixed Income Commentary

The Federal Reserve is on a path to raise short-term Fed Fund Rates 25 basis points each quarter at least through year-end 2018 and projected to include the first two quarters of 2019. The interesting dynamic of rising interest rates during a period of inventory consolidation is that there has been a disconnect in municipal bond pricing compared to other sectors of fixed income. Municipal bond pricing has adjusted but at a slower pace than taxable fixed income sectors. This also occurred in 1994 and 2004 as the FOMC increased interest rates. New issuance and inventory play a part in pricing. There will be more than $400 billion in municipal bonds maturing in 2018, with additional called bonds adding to this total. New issuance is calculated to be an optimistic $300 billion. More demand during a period of shrinking supply will cushion the decline in price even in the face of rising interest rates.

Junk is coming to the market at a faster pace. The term junk bond refers to less than investment grade securities rated lower than BBB-/Baa-. With interest rates still below the historical averages and supply not keeping up with maturities, investors have reached for more yield. This has allowed municipalities with less than stellar credit to sell bonds at a very narrow spread to investment grade bonds. This is favorable for the lower grade municipalities but really places a higher risk on the investor as the return for taking on additional risk is not reflected in the income column. An example is the Loma Linda University, a junk rated hospital east of Los Angeles, California scheduled to sell up to $400 million in debt securities. The spread between the Loma Linda University junk rated bond maturing in 2056 and investment grade is a mere 1.71 percentage points. In perspective, taxable fixed income spreads between high yield and investment grade is around 3.40 percentage points. Both tax exempt and taxable high yield to investment grade spreads are extremely narrow. Historically, this narrow spread is advantageous to the municipality or corporation issuing the bonds and extremely riskier to the investor. Not surprisingly, investors query into high yield investments occur when the risk has increased and the potential reward has decreased. Junk rated bonds are more volatile and less liquid than investment grade bonds. Investment grade bonds are clearly the safer investment, especially when taking the narrow spread into the calculation. Crossmark Global Investments does not invest in high yield municipal bonds.

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 10 to 15 year range with a call feature between 2019 and 2024. 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

Top 10 Model Holdings [1]	Weight
1. Microsoft Corp.	5.45%
2. Apple, Inc.	4.83%
3. Home Depot, Inc.	3.71%
4. JP Morgan Chase & Co.	3.57%
5. Texas Instruments, Inc.	3.19%
6. Unitedhealth Group, Inc.	3.15%
7. CDW Corp.	3.14%
8. Cisco Systems, Inc.	2.98%
9. Honeywell International, Inc.	2.88%
10. Harris Corp.	2.84%
Total of Portfolio	36.77%

Covered Call Income

Top 10 Model Holdings [1]	Weight
1. Microsoft Corp.	4.23%
2. Visa, Inc.	3.73%
3. PayPal Holdings, Inc.	3.51%
4. Abbott Labs	3.51%
5. Valero Energy Corp.	3.46%
6. Intel Corp.	3.15%
7. Delta Air Lines, Inc.	3.08%
8. Pfizer, Inc.	3.08%
9. Nike, Inc.	3.07%
10. General Motors Co.	3.05%
Total of Portfolio	33.87%

[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 5/31/2018.

About Crossmark's 30 Year History

Crossmark Global Investments is an innovative investment management firm. The firm provides a full suite of investment management solutions to institutional investors, financial advisors and the clients they serve. We have a multi-decade legacy of specializing in responsible investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas.

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