CROSSMARK GLOBAL INVESTMENTS

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May 2018

MONTHLY COMMENTARIES

Monthly Commentaries Overview

April was a busy month. More than 75% of the S&P 500 reported Q1 2018 earnings, and so far, the results have been quite impressive. In aggregate, ~75% of S&P 500 companies have exceeded consensus Revenue and Earnings estimates with year-over-year (YoY) Q1 growth in each reaching ~8% and ~22%, respectively. So, what was the bloodless verdict of the market in response to such positive Q1 earnings data? Not so impressed…despite a ~6% earnings surprise (meaning that Q1 2018 actual earnings growth was 600 bps higher than the year-over-year consensus earnings growth forecast), just under half of the reported S&P 500 companies saw the price of their shares appreciate after releasing Q1 results. The narrative floating around for the less-than-enthused market response ranged from 1) 'one-off tax and accounting gains skewed results higher' to 2) 'concern that we have now hit peak earnings growth in a late cycle market where the Fed is tightening' on the other. Both seem convincing, but whatever the true reason, we can be certain that a great quarter was already priced in the market. Nonetheless, as the pace of incremental earnings releases subsides going into May (90% of the S&P 500 will have reported by May 15th), the focus of investors invariably tends to return toward the macroeconomic landscape and sector-wide themes relative to the more company-specific focus of earnings season.

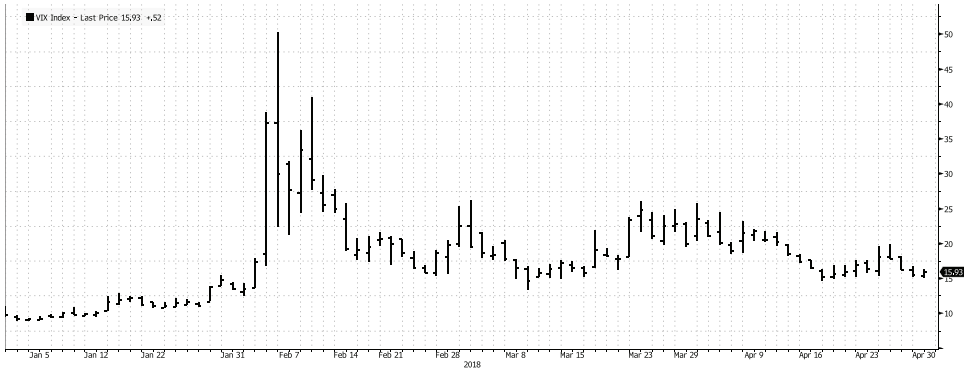
At Crossmark Global Investments, our focus will be to continue digesting Q1 results as they come in and assess the earnings implications and outlook for our portfolio holdings going forward, all while continuing to keep a keen eye on broader macroeconomic, political, and geopolitical developments. This focus is exactly what you'll find in our portfolio managers' monthly commentaries. As a quick preview of what to expect in the following pages, a few recurring themes include thoughts on the current Fed tightening cycle, the possibility of rising interest rates, and the likelihood for increased volatility should these first two continue on their current paths higher. More importantly, however, is how each is attractively positioned in this type of environment.

Covered Call Income Commentary

Covered Call Income: April in Review

Volatility, which returned to the markets with a vengeance in the first quarter, persisted through much of April. Global headlines continued to play a major role within the markets. The potential for a trade war with China and escalating tensions between the U.S. and Russia are two of the main culprits to keep an eye on. Earnings season has started and so far has exceeded investor expectations. Many investors still remain somewhat cautious that the current pace of growth will at some point give way to accelerated inflation which in turn could lead to tighter monetary policy from the Fed. The Fed is still expected to announce two more rate increases prior to the end of 2018. All of these potential events play a part in the resurgence in volatility. Volatility is healthy for the markets and important for covered call strategies. The Covered Call Income team took advantage of the swings in volatility by strategically placing trades to enhance income as well as resetting the delta of the portfolio. Just as the month of March, April proved to be another important month in regards to selling covered calls.

VIX April 2018

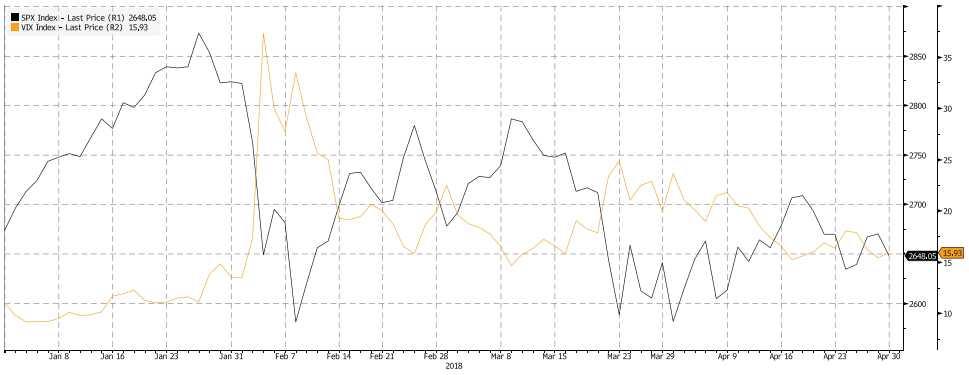


Source: Bloomberg

Covered Call Income: Looking Ahead

Finally volatility has returned, the Fed is picking up the pace with potential rate increases and trade wars with China seem to be right around the corner. All that being said, global growth is still strong and the U.S. economy is getting a jolt of fiscal stimulus. Earnings season will be in full force as well as the calendar flips to May. Surveys of investors still suggest plenty of optimism within the markets, even after the late January early February market correction. Continue to look for the Covered Call team to look for trading opportunities as they present themselves to increase option income. To say the markets have been volatile since February would be an understatement. Time to press on to the summer.

VIX vs S&P 500 April 2018



Source: Bloomberg

Large Cap Core Growth Commentary

After tumbling in early February, the S&P 500 has traded mostly sideway between approximately 2600 and 2800 while bouncing off the key 200 day moving average. The Russell 1000 Growth Index, our benchmark, traced out a similar pattern. For the month, the S&P 500 returned 0.384% while the Russell Growth posted a 0.349% return. All in all the price action was fairly meager compared to some of the first quarter movement that we witnessed. Our Large Cap Core Growth model managed to edge ahead of both indexes for the month of April. Year-to-date we lagged the Russell 1000 Growth Index while besting the S&P 500 by a few basis points. Looking ahead we think the market may continue sideways even with robust second quarter earnings looking likely. The headwinds of rising interest rates, political infighting in Washington, and talk of trade wars could put a lid on prices for a couple of months or more.

Turning to our Large Cap Core Model, our best performing sectors were Materials and Energy. Our energy holdings were boosted by upward trending oil prices. Lagging sectors for April were the economically- sensitive Industrials and Consumer Discretionary, our only sectors to report negative returns for the period. Among individual names, our best performing stock was Citrix Systems, the technology solutions company. The company jumped 10.89% after posting excellent quarterly results in late April. UnitedHealth Group also spiked 10.47% after strong results for the quarter followed by a boost to the full year forecast. Lagging stocks included Deere and 3M after concern over new tariffs and their impact on profits. We made one adjustment in the model for April, trimming our position in Lennar, the homebuilder.

Taxable Fixed Commentary

In the words of a very wise and powerful Jedi Master, “Fear is the path to the dark side”. Although Yoda probably didn’t have the financial markets in mind when he shared his words of wisdom, they do apply to the investor psyche present today. We have many uncertainties in the markets including tariffs, possible trade wars, rising inflation and rate hikes, just to name a few. But the key is to not allow the fear of uncertainties to derail your investment thesis.

At Crossmark, our fixed income taxable portfolios have been positioned in such a way as to reduce the volatility that accompanies interest rate movements and focus on the income component that our investors rely on to meet their liabilities. These two components have been the largest positive contributors to return YTD and for the month of April as every fixed income product continues to outperform its comparable index. The overweight to the investment-grade corporate allocation has continued driving the higher income levels as compared to the index providing a strong income return to the portfolio. Regardless of market value volatilities that can occur, these income levels do not change and provide a continuous stream of cash flow from the portfolio.

We have made it through the first 3 Federal Open Market Committee (FOMC) meetings of 2018 with one rate hike, although we anticipate that the Federal Reserve has more rates hikes coming through the second half of the year. Our short duration positioning will be maintained in order to reduce the level of volatility we see in a rising rate environment, even though we have the option to hold a bond until its maturity date and not be as concerned with daily market value fluctuations. A rate hike in June is basically priced into the market with the results of the September and December meetings still up in the air and the 3.00% level for the U.S. 10yr Treasury note still a key level to watch.

Our four-step investment process built on duration, yield curve structure, sector selection and individual security selection remains consistent throughout the market cycle and is not signaling a shift in strategy at this point. However, we will continually monitor our inputs, adjust our outlook as necessary and look for opportunistic trades for the portfolios. Don't let fear take you to the dark side. Have conviction in your investments and the ability of your current positioning to help you ride through the volatility. As always, we are happy to answer any questions you may have or discuss the current state of the markets.

Municipal Fixed Income Commentary

Crossmark Global Investments municipal bond product outperformed the benchmark for April due to the shorter duration and conservative nature of concentrations in general obligation and essential services revenue bonds.

Volatility in fixed income investments have investors nervous about potential negative returns and future pricing. While headline news carries a fear factor to increase readership, the current move in interest rates and subsequent volatility, has not reached levels experienced in 1994 or 2004, the last two periods of time when the Federal Open Market Committee raised Federal Funds rates. The 1994 and 2004 periods of volatility may be a distant memory to current investors so sharing a little history may help place our current situation into perspective.

In 1994, the FOMC held interest rates at a then low level around 3.00 percent following the Savings and Loan crisis. From February 1994 to June 1995, the Federal Funds rate moved higher by 300 basis points. In 2004, FOMC had eased Federal Funds rates due to the dot com bubble, 9/11 and the first Iraq War. Federal Funds rate was a low 1.00 percent. From June 2004 through June 2006, the Federal Funds rate moved higher by 425 basis points.

In comparison, beginning December 2015, the FOMC have raised Federal Funds rates 25 basis points six times for a total of 150 basis points as of May 1, 2018. Additional increases are anticipated, but the pace of the current increases has been subdued compared to 1994 or 2004. The 10 year Treasury has risen from an intraday low on July 3, 2016 of 1.38 percent, closing near a historical low of 1.42 percent to a high of 3.03 percent April 26, 2018.

Yields are extremely attractive right now and an excellent entry level for new cash allocated to municipal bonds. To begin 2018, the 30-year Treasury was near 2.63 percent. The yield curve has changed so much in the last four months that the 3-year Treasury is now 2.63 percent, which is the equivalent of dropping 27 durations in a four-month period. This extreme change in rates in a short period of time hasn't occurred since 2004.

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. Cisco Systems, Inc.	3.19%
6. UnitedHealth Group, Inc.	3.15%
7. Texas Instruments, Inc.	3.14%
8. Harris, Corp.	2.98%
9. Honeywell International, Inc.	2.88%
10. CDW Corp.	2.84%
Total of Portfolio	36.02%

Covered Call Income

Top 10 Model Holdings [1]	Weight
1. Microsoft Corp.	4.08%
2. Abbott Labs	3.38%
3. PayPal Holdings, Inc.	3.25%
4. Valero Energy Corp.	3.22%
5. Pfizer, Inc.	3.19%
6. Gilead Sciences, Inc.	3.15%
7. Halliburton Company	3.08%
8. Delta Airlines, Inc.	3.04%
9. Intel Corp.	3.00%
10. Nike, Inc.	2.98%
Total of Portfolio	32.37%

[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 4/30/2018.

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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