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November 2018

MONTHLY COMMENTARIES

Monthly Commentaries Overview

Large market corrections always seem to come during the month of October. Perhaps a bit of confirmation bias, but this October proved to be no different. Before Trick or Treaters were able to get their first piece of candy on Halloween, the USD-equivalent of approximately $7.8 Trillion (~6%) had been wiped from global bond and equity exchanges over the prior 31 calendar days. However, if we measure the October drawdown from peak-to-trough (Sep 22nd to Oct 30th), the USD-equivalent of approximately $9.2 Trillion has been erased from global stock and bond exchanges. This compares to the quicker but lesser-in-absolute-magnitude USD-equivalent loss of $8.6 Trillion during the "vol event" of late-Jan'18 to mid-Feb'18. Year-to-Date through end of October, global exchanges have seen market values shrink by an aggregate ~$9 Trillion (~6.9%). However, from the Jan. 28th peak, market values had contracted a staggering USD-equivalent of ~$16 Trillion (or ~12%) through end of October 2018.

The global market selloff described above has been especially painful for the rest of the world, especially emerging market countries. While the brief but painful Jan/Feb "vol event" and the declines seen in October have been painful for the US on an absolute basis, the global market selloff has been relatively benign to the US on a relative basis for much of 2018. In fact, Year-to-Date through end of October, the aggregate market value of US bond and equity exchanges have only fallen by ~$400 Billion (-0.8%) relative to the ~$9 Trillion (-6.9%) erased from global exchanges (including the US). The big question for markets going forward is whether this performance gap can be sustained for the remainder of 2018 and into 2019.

Moving on to a preview of our portfolio managers' October monthly commentaries.

In both our Taxable Fixed Income and Municipal Bond commentaries, both managers have positioned their portfolios to be shorter duration relative to their respective benchmark indices, and correctly so. However, as rates creep higher, they have now begun looking for opportunities further out on the yield curve. For Taxable Fixed Income, this approach will likely be more opportunistic in nature, "as the 10yr yield makes it way ever closer to the assumed neutral rate around 3.25-3.40%". As stated in the Municipal Bond commentary, the approach will be less tactical given recent technical and market structure developments (i.e., liquidations in closed-end muni funds) that have caused favorable pricing in the short term; here the approach has been to, "buy municipal bonds like it is 2011."

In Large Cap Core Growth, we start with a high-level assessment exploring potential reasons for a historically volatile month of October. We then finish up with an assessment of the LCCG portfolio, which outperformed the Russell 1000 Growth Index benchmark in October given our underweighting to the high valuations of the "FANG-type stocks [that] gave up some ground" during the month. Finally, in our Covered Call Income commentary, we naturally overweight the conversation to the recent volatility in equity markets and finish with a look ahead to the end of the year.

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

Until next Month!

Taxable Fixed Commentary

The mid-term elections have passed and it is now time to get on with business focusing on fundamentals, earnings and how central banks will react to global growth as we head into 2019. The volatility seen during the month of October sent many investors reaching for safety on concern that the long awaited bear market was emerging. However, the as-expected outcome of the mid-term election provided a relief rally and put one of the uncertainties plaguing the market behind us.

Along with equity market volatility, we saw the US 10yr treasury yield move in the month of October as well. Beginning the month at a 3.08%, yields moved up to a high close of 3.23% in the first week of the month but retreated and closed the month at a 3.14%. Investor sentiment plays an important role in the longer end of the curve so when you have mid-term elections, trade and tariff issues, questions on what the Fed will do, and earnings and economic reports, there is plenty of room for volatility.

Our fixed income taxable products have been positioned with shorter durations than their comparable indices and elevated levels of income to reduce interest rate sensitivity in a rising rate environment and benefit from strong income flows. All of our products have continued to outperform YTD through the 3rd quarter due to the above mentioned positioning. During the month of October, the largest positive contributors to outperformance for the Core Fixed, Fixed Intermediate and Corporate models were our yield curve positioning as we focused on the short to intermediate portion of the curve, our selection effect and our shorter duration, followed by positive contribution from higher levels of income. For the Current Income and Income Opportunity accounts, we lagged during the month of October although still outperforming YTD. This lag was due to the fixed rate preferred allocation that has greater volatility in market value due to the longer duration of the sector. However, this sector is also what provides the elevated level of income flow which was the largest positive contributor to performance relative to the index for both products.

As we move towards the end of 2018, we will continually analyze our strategy based on the 4-step investment process that drives our decisions. This process includes multiple inputs that are utilized to evaluate our duration target, yield curve positioning, sector evaluation and security selection. As the 10yr yield makes it way ever closer to the assumed neutral rate around 3.25-3.40%, we will be looking for opportunities to extend duration and take advantage of higher yields further out the curve. Whether you like it or not, the holidays are here, and we look forward to finishing out the year with strong strategies that help you reach your financial goals and keep you in a jolly mood. As always, feel free to contact us with any questions you may have. And just to make your eyes widen, there are less than 50 days to Christmas!

Municipal Fixed Income Commentary

Buy municipal bonds like it is 2011. This theme may sound familiar but it certainly is worth repeating. With municipal bond mutual funds liquidating over numerous consecutive weeks to satisfy individual investor redemption requests, prices on municipal bonds have approached 2011 pricing. Crossmark Global Investments remain aggressive buyers of municipal bonds heading into November for called bonds, maturing bonds and deposits to existing or new accounts. As projected last month, interest rates did work their way to the top of the anticipated trading range on the 10 year Treasury around 3.25 percent. Requests by municipalities for new cusips project a steady stream of new issues to hit the market through year end. With favorable pricing now and in the short-term, Crossmark Global Investments is focusing on extending duration on called bonds, maturing bonds and new deposits. Municipal bond inventory is sufficient, fairly priced and reinforce why Crossmark Global Investments are aggressive buyers.

Federal Open Market Committee (FOMC) guidance states a rate hike in December 2018, three hikes in 2019 and two in 2020. Crossmark Global Investments has been stating for several quarters that the guidance may be aggressive in light of anticipated positive GDP growth and the Crossmark Global Investments Municipal Bond Portfolio Manager is factoring in a total of three hikes left (including December which is already factored in), if that, depending on a lot of economic growth factors. As volatility increases, FOMC guidance may become wishful guidance instead of actionable guidance. Market volatility, economic reports and a changing political environment could derail FOMC guidance of five interest rate hikes through 2020. If inflation surprises on the growth side then adjusting two rate hikes back into the calculation may be warranted.

Separately Managed Accounts may be faring better than bond funds in the current environment. Bond fund managers are forced to liquidate or accumulate bonds based on investor deposits or withdrawal requests. Often, the flows into or out of a fund may be in stark contrast to the trend in pricing. In the current environment, bond fund investors are requesting liquidations as prices are falling while Separate Managed Account managers are able to acquire bonds at lower pricing. When investors deposit into bond funds, fund managers may be forced to purchase bonds at a rising price environment while Separately Managed Account managers have the option to pick a potential better time to allocate to bonds.

High yield municipal bond funds and ETF's continue to produce a warning alarm from Crossmark Global Investments. While the spread between high yield and investment grade is not as narrow as it was this summer, the risks continue to appear to be excessive. Another warning sign is that new issue offerings of high yield municipal bonds are increasing. Historically, this can be a sign of a near top in pricing as entities attempt to take advantage of selling non-rated or below investment grade bonds to the public in anticipation that rates will continue to rise. Deals coming to the market include a proton cancer therapy center, a methanol production facility in Texas using bovine "end product" as fuel, and a luxury apartment complex in Cleveland. Then there was the largest high yield deal for the year, nearly $200 million of bonds, sold by a retirement center which is one of the most default prone sectors in fixed income. Fortunately there are investors and savvy advisors that have reduced allocations or liquidated high yield funds. High yield funds have experienced outflow for five consecutive weeks, the longest streak of outgoing cash flow since January 2017.

Closed-end municipal bond funds have access to use leverage to potentially boost returns when prices rise but exacerbates losses when prices decline. Leverage and the widening of discounts on closed –end municipal bond funds have resulted in losses up to 5 times the loss in the broader municipal market as interest rates have risen during the month of October. When interest rates rise the cost of leverage also rises further reducing return to shareholders. More than 90 percent of closed-end municipal bond funds posting a loss for the calendar year, including roughly 15 percent of this sector that has lost greater than 10 percent. Tax loss selling in closed-end municipal bond funds may keep discounts wider going into the remainder of the year.

Municipal Fixed Income Commentary

The mid-term elections should produce common ground for a push for infrastructure. Of course the sticky part of the details will focus on how and where the money will come from for the investment in infrastructure. In terms of roads, highways, bridges and airports there have been discussions of raising the Federal gas tax. Several entities such as the U.S. Chamber of Commerce and the American Trucking Association have endorsed raising fuel taxation to fund infrastructure. The last time the gas and diesel fuel tax was raised was 1993. There has been a recent increase of travel but the efficiency of the newest technology has actually dropped the consumption of fuel on a per mile basis. Put in more simplistic terms, more usage at a time of declining revenue doesn't work well to maintain basic infrastructure. The Society of Civil Engineers estimate an additional $2 Trillion is required by 2025 just to bring our current infrastructure up to an average grade. Bipartisan Congress will need to address this at some junction of time before deterioration adds to human and property risk. The bond market is ready to participate.

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 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 Commentary

With six straight months of positive returns for the S&P 500 perhaps it was time for a breather so maybe we should have guessed it was time for another October swoon. After months of working its way back to another new all-time high in late September, the market crossed the threshold into October and almost immediately started falling, then plunging. We have seen a lot of these October declines over the years with various reasons given from farmers needing cash for crops (seems dated to say the least) to hedge fund redemptions to a halt to corporate buybacks during earnings season. Perhaps the most reasonable explanation is that October is when a lot of analysts realize they have been too optimistic for the year and they begin aggressively lowering earnings and guidance expectations to "true up" the numbers. As is typical for these declines, this one stopped near the end of the month and rallied into early November. Then there is the "mid-term" election pattern. The thought is that the election creates uncertainty, causing weakness in the market. After the election the uncertainty is removed and stocks rally. We will have to wait and see on this.

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 stated 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 a good October as the tech sector, especially the "FANG-type" stocks gave up some ground. We are fairly heavy in technology but less so the very-high PE names. We outperformed our Russell 1000 Growth benchmark significantly for the period. Our best performing sectors were Consumer Staples, down but only by 0.36%, and Materials, down 2.32%. Worst performing sectors were Industrials which fell 8.67% and Consumer Discretionary which were down 9.12% for the period. As for stocks, Verizon won the performance derby, jumping 8.10% due to its safe haven status, and Coca-Cola, also somewhat of a safe haven, gained 3.66%. Our worst stocks for October were FLIR Systems, down 25.82% due to poor third quarter guidance, and Square, Inc. which fell 25.82% due to weakness in the payments sector along with the departure of the CFO. Adjustments to the portfolio included the sale of FLIR in early November.

Covered Call Income Commentary

Covered Call Income: October in Review

October turned out to be downright scary for the markets as stocks had their worst month of performance since September of 2011. Volatility came back with a vengeance which should not come as that big of a surprise given the fact that interest rates continue to rise, Fed uncertainty seems to be higher, trade negotiations with China persist and mid-term elections are rapidly approaching. The higher volatility that investors are experiencing seems likely to persist. Sounds pretty unnerving. However, the markets are entering what has been a historically strong seasonal period. The months of November and December of mid-term election years have been quite strong as history has shown. Look for this trend to continue regardless of the election outcome. The broader fundamentals of the markets still remain favorable. Corporate earnings are up again over 20%, profit margins remain close to historical highs, and sales growth is running at a pace not seen in several years. All of these factors are indicating a healthy tailwind for the markets.

S&P 500 vs VIX

Source: Bloomberg

Covered Call Income: Looking Ahead

Stocks were able to rally the last week of the month as the markets saw three straight daily gains of at least 1%. The markets were helped by improved consumer sentiment, positive earnings growth and signs of potential progress with China and trade negotiations. Earnings season is coming to a close and quarterly profits are set to grow at the best pace in the last eight years. Looking ahead to November has the mid-term elections that could very well swing control in the house and senate back to the Democrats as well as the G20 Leaders' summit which convenes on the 30th. 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 two months of 2018 are 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.	6.11%
2. Apple, Inc.	6.03%
3. JP Morgan Chase & Co.	3.52%
4. CDW Corp.	3.48%
5. UnitedHealth Group, Inc.	3.37%
6. Home Depot, Inc.	3.37%
7. Cisco Systems, Inc.	3.26%
8. O'Reilly Automotive, Inc.	3.00%
9. Honeywell Intl, Inc.	2.85%
10. Harris Corp.	2.78%
Total of Portfolio	37.77%

Covered Call Income

Top 10 Model Holdings [1]	Weight
1. Abbott Labs	3.95%
2. Visa, Inc.	3.95%
3. Oracle Systems Corp.	3.50%
4. Coca Cola Co.	3.43%
5. Intel Corp.	3.36%
6. Cisco Systems, Inc.	3.28%
7. Nike, Inc.	3.23%
8. Exelon Corp.	3.14%
9. Delta Air Lines, Inc.	3.14%
10. Microsoft Corp	3.06%
Total of Portfolio	34.04%

[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 10/31/2018.

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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