CROSSMARK GLOBAL INVESTMENTS

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September 2018

MONTHLY COMMENTARIES

Monthly Commentaries Overview

Labor Day in the U.S. is perhaps one of the holiest of market holidays for professional investors (behind Christmas and Good Friday, of course). It marks the unofficial end of Summer and usually caps what has historically been one of the worst months (August) for U.S. equity performance – so, many of us have been conditioned to look forward to a usually much-needed breather over Labor Day weekend, something our non-U.S. based peers don't get. This August, however, was a little different than the typically seasonally weak monthly performance.

U.S. equities as proxied by the S&P 500 actually gained +3% in August and hit new all-time highs, which extended the S&P 500's outperformance over the rest of the world (as proxied by the MSCI World ex-USA Index) by an additional +5%. In fact, year-to-date through August, the S&P 500 has outperformed the MSCI World ex-USA Index by an incredible +12.8%. Given the macro back drop of a tightening Federal Reserve against a widening budget deficit, continued trade war escalation, EM currency crises, and mid-term elections nearing, almost all U.S.-invested long-only investors would have gladly given up their Labor Day vacations to lock-in another month of August 2018-esque performance.

In our portfolio managers' August commentaries, which can be located on the following pages, you'll find that a lot of the above expectations / sentiment was equally shared, especially given the macro backdrop described above (which has been part of the market narrative well before August).

In our Taxable Fixed Income Commentary, we discuss how volatility – not just in U.S. equities, but in U.S. government rates – has been quite low despite a tightening Fed and an uncertain domestic and global macro market environment.

In our Municipal Bond Commentary, we delve into, among other aspects of the muni market, the logic behind what is currently the steepest municipal bond yield curve relative to U.S. Treasuries in over 18 years and how we are playing it.

In our Large Cap Core Growth Commentary, we discuss the U.S. economy and U.S. equity markets in general – but more specifically, we highlight how the Russell 1000 Growth Index (our Large Cap Core Growth benchmark) is "starting to resemble a technology sector fund with its heavy "FANG" and technology weighting".

And last but not least, in our Covered Call Income Commentary, we give our take and review of markets through the options investing lens as we continue to expect unfolding market uncertainties to ultimately cause more market volatility going forward.

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 summer has come to an end and as we tidy up our desks and prepare for the holiday weekend, we think back on the lazy days of the summer season. Oh wait, that's not quite right! Unlike most summers, this year we have had plenty to keep us busy including incredible earnings, central bank meetings, tariff implementation and trade disputes, surprising elections and questions surrounding Emerging Market currencies.

One would assume that with so many uncertainties consistently feeding the daily headlines, the volatility in the market would be quite high. However, for the most part, the markets have been quite resilient. The U.S. 10yr yield has maintained its range of 2.80-3.00% which we have seen consistently over the past quarter. The yield curve has flattened as another rate hike by the FOMC is expected during the September meeting with Fed Fund futures showing about a 70% probability for an additional hike at the final meeting of the year in December.

During the month of August, we hit both the low and the high yield on the 10yr Treasury for the quarter ranging from 3.00% at the beginning of the month to a 2.81% towards the end of the month. Based on the Fed Fund futures, we anticipate we will see additional rate hikes going forward and therefore have positioned our portfolios in a conservative position with reduced sensitivity to interest rate movements. This approach has worked well YTD as the portfolios have outperformed their comparable indices for the year. As yields moved down during the month of August, this positioning served as a headwind with our larger income component of the portfolio providing the largest positive contributor to performance.

There are many events left in the final months of the year including mid-term elections, central bank meetings and continued negotiations on trade matters. We will carefully monitor developments from these items along with economic reports to utilize in our 4-step investment process that develops our strategy based on duration, yield curve positioning and sector and security selection. For now, our overweight to the corporate allocation and underweight to the treasury allocation will continue until such time we anticipate that the business cycle is changing. We will continually monitor the markets and update our strategy based on changing outlooks through our investment process, always looking for opportunities within the portfolios.

We hope you enjoyed your summer of 2018 and we look forward to finishing out a great year with you. As always, feel free to reach out if you have any questions regarding our investment process, strategies or portfolios and we are happy to discuss them with you. Enjoy the beach for one last weekend and see you on the other side of summer!

Municipal Fixed Income Commentary

The municipal bond yield curve relative to the Treasury yield curve hit the steepest level seen in the last 18 years. Historically, the municipal bond yield curve tends to steepen during periods when Treasury curve flattens. There are some obvious reasons for this disconnect between municipal bonds and Treasuries. Tax reform, which included a reduction in tax rate drove institutional buyers to the sideline. Equity markets continue to press into all-time highs, which is far more exciting to communicate with others than fixed income investments. Additionally, individual investors with a fear of rising interest rates by the Federal Open Market Committee (FOMC), slowed the pace of buying municipal bonds. It is fair to add that there are more complicated parts to the steepening of the municipal bond curve that includes, but is not limited to, economic data, geopolitical issues like tariffs and trade, currency strength, and international economics. Municipal bonds are less exposed to foreign growth and currency exchange rates. In summary, municipal bonds remain a solid choice for the fixed income portion of asset allocation, even when considering the lower tax brackets created during tax reform.

Some of the biggest U. S. banks reduced their exposure to municipal bonds in 1Q18 and continued to reduce holdings into 2Q18, especially on the longer maturities. Financial writers point to the tax reform as the primary driver as the federal government cut corporate tax rates from 35 percent to 21 percent, diminishing the tax benefits of the securities. Commentaries are quick to pick a reason then move on to another topic but in this case, an expanded observation and/or speculation warrants discussion. In 1Q18, the 10 year Treasury moved from a 2.43 percent to 3.11 percent which coincides with the bulk of the municipal bond reduction by most U. S. banks. In 2Q18, interest rates briefly dipped below 2.70 percent before moving back to the 2.85 percent level to end August 2018 as banks reduced municipal bond holdings further. No doubt banks were impacted by lower tax rates but few economists discuss if banks view the FOMC as continuing to raise short-term interest rates through 2020 as highlighted in FOMC written statements as well as Congressional hearings. Banks traditionally purchase longer term maturities and the longer duration bonds are more negatively impacted than shorter maturities in a rising interest rate environment. It would appear that banks reducing longer maturities in a period of rising interest rates with FOMC guidance to the future to continue hikes would be sound business management. In comparison, Crossmark Global Investment Separate Managed Account municipal bond portfolio duration is considerably shorter than the index resulting in favorable performance when compared to longer durations in rising interest rate environments. Should interest rates continue to rise, consideration will be given to increase duration in the SMA portfolios.

Reporting of new issuance of municipal bonds is entertaining as reports of issuance being down 11 percent year to date while other reports show an increase of 21 percent. Both are accurate. The contrast between overall issuance and financing for new projects has been the story all year. An explanation of issuance down 11 percent is based on the loss of advance refunding which ended in 4Q17. Advance refunding merely refinances existing debt. When one removes advance refunding data in 2017 then views new project issuance, primarily for infrastructure, it has increased 21 percent year to date. There may be increased focus on repairing crumbling infrastructure going forward with advance refunding on the shelf. Crossmark Global Investments created a white paper “Infrastructure, Paving the Way to Economic Recovery” in August 2014 which outlined a future of increased infrastructure activity beginning with roads, transportation, a resurgence in housing to create water and sewer projects and evolving to CAPEX spending as the economy improved. Most reports claim that infrastructure investment has been absent while in reality infrastructure spending has increased. In 2015, new money borrowing grew by 10.4 percent, in 2016 by 9.5 percent and in 2017 by 15.7 percent. 2018 is on track for another increase in new money spending on infrastructure.

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 20 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 Commentary

The rally in stocks continued for its fifth consecutive month with the S&P 500 gaining another 3.26% in August on a total return basis. For the year-to-date the index has gained 8.52%. The red hot Russell 1000 Growth Index continued to roll, gaining 5.45% for the month and 16.44% year-to-date. The Russell index is starting to resemble a technology sector fund with its heavy "FANG" and technology weighting. Apple's weighting, for example, hit 8% of the Russell index as its market capitalization crossed the one trillion dollar mark. Not bad for a company that was teetering on bankruptcy some years back, before Steve Jobs worked his magic. The U.S. economy continues to hum along with both the manufacturing and service PMIs still well above the key 50 level, indicating we are still in expansion mode. Additionally, the S&P 500 finally managed to hit a new all-time high of 2916 on August 29. Historically, new highs are a very bullish event. Earlier, the NASDAQ, the smaller cap Russell 2000 Index and the Advance-Decline Line (a well-known technical indicator) all plowed ahead to new highs, bolstering our conviction that the S&P 500 would join the fun and it finally has. With several important indexes making new highs, markets are said to be "in gear," also considered to be quite bullish. And let's not forget, in August the bull market became the longest on record as it crossed the 113.4 month mark with few signs of it or the economy slowing down anytime soon.

Corporate earnings should certainly provide support for stocks. Earnings for the third quarter are expected to be up about 20% for the S&P 500 and this follows a +24% gain for the second quarter, with help, of course, from the year tax cuts. For the full calendar year 2018, EPS growth is expected come in at 20.6%. Of course, earnings growth should slow in 2019 with the anniversary of the tax cuts but it should still be in the 10% area, according to the consensus estimates. The twelve month forward PE ratio currently stands at about 16.7x so valuations have improved since last January's peak, leaving room for more upside.

Turning to our Large Cap Core Growth Model, our top performing sector for August was Materials, up 6.95%, followed closely by Consumer Discretionary which rose 6.80%. Conversely, underperforming sectors included Consumer Staples, down 3.62% and Energy, down 2.25%. In individual names, Apple was our top performer, up 20.04% due to increased expectations for the iPhone. However, even though Apple is our second largest holding, it is somewhat underweight versus the Russell 1000 Growth Index and actually cost LCCG a few basis points due to the weighting. Cisco came in second for August, up 12.96% on strong earnings results. On the flip side Microchip Technology declined 8.6% while Schlumberger declined 6.46%. For the period we made several adjustments to the portfolio. First we sold Polaris Industries due to performance issues and swapped the proceeds into O'Reilly Automotive. Later we sold Microchip Technology and trimmed Constellation Brands. Finally, we initiated positions in Palo Alto Networks which provides network security solutions to various types of enterprises and Intuitive Surgical, a maker of surgical systems.

Covered Call Income Commentary

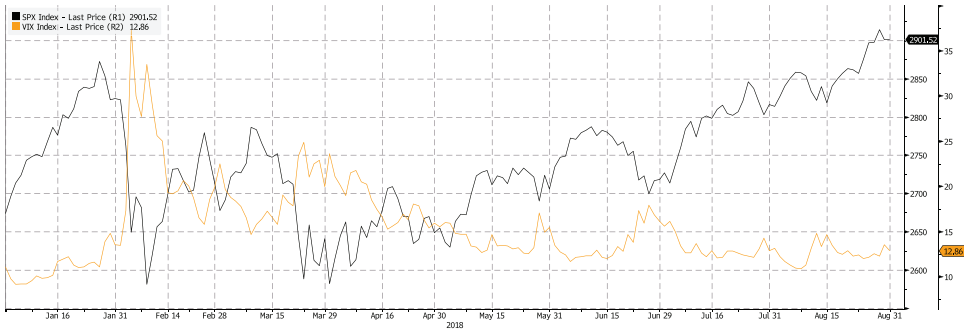
Covered Call Income: August in Review

Historically, the month of August has been one of the worst performing months of the year. Investors were faced with new U.S. sanctions against Iran, relationship strains between the U.S. and Turkey and the continued deterioration of trade talks surrounding the U.S and China. Most equity markets and risk assets sold off, with one exception being the S&P 500 which was up once again on strong investor sentiment and a lack of inflationary concerns. Consumers continue to benefit from the tailwinds provided by fiscal reform.

Even though U.S. stocks hit all-time highs in the month of August, the sectors leading the charge were more defensive in nature. Telecom, utilities and healthcare outperformed while materials, energy and industrials underperformed for the month.

Trade rhetoric was once again at the forefront in August with the U.S. and Mexico announcing an agreement with the hopes that Canada would soon come to the table. Trade talks with China appear to have stalled for the time being. Trade tensions continue to persist which will lead to increased volatility. Volatility is advantageous to covered call strategies and overall is healthy for the markets in general. The Covered Call Income team took advantage of volatility the first part of August by placing option trades to generate premium income.

VIX Trailing 12 months



Source: Bloomberg

Covered Call Income: Looking Ahead

Trade uncertainties are going to continue to loom over the U.S. markets and emerging market economies. That being said, there is optimism within the markets as the U.S. and Mexico reached a trade deal at the end of the month. The markets continue to rally on positive trade news but also pullback on the lack of developments. That uncertainty will surely bring more volatility to the markets. As we head towards the end of the third quarter, the Covered Call Income strategy is well positioned for the market fluctuations that lie ahead.

Large Cap Core Growth

Top 10 Model Holdings [1]	Weight
1. Microsoft Corp.	6.05%
2. Apple, Inc.	5.91%
3. Home Depot, Inc.	3.62%
4. JP Morgan Chase & Co.	3.49%
5. UnitedHealth Group, Inc.	3.26%
6. Cisco Systems, Inc.	3.20%
7. CDW Corp.	3.19%
8. Texas Instruments, Inc.	3.07%
9. Honeywell Intl, Inc.	2.95%
10. O'Reilly Automotive, Inc.	2.95%
Total of Portfolio	37.71%

Covered Call Income

Top 10 Model Holdings [1]	Weight
1. Visa, Inc.	4.04%
2. Abbott Labs	3.67%
3. Nike, Inc.	3.39%
4. Oracle Systems Corp.	3.34%
5. Intel Corp.	3.33%
6. Cisco Systems, Inc.	3.28%
7. Valero Energy Corp.	3.24%
8. Delta Air Lines, Inc.	3.21%
9. Emerson Elec Co.	3.16%
10. Gilead Sciences, Inc.	3.12%
Total of Portfolio	33.79%

[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 8/31/2018.

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 $5.1 billion in AUM.

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