Wealth
Management

Investment Management Group

REVIEW&OUTLOOK *written by Broadway Bank's Portfolio Managers*

FIRST QUARTER **2016**

There and Back

The S&P 500's 1.4% total return during the first quarter masks what was a tale of two halves. The first six weeks of the quarter generally saw stocks fall, culminating in a 9.2% drop in equities by mid-February. Ironically, crude oil moved in much the same fashion, declining 29.3% through mid-February. While Large Cap U.S. stocks and Crude Oil tend to be positively correlated, the strength of their relationship doubled in 2016, causing them to move nearly in lockstep with one another this year, and causing both to bottom simultaneously on February 11th.

Following their mid-quarter troughs, both stocks and crude staged stunning recoveries with the S&P 500 jumping 12.7% and crude rising 58.2% from their respective lows. Despite the interim volatility, crude went on to finish the quarter up 3.5% year-to-date as of March 31st, while stocks ended higher 1.4%, as discussed. Interestingly, the gain that the S&P 500 earned during the first three months of the year was virtually identical to the gain it earned for all of 2015. While all the volatility experienced early in the year certainly feels unusual, material intra-year changes in the price level of stocks are actually more the norm than the exception. Over the past three-and-a-half decades, the S&P 500 has experienced average intra-year peak to trough drops of almost 16.0%, yet has gone on to close in positive territory roughly three-quarters of the time. To that end, Broadway Bank's focus on each client's long-term investment plans remained key throughout the quarter, and our diversified portfolios provided downside protection during the softer half of the quarter, while enjoying the upside returns as the market strengthened.

From a longer-term perspective, the S&P 500 has now generated an average annual return of 16.9% since the market bottomed almost seven years ago in March 2009. If the S&P 500 were to generate the same return during the coming three quarters that it generated in the January to March period, that would imply a return on the order of 5.5% for all of 2016. Going forward, stabilization in oil, continued strength of U.S. economic data, earnings growth, and election uncertainty will all have an impact on equity market returns for the remainder of the year. In the meantime, your Broadway Bank Wealth Management team of portfolio managers continues to be diligent in following all of these factors on your behalf with the aim of optimizing your returns and mitigating risk.

Equity Market Review

Within the Large Cap space, Value-oriented stocks outperformed those with a Growth orientation by almost a full percentage point during the quarter, marking a reversal from the material outperformance of Growth during 2015. Sectors that performed best were Telecoms and Utilities, which were each up over 15.0% as investors continued to look for defensive names. Those sectors that struggled during the quarter included Financials and Healthcare, which both fell over 5.0%, albeit for different reasons. Healthcare, the S&P 500's hardest hit sector in the quarter, faced headwinds in Biotech and from possible changes to healthcare reform following the presidential election. The Financials sector, on the other hand, is one of the most interest-rate sensitive sectors in the index. With the volatility in interest rates, low trading volumes, and a flatter yield curve (which makes the margin between lending and deposit rates narrower), the sector suffered a loss during the first quarter.

The equities that performed best within Broadway Bank Wealth Management portfolios over the quarter were generally names that were not components of the best performing sectors. These included Spectra Energy, Cummins, Hasbro, Genuine Parts, and Target. On the flip side, some of the softest names over the course of the quarter were Novartis, ConocoPhillips, PNC Financial, Monsanto, and Disney, most of which had company-specific issues.

Looking beyond the S&P 500, the return on Mid Cap stocks outpaced those of Large Caps by almost two-and-a-half percentage points during the quarter, generating a return of 3.8%. The laggard in the U.S. market was Small Cap stocks which fell by 1.5%, as measured by the Russell 2000.

Owing in part to the strength of the U.S. economy and continued strong data coming out of the U.S., domestic stocks as a group again outperformed Developed International stocks as the MSCI EAFE index fell 2.9% in the quarter. However, Emerging Markets represented a bright spot in portfolios with a gain of almost 5.8% on the MSCI Emerging Market index. Emerging Markets has outpaced every other equity sub-class so far during 2016. With attractive valuations and rising incomes, Emerging Markets continue to offer opportunities to capitalize on the long-term economic growth potential outside the U.S.

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Fixed Income Review

Despite the fact that the Federal Reserve raised short-term interest rates in December for the first time since 2006, the bond market continued to push longer-term rates lower during the quarter. The yield on the 10-year U.S. Treasury fell by roughly half a percent during the first three months to end at 1.78%. However, during the quarter, the 10-year yield fell to as low as 1.66%. To put that into perspective, for the 50 years from 1961 through 2011, the 10-year Treasury yield never closed below 2.0%. This reinforces that we continue to be in a historically low-yielding environment.

Falling yields have been a tailwind for fixed income returns. The Barclays Aggregate Bond Index returned 3.0% during the quarter, or slightly more than double the return on the S&P 500, which is an unusual outcome given that bonds are traditionally considered less risky than equities.

Monetary Policy Review

As of the end of 2015, policy makers were forecasting four quarter-point increases in the Fed Funds rate during 2016. However, as of the March Federal Open Market Committee meeting, a more dovish Chairman Yellen backtracked on that, suggesting just two hikes this year. While continued low rates make generating income from bonds difficult, the stock market tends to like lower rates, which helps to explain some of the turnaround in equities late in the quarter.

Based on the Federal Reserve's "dual mandate" of maximum employment and stable prices, there appears to be little need to hike rates significantly. Unemployment hovered around 4.9% nationally throughout the quarter. According to the Bureau of Labor Statistics, unemployment in Texas as of February was even lower, at 4.4%, with the rates in San Antonio and Austin at 3.6% and 3.1%, respectively. Inflation meanwhile, as measured by the Federal Reserve's preferred core-Personal Consumption Expenditure or core-PCE indicator, remained well below its 2% target. With housing prices, as measured by the Case-Shiller index, growing at rates close to their long-term average of around 5.0%, hourly earnings up just 2.3% as of the last reading, and the Purchasing Managers Index just above 50 (indicating modest expansion), the U.S. economy appears to be on sound footing without near-term risk of a recession. To that end, rather than preempting any perceived threat of inflationary pressures, the primary purpose for a rate hike would be normalizing rates that were decreased to abnormally low levels in the aftermath of the 2008/2009 recession.

Meanwhile, Outside of Traditional Stocks and Bonds . . .

One of the shining stars during the quarter was gold, which was up 16.0% and had its best quarter in three decades. This is an asset class that tends to do well when there is a flight to quality as we saw during the earlier part of the year. With pockets of economic uncertainty globally, investors rushed to buy the metal, but we would caution that the price rise experienced early in the year is unlikely to be replicated in the coming quarters.

Real Estate Investment Trusts (REITs) also had a respectable quarter, returning 6.1% in the U.S. based on the Dow Jones Equity REIT Total Return Index, and 6.7% globally per the S&P Global REIT Index. Both the domestic, as well as the global, returns outpaced those of large cap stocks by a healthy margin during the quarter. Over the last 20 calendar years, REITs have experienced one of the highest average annual returns of any asset class, generating almost 12.0% per year, which is about a percent and a half higher than the average return on the S&P 500 over the same time frame.

Commodities prices strengthened after a challenging 2015. The Commodity Research Bureau index of commodity spot prices was up 7.1% during the quarter. Master Limited Partnerships (MLPs) were down nearly 6.3% as measured by the S&P MLP index after they, too, experienced a tough 2015. However, high single digit yields on MLP assets continue to offer what we see as an attractive income stream.

*Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	2.2%	2.1%	9.3%
S&P 500 Index	1.4%	1.8%	11.8%
MSCI EAFE*	-2.9%	-7.8%	2.9%

*EAFE = Europe, Australasia, & Far East International Index
**Annualized Return

2 Year Treasury Bond Yield as of 3/31/16	0.72%
2 Year Muni Bond (AAA) Yield as of 3/31/16	0.74%