

Investment Management Group

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

SECOND QUARTER 2016

WAS THE MARKET REACTION TO "BREXIT" MUTED?

After falling 5.4% in the two days following the U.K.'s surprise "Leave" vote in late June, the S&P 500 rallied almost all the way back to its pre-referendum level as quarter-end approached. Even though the broad large-cap index was relatively unchanged by Brexit after all was said and done, British and European banks remain significantly weaker following what were double digit post-vote declines. U.S.-based companies with significant operations in Britain were also hit hard.

While the U.S. stock market quickly snapped back after the referendum, several other markets have not. Currencies considered to be "safe-havens", particularly the U.S. dollar and Japanese yen, strengthened versus both the British pound and the euro, leaving the pound at a 31-year low by early July. Weaker foreign currencies and a higher dollar can harm the earnings of U.S.-based companies that have international operations or direct investments abroad. Broadway Bank Wealth Management continues to review country and currency exposures of the international stock mutual funds it holds on clients' behalf.

Currency fluctuations can be even more detrimental to foreign bond returns, especially in a low interest rate environment. For the last year or so, Broadway Bank Wealth Management has invested its clients' foreign bond allocation in funds that are immune to currency fluctuations or "dollar-hedged" bond funds. This tactical shift proved to be helpful during the Brexit shakeout as the extreme moves in the deeper and more widely held foreign currencies had little to no impact on returns of these funds.

Finally, and perhaps more noticeably, bond yields continue to fall as investors pile into U.S. Treasuries, German Bunds (government bonds), and Japanese Government Bonds (JGB's) seeking safety. After Brexit, even the Japanese 20-year bond fell to a negative rate. The 10-year and 30-year U.S. Treasury bonds hit historic lows following the referendum as well.

U.S. ECONOMIC REVIEW

Despite the political uncertainties caused by Brexit, the U.S. economy remains relatively robust. Gross Domestic Product (GDP) grew by an annualized 1.1% during the first quarter of 2016. While this rate is somewhat softer than the expected growth rate for the full year, it does follow a seasonal pattern of lower growth rates during the first

quarter and is relatively strong compared to growth of 0.6% during the first quarter of 2015 and -0.9% during the first quarter of 2014. Housing represented a bright spot in this year's first quarter release, but Personal Consumption, which has led the report in the past, lagged. The outlook for second quarter U.S. GDP growth is more optimistic. The Atlanta Fed's GDPNow Index, which tracks real-time indicators for current economic growth, predicts a 2.4% annualized growth rate for the second quarter. Meanwhile, consensus for the full year 2016 is now closer to 2.0%.

The U.S. economy created an average of 147,000 jobs per month during the second quarter (down from 200,000 per month during the first quarter). The unemployment rate bounced around an eight-year low, ending June at 4.9% which is right on top of what the Federal Reserve sees as the natural rate of unemployment (4.8%). The unemployment rate is being driven by a lower than average labor participation rate of 62.6%, meaning more and more workers are retiring or leaving the workforce due to discouragement. Unemployment claims have not changed much as they continue near 16-year lows. With the employment picture fairly strong, the implication for companies could be upward pressure on wages if the labor market continues to tighten.

FIXED INCOME REVIEW

The Federal Open Market Committee left its benchmark rate on hold both times it met during the quarter. Given volatility in the jobs numbers and global growth uncertainties following Brexit, the market now thinks it could be 2017 before we see another interest rate increase. Nonetheless, with over a third of government bonds worldwide yielding less than 0.0%, and almost three-quarters yielding less than 1%, U.S. yields remain some of the highest in the developed world on a relative basis. That has triggered abnormally high demand for U.S. bonds and has pushed up prices. So far this year, the benchmark Barclays U.S. Aggregate Bond Index is up 5.3% and the Bank of America High Yield index is up 9.3%, both of which represent unusually large returns. Even sectors like Treasury Inflation Protected Securities (TIPS) are up a surprising 6.2%. By quarter-end, the yield on the 10-year U.S. Treasury had fallen to 1.49% or one-third below where it started the year. By early July, that yield hit a record low of 1.33% which is making income generation a challenge.



EQUITY MARKET REVIEW

Despite the bumpy ride late in the quarter due to the aforementioned Brexit issues, the S&P 500 increased almost 2.5% on a total return basis between April and June and is up 3.8% on a year-to-date basis. This compares favorably to the 1.2% return that the S&P registered for the first half of 2015. Mid-Cap and Small-Cap stocks have fared even better, increasing 4.0% and 3.5% respectively during the quarter and 7.9% and 6.2% during the first half. Value-oriented securities significantly outperformed Growth stocks in every size category during the first half of the year which is a continuation of the trend that started in August of last year.

From a sector perspective, Utilities and Telecoms have had a strong year, both increasing roughly 24% so far during 2016. Energy and Staples, along with Materials (albeit to a lesser extent), have also outperformed the S&P on a year-to-date basis. On a more micro level, some of the specific stocks within Broadway Bank Wealth Management portfolios that have fared best this year include Spectra Energy, Cummins, Hasbro, AT&T, Nextera, General Mills, and Verizon. Those names that have struggled tend to be in the Financials sector, for the most part, which ranks as the worst performing sector within the S&P. They include MetLife, PNC Financial, and Wells Fargo, as well as some Consumer Discretionary stocks like Nike and Williams Sonoma.

On the international front, Developed International stocks are struggling this year. The MSCI EAFE fell 1.2% during the quarter and is down 4.0% year-to-date due to broad-based softness in a number of geographies. Japan, a market to which we have only limited indirect exposure, has been among the hardest hit in local currency terms given that a strengthening yen (up 14.1% in 2016) is hurting exporters.

Emerging Market stocks are faring considerably better than their Developed Market counterparts. The MSCI Emerging Market Index rose 0.8% for the quarter but is up 6.5% for the year, making it one of the best performing equity asset classes so far this year. Over 70% of the exposure of that index is to Developing Asia, which has thus far seen limited fall-out from Brexit and stands to benefit from above-average long-term economic growth as incomes in that region increase over time. We continue to recommend modest exposure to Emerging Markets, but note that returns in this segment can be volatile from period to period.

Given that we are now 88 months into the current bull market, investors are increasingly asking how long this expansion will last. With the forward Price/Earnings (P/E) multiple of 16.6x on the S&P 500 as of June 30 sitting just slightly above the 25 year average of 15.9x

(compared to over 24.0x during the Tech boom), valuations are far from excessive. This suggests that the market can continue to expand and can do so in line with earnings growth going forward.

ALTERNATIVE ASSET REVIEW

A perfect storm of low bond yields, equity market volatility, and political uncertainty has helped some Alternative Asset returns outperform those of most other asset classes this year. Gold, for example, has appreciated 25.6% since year-end. Meanwhile, U.S. Real Estate Investment Trusts (REITs), as measured by the Dow Jones Equity REIT Total Return Index, are up 14.0%, and Global REITs are up 12.3% according to the S&P Global REIT Index as investors search for yield. Master Limited Partnerships, another higher yielding asset class, also benefitted, rising 14.5% so far during 2016. This underscores the benefits of diversification and the value of a modest allocation to non-traditional asset classes.

*Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	4.3%	4.5%	9.0%
S&P 500 Index	3.8%	4.0%	11.6%
MSCI EAFE*	-4.0%	-9.6%	2.6%

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

**Annualized Return

2 Year Treasury Bond Yield as of 6/30/16	0.58%
2 Year Muni Bond (AAA) Yield as of 6/30/16	0.62%



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