Investment Management Group

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

THIRD QUARTER **2016**

AN END TO OPECULATION?

Speculation of a deal amongst OPEC members finally ended on September 28, as delegates signaled they had reached a tentative agreement. The agreement was to cut production by 700,000 barrels per day with output to be 32.5-33.0 million barrels per day. OPEC estimates its current output is 33.25 million. OPEC is significant because it accounts for approximately 40% of the world's oil production.

The plan will be finalized in late November at a regularly scheduled OPEC meeting. It appears Saudi Arabia finally relented to pressure from lower crude prices. Saudi Arabia and Iran had been bickering over Iran's participation which helped to derail a deal in Doha back in April. Saudi Arabia decided two years ago to let oil markets balance on their own by defending market share instead of managing supply. U.S. shale oil was the main target of this strategy. Since Saudi Arabia decided to flood the market with oil in November 2014, U.S. lower 48 production has fallen by about 4%, while OPEC production has grown by over 9%.

Over the last two years Saudi Arabia has learned the decrease in prices had intended and unintended consequences. On top of the 4% decline in production (almost 14% from June 2015), some estimate up to 100 North American oil and gas companies have filed bankruptcy in the last 24 months. OPEC likely underestimated American ingenuity and the industry's ability to reduce costs and improve operating efficiency. Not only did companies retreat from less profitable fields, but they also found new fields that could be produced at lower prices. Horizontal innovations have made new plays in the Permian, the SCOOP and STACK in Oklahoma, and the Alpine High in West Texas, profitable at prices existing before the OPEC agreement. OPEC risks production increases from U.S. shale drillers as less profitable plays become more economical and energy companies increase spending after they have learned to live within their means. Indeed, rig counts have increased 15 of the last 18 weeks through September 30.

Details on the cut are lacking. These details will need to be determined at November's meeting for the first production cut in eight years to take effect. This task will be difficult given members' ideological and geopolitical differences. History also reminds OPEC watchers that members frequently cheat on production quotas. Two themes remain certain after OPEC's big agreement: the energy industry will continue to innovate to bring costs lower and speculation as to OPEC's actions and intentions will not end.

OPEC is a large piece of the supply side of crude oil. Supply and demand significantly impact prices. Oil prices have a significant impact on inflation, the economy, consumers, and markets, aside from individual energy company equities and bonds we hold in client portfolios. With such far reaching effects, we stay current on any supply changes in crude oil so that we can adjust client portfolios as needed.

MONETARY POLICY REVIEW

The Federal Open Markets Committee (FOMC) again held off on raising interest rates during its September meeting. The meeting was not without debate. In fact, three members voted in favor of raising the Fed Funds rate. On the other hand, according to the voting record known as the dot plot, three officials believed there should be no rate hike during 2016. However, the median forecast is for one rate hike during 2016. As of the end of the quarter, the financial markets were pricing in a 59% probability of a December rate hike. Such action less than a week before the presidential election (at the November FOMC meeting) would be an extremely rare event.

Participants reduced their longer-run GDP growth outlook to 1.8% from 2.0%. They also reduced their longer-run outlook for the Fed Funds rate to 2.9% from 3.0%. While significantly higher than today's rate of 0.4%, this longer-run rate is anticipated for 2020 and beyond. At the end of 2017, participants saw the Fed Funds rate being near 1.1%, suggesting rates will rise 0.50% during the calendar year.

ECONOMIC REVIEW

TThe U.S. economy grew at a 1.4% annualized rate during the second quarter. Consumption was again responsible for most of the growth, increasing at a 4.3% rate. Third quarter economic growth is currently expected to be closer to 2.8% after concerns over "Brexit" were deemed overblown and seemed to have had little impact on U.S. economic growth. Projections for full-year 2016 economic growth stand at 1.5%. Future economic growth is predicted to be about 2.2% in 2017, again led by personal consumption.

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The September jobs report showed the U.S. added 156,000 jobs for the month. The unemployment rate rose slightly to 5.0% mostly due to a rise in labor force participation, meaning the increase was due to more people beginning to seek jobs as opposed to losing jobs. Economic data has been mixed lately as Factory Orders and Durable Goods Orders have risen slightly but Industrial Production has decreased somewhat. The Services Sector, which makes up most of the U.S. economy is still on sound footing. Future indicators are flat as the most recent Leading Economic Indicators Index was slightly lower; however, the New Orders measure from the Institute of Supply Management survey was quite strong.

The rate of inflation has increased since the beginning of the year. Currently, the Fed's preferred inflation measure is at 1.7%. Removing food and energy, consumer and producer prices rose 2.5% and 1.0%, respectively during the month of August. Including food and energy, consumer prices rose 1.1% while producer prices were flat.

CAPITAL MARKETS REVIEW

The S&P 500 gained 3.9% during the third quarter. Amazingly, it was able to quickly shake off fears of the Brexit vote. This brings its return to 7.8% for the year. Mid- and small-cap stocks performed even better during the quarter, rising 4.1% and 7.2%, respectively, bringing their returns into the lower teens for 2016.

International developed market stocks were higher by 6.5% for the quarter. Emerging market stocks were the best performers, rising 9.2%. Emerging markets stocks are also leading returns for the year up 16.3%. Developed nations' stock market performance year-to-date is slightly better than even.

The best performing sector year-to-date is Energy as oil prices have rebounded off lows from earlier in the year. Telecommunication Services and Information Technology stocks follow Energy as high performers. Healthcare, Financials, and the Consumers (Discretionary and Staples) have lagged. Each has risen less than double digits for the year; however, all sectors are in positive territory. Financials were further impacted as the stellar performing Real Estate Investment Trusts (REITs) were extracted from the Financials sector and classified as a sector in their own right.

Companies currently held in Broadway Bank Wealth Management portfolios that contributed the most to portfolios year-to-date include: Cummins, QUALCOMM, Amphenol, AT&T, and Merck & Co. The largest detractors to portfolios year-to-date include: iShares Nasdaq Biotechnology Index ETF, Nike, Wells Fargo, Walt Disney, and Williams-Sonoma.

Broad commodities fell 3.9% during the quarter; however, the two most closely watched commodities, crude oil and gold, were nearly flat. REITs were slightly lower during the quarter as they exhibited sensitivity to speculation around interest rate changes. Master Limited Partnerships (MLPs) were also sensitive to rate speculation and nearly flat during the quarter; however, many were able to access the debt and equity markets, which serves as a very positive sign that investors are gaining confidence in the asset class again. Both REITs and MLPs are up double digits for the year.

Municipal bonds were slightly lower during the quarter as measured by the S&P Municipal Bond Index. Similarly, the Barclay's Aggregate Bond Index was slightly higher for the quarter, rising 0.5%. The major movement was in credit risk instruments. The Bloomberg High Yield Index rose 5.5% or 5.0% more than investment grade bonds. The 10-year Treasury Bond interest rate rose to 1.60% from 1.47% at the beginning of the quarter. On the short-end, the 2-year Treasury Bond interest rate rose to 0.76% from 0.58%.

As always, Broadway Bank's Investment Management Group remains attentive to the changing economic and market landscape and we continue to adjust client portfolios as warranted. With the upcoming election and possible rate hike during the fourth quarter, we expect an uptick in volatility. Please do not hesitate to reach out to your Wealth Advisor or Portfolio Manager with any questions or concerns.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	7.2%	15.5%	9.2%
S&P 500 Index	7.8%	15.4%	11.1%
MSCI EAFE*	2.2%	7.1%	1.0%

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

2 Year Treasury Bond Yield as of 9/30/16	0.76%
2 Year Muni Bond (AAA) Yield as of 9/30/16	0.78%

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