Wealth Management

Investment Management Group

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

FOURTH QUARTER **2016**

THE MARCH HIGHER CONTINUES

After a drop of over 10.0% during the first few weeks of 2016, few would have guessed that the S&P 500 would go on to hit multiple all-time highs and finish the year with an above-average total return of 12.0% for all of 2016. The U.S. stock market posted positive returns in nine out of 12 months of the year. During the fourth quarter alone, the S&P 500 was up 3.8%, all of which came after the election.

Trump's win has spurred a material ideological change. While details remain sparse at this point, prospects for a pro-growth environment under a Trump administration have spurred the market to previously unseen levels. Promises of significant corporate and personal tax cuts could mean more money in the pockets of investors, while a potential tax holiday on the repatriation of overseas corporate cash could stimulate domestic capital investment. Furthermore, Trump's pro-business stance and his comments about looser regulation have suggested to investors that compliance costs could fall going forward, thus putting upward momentum on earnings. In addition, there is hope that fiscal stimulus could be supportive of economic expansion which has been an especially welcome potential development given that monetary stimulus has run its course.

Having said all this, the S&P 500 has risen for almost eight consecutive years, generating average annual returns of 17.7% since the market lows in early 2009, almost twice the annual average. Large cap U.S. stocks are now some 76% above their pre-recession peak. The forward price/earnings ratio for the S&P 500, one common measure of value, now stands at 16.9x which is above the 25-year average of 15.9x. With this as a backdrop, being judicious about equity investments will be key going forward. Many of the above policy measures, if enacted, will help certain industries and companies at the expense of others and come at a time when the economy is in the latter stages of expansion. For example, talk of deregulation and higher interest rates pushed the Financial sector up 21% during the fourth quarter, while rumblings over the repeal of healthcare reform and pressure on drug pricing brought the Healthcare sector down 4.0% for the fourth quarter and made it the only S&P sector to generate negative returns for the year. This disparity in returns creates opportunities for investors.

Despite what it may seem, volatility (as measured by the VIX Index) as of year-end was well below average and has far more potential to increase than decrease over the year ahead. To that end, being selective with equity investments can make a material difference to overall returns. Simply put, the benefit of using Broadway Bank Wealth Management's actively managed strategies can be considerable given the economic and market uncertainties that abound. Both of our proprietary large cap equity strategies outperformed the S&P 500 over the last year with less risk. Among the large cap companies in the portfolios that fared best on an absolute and relative basis were Cummins, CSX, Deere, Qualcomm and Spectra Energy. Conversely, names like Nike, Roche, Novartis, Cerner and VF Corp struggled.

OUTSIDE OF LARGE CAP EQUITIES...

Small cap stocks were one of the best performing domestic equity sectors last year, jumping 26.5% as measured by the S&P Small Cap 600 Index, with almost half of that increase coming after the election. The S&P 400 Mid Cap Index also delivered healthy returns of 20.7%. Within all market capitalization levels in the U.S., Value beat Growth by a factor of two to three times as investors looked for dividend paying stocks and attractive valuations in a low interest rate environment during much of the year.

The international markets were more mixed. Emerging market stocks were strong early in the year and went on to end 2016 with a total return of 11.3%. Developed international markets, however, struggled and delivered a return of just 1.6% for the year. One key concern with international stocks was the appreciating U.S. dollar, which has become steadily stronger since mid-2014, as it has become increasingly clear that Federal Reserve policy is diverging from that of other central banks. The fact that the U.S. is now raising rates, albeit slowly, contrasts with other markets where monetary policy remains stimulative. That has been one of the key reasons for the rise of nearly 30% in the value of the U.S. dollar against a basket of currencies (to a 14-year high) and the related softness in developed market returns over the same timeframe.

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FIXED INCOME REVIEW

The solid results throughout the U.S. equity market during 2016 contrast somewhat with an exceptionally volatile bond market. The 10-year U.S. Treasury started the year with a yield of 2.27%, fell to an all-time low of 1.36% following Brexit (after spending the 50-year period until 2011 trading above 2%) and ended the year at 2.45%, taking bond investors on an unusually wild ride. At the same time, yields on government bonds outside the U.S. fell into negative territory in many developed markets around the globe. The Bloomberg Barclays U.S. Aggregate Bond Index ended the year up 2.7% after a tough fourth quarter when the return on the index fell 3.0%. High Yield, which tends to be more economically sensitive than other parts of the fixed income market, was the star performer during 2016 with its 17.1% total return. This was followed by sectors like Treasury Inflation Protected Securities (TIPS) that returned 4.7%. The Muni market was just barely positive with a return of 0.25% for all of 2016.

One reason for the bond market volatility last year was the ambiguity surrounding Federal Reserve policy. The Fed increased the overnight rate for the first time since 2006 in December of 2015. Going into 2016, the Fed itself had predicted a series of four additional increases throughout 2016, but it wasn't until December that the Fed finally acted, hiking the benchmark rate a quarter of a point. Interestingly, the 2016 rate increase did little to change the steepness of the yield curve and, rather, was a catalyst for the entire curve increasing fairly proportionately. By year-end, the main message from the bond market was that, if anything, inflation could rear its head over the near-term.

ELSEWHERE IN PORTFOLIOS

The return on alternative investments was mixed during 2016. Master Limited Partnerships (MLPs), which fell over 30% during 2015, were up 18.3% during 2016 as measured by the Alerian MLP Index and remain attractive due to the healthy 6.5% yield the sector continues to offer. Meanwhile, Real Estate Investment Trusts (REITs), another income-generating sector, were flat for the year and down 4.4% during the fourth quarter. The REIT sector's sensitivity to higher interest rates means that as rates continue to rise, REITs may struggle going forward.

Hedge funds are an alternative asset class that may or may not offer an income stream, and is a sub-sector that tends to perform best when the stock market is softest. With that backdrop, the return on the benchmark HFRX Global Hedge Fund Index was 2.5% for the year and 1.1% for the final quarter of the year.

Among non-income producing alternative assets, gold had a strong first half, jumping 24.6% by June 30th but ending the year with a gain of just 8.6% after a weak second half. This contrasts with crude oil which was one of the more volatile parts of the commodity space last year. Crude began the year at $37.04/barrel, fell almost 30% during the first few weeks of the year, and went on to more than double from its low to finish the year at $53.72 for a 45.0% return.

ECONOMIC REVIEW

Inflation, as measured by the Fed's preferred indicator, stood at 1.6% as of the end of November, well inside of the Fed's 2% target. One of the key drivers of inflation tends to be wage growth. On that note, the unemployment rate has fallen from a cyclical high of 10.0% in October 2009 to 4.7% as of the December reading, suggesting that we are now at "full employment" and any further drop in this rate could start to put upward pressure on wages as companies have to pay a premium to find workers.

The economic expansion that has underscored the dramatic drop in unemployment has now lasted 90 months. Since 1900, the average expansion has lasted just 47 months, although the current expansion is not the longest on record. Average GDP growth during the most recent expansion has been 2.1% and was 1.7% year-over-year as of the most recent reading during the third quarter of 2016.

All in all, steady economic growth over the past several years has supported attractive returns on traditional stocks and bonds almost across the board. As uncertainty rears its head and we reach the tail end of the current economic cycle, Broadway Bank's Investment Management Group continues to be disciplined and attentive to the changing economic and market landscape and we continue to adjust client portfolios as warranted.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	16.5%	16.5%	8.7%
S&P 500 Index	12.0%	12.0%	8.9%
MSCI EAFE*	1.6%	1.6%	-1.0%

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

2 Year Treasury Bond Yield as of 12/31/16	1.19%
2 Year Muni Bond (AAA) Yield as of 12/31/16	1.25%

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