Wealth
Management

Investment Management Group

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

FIRST QUARTER **2017**

Happy Anniversary, Mr. Market

On March 9, 2017, the current bull market turned eight years old. Over that time frame, the S&P 500 has increased 314% on a total return basis or almost 18.0% per year. While the length of this bull market is about twice the average typically experienced, the calendar is one of the worst ways to gauge the health of a cycle. To that end, the current bull market remains well short of the 12-year increase in stocks that ran through early 2000. Furthermore, the magnitude of the increase in forward price/earnings ratios so far this cycle has not been excessive. Following a normal recession, the S&P 500 tends to rise roughly 75.0% above its prior peak before again correcting. As of quarter-end, the market was just 50.9% above the prior peak for the S&P 500 set in late 2007, which suggests that any pullback in prices may represent a buying opportunity if history repeats itself. As Warren Buffett recently suggested, 10, 20 or 30 years from now investors will be thankful they had exposure to equities at this level given the long-term potential for strong results.

On a year-to-date basis the total return for the S&P 500 during the first quarter was a solid 6.1%. This compares to an average first quarter return of 1.6% over the past 25 years. The market has experienced only a single quarter over the past 17 where growth was negative. Within the large cap space, growth stocks outperformed value stocks by 524 basis points thanks to strong performance from sectors like Tech and parts of Healthcare such as Biotech. At the other end of the spectrum, Telecoms and Energy struggled during the quarter with both sectors ending in negative territory. The performance of Broadway Bank's Wealth Management portfolios generally followed a similar pattern with some of the best individual returns on an absolute basis coming from Tech names such as Apple, Facebook, Checkpoint and Oracle and some of the softest coming from Energy names such as Occidental Petroleum, ExxonMobil, Chevron and Schlumberger. With a dispersion in returns between the top and bottom performing sectors during the quarter of 19.3 percentage points, using professional management for this piece of the portfolio can provide material advantages.

On the International Front

Diversification via non-U.S. stocks has generated a healthy contribution to returns so far this year. Non-U.S. stocks had a very strong quarter. Emerging market equities rose 11.5% over the quarter, or almost twice the rise in U.S. large cap stocks, and developed international equities rose 7.4%. Despite the strength so far in 2017, stocks in these foreign markets remain well below their previous peaks with the developed international index still 25.0% below the high set in 2007 and emerging markets still 28.4% below the 2007 peak. With U.S. stocks now above their previous highs, this makes non-U.S. stocks look attractive on a relative basis. Furthermore, if the U.S. dollar depreciates as the current administration is suggesting, this could add to the returns in U.S. dollars in both of these areas.

Outside of Large Cap

Small and mid cap stocks both delivered double digit returns during 2016, much of which came after the election. Both areas continued to exhibit strength during early 2017, although returns have been below large cap this year with the S&P 400 MidCap Index up 3.9% in the first quarter and the S&P 600 SmallCap Index up 1.1%. These areas tend to be somewhat more domestically oriented than large caps and will therefore continue to move based on factors such as U.S. tax policy, interest rates and economic strength.

Fixed Income Review

History has shown the stock market often reacts positively when yields rise from a low level in light of the fact that rising yields tend to be a sign of economic strength. By most measures, we appear to be in such an environment. At the Federal Reserve's March meeting, committee members again voted to increase the benchmark rate by a quarter point. The Fed has now tightened three times during this cycle and has signaled that we should expect rates to increase at least two more times during 2017. One development with the potential to increase the pace of higher interest rates could be the Fed's unwinding of its balance sheet. To the extent that the Federal Reserve, as a larger buyer of bonds, is absent from the market, this could soften demand for certain classes of fixed income and increase rates commensurately over time.

The Federal Funds rate is now targeted at a range of 0.75-1.00% which contrasts with what many see as a neutral rate of roughly 3.00%. The prevailing rate is also well below the peak of 5.25% set in 2006 when the Fed last engaged in a series of rate hikes.

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Even with continued efforts to raise rates later this year, it is appearing increasingly likely that interest rates will remain accommodative and low enough to continue stimulating the economy for the foreseeable future.

While the Federal Open Market Committee sets short-term interest rates, it is the market that determines what happens to longer-term rates. During the first quarter, the yield on the 10-year U.S. Treasury fell from 2.45% to 2.39%. Despite this dichotomy in the direction of short-and long-term interest rates, returns across the fixed income space were positive during the first quarter. The Bloomberg Barclays US Aggregate Bond Index was up 0.8%, Treasury Inflation Protected Securities (TIPS) increased 1.3% and high yield bonds rose 2.7% after jumping 17.1% during 2016. Our portfolio managers made a well-timed tactical shift by trimming taxable high yield bond exposure during the first quarter on behalf of our clients.

In an environment where rates continue to be low on a relative basis, we caution against reaching for yield by buying long-term securities. Even an otherwise "risk free" 30-year government bond can experience a double digit loss in value if rates go up even one percentage point. As we prepare for the possibility of higher future interest rates, our in-house fixed income specialist is emphasizing high quality, shorter-term individual bonds, where appropriate, to insulate against the aforementioned interest rate risk and to ensure liquidity is available to take advantage of higher rates as they materialize.

Elsewhere in Portfolios

When traditional stocks and bonds are strong, as they were during the January-March quarter, alternative investments sometimes underperform. This basket of investments tends to have low correlations to traditional securities, meaning their returns move in different directions at different times. To that end, alternatives can be thought of as acting like the insurance policy on your home. In a normal environment, the premiums you pay for that insurance policy can represent a small drag on your overall net worth, but the minute storm clouds appear is when you are most thankful for the coverage. In a similar vein, alternatives tend to provide the best relative performance when the market is soft. While alternatives generally delivered positive returns during the quarter, those returns were, as expected, somewhat lower than for traditional stocks and bonds. The HFRX Global Hedge Fund index was up 1.7% during the first quarter with Master Limited Partnerships (MLPs) up 4.0% based on the Alerian MLP Index and Real Estate Investment Trusts (REITs) up 3.5%. Gold was a standout in this space with its 8.3% return over the last three months.

Economic Review

While economic growth remains positive, the U.S. seems anchored to GDP growth around 2.0%. The cumulative real economic growth we have experienced this cycle has been one of the weakest on record in the post-war era and is likely one of the reasons the current bull market has been able to last over eight years. According to the Bureau of Economic Analysis, it took until 2011 for the size of our economy to claw back to its pre-recession peak of 2007. Comparing that to the stock market, it took even longer—until 2013—for the S&P 500 index to again reach a level of 1565 where it had stalled before the recession. Following a recession, at least one highly regarded economist calculates that GDP typically goes on to expand by almost 25.0%, yet the cumulative expansion we have seen since 2007 has been roughly half that. This suggests economic growth may have room to continue which, in turn, suggests the bull market could continue as well. With that in mind, the Investment Management Group at Broadway Bank continues to assess these economic and market factors and looks forward to potentially celebrating yet another anniversary of the bull market.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	5.2%	19.9%	10.6%
S&P 500 Index	6.1%	17.2%	10.3%
MSCI EAFE*	7.4%	12.3%	1.1%

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

2 Year Treasury Bond Yield as of 3/31/17	1.26%
10 Treasury Bond Yield as of 3/31/17	2.39%
2 Year Muni Bond (AAA) Yield as of 3/31/17	1.09%