Wealth Management

Investment Management Group
REVIEW & OUTLOOK written by Broadway Bank's Portfolio Managers
SECOND QUARTER 2017

A Blast From The Not-So-Distant Past

Going into 2017, crude oil continued to rally thanks to a presidential election outcome the market perceived as pro-growth and a surprise OPEC agreement on cutting production that occurred late last year. Fast forward six months and crude oil prices had their biggest half-year decline since 1998. Oil fell into bear market territory in late June, falling almost 21.0% from its peak by June 21. It made up some ground late in the month resulting in an almost 14.0% loss so far during 2017. Almost 9.0% of this drop came from the second quarter alone.

This drop was caused by several factors, most of which play into the main determinants of crude oil prices: supply and demand. In this case, demand has remained fairly constant. Supply, on the other hand, has grown significantly. As supply has increased and demand has not changed by a large factor, prices have dropped.

Supply has increased mainly due to the rise in prices late in 2016. As shale oil producers reduced production costs through advances in technology and drilling techniques, they were able to drill profitably for oil in the low to mid-$50 per barrel range. As profit margins increased, producers quickly put rigs back into service. Through the end of the second quarter, producers added to the nation's working oil rig count for 23 consecutive weeks. This was the longest stretch of uninterrupted growth on record dating back to 1987. On June 30, the count was 756 compared to a low of 316 in May of 2016. Producers added rigs in the second quarter of the year, even as prices fell, because much of their production was hedged earlier in the year at the mid-$50 level. This means that with oil prices in the mid-$40s, producers were still effectively selling the oil they were producing now and in the near future at over $50. Thus, the price drop did not have an effect on well profitability. New areas of shale formations also provided new premium drilling locations, which in turn, gave producers even cheaper wells with faster paybacks. These areas included new zones in the Permian Basin along with the SCOOP and STACK plays in Oklahoma. OPEC met again in June to reassess their supply cuts and while the cuts were extended for nine months, many oil bulls had hoped that the cuts would be deeper or extended for 12 months.

Output from the newly deployed rigs is flowing fast. U.S. production was just over nine million barrels per day in April. The Energy Information Agency (EIA) projects that output will grow every quarter this year and reach ten million barrels per day in 2018.

While volatility has been low in the equity markets, it has been rampant in the commodity and energy markets. When investing in individual energy companies, Broadway Bank Wealth Management's current strategy is to focus on financially strong companies that operate efficiently within their industry, so they can withstand any price environment. Furthermore, it is these companies that can take advantage of weaker players from whom they can buy quality assets at a discount price should the occasion arise.

The Trend Continues...

The S&P 500 recorded a year-to-date gain of 9.3% through the end of June. About one-third, or over 3.0%, of this was achieved during the most recent quarter. Many of the underlying trends from the first quarter remained intact. Mid cap and small cap stocks underperformed large cap stocks with year to date gains of 6.0% and 2.8%, respectively. Growth outperformed value by an 8.4% spread (13.3% return for growth vs. 4.9% for value). The Information Technology, Health Care, and Consumer Discretionary sectors were up double-digits for the year (17.2%, 16.1% and 11.0%, respectively). Energy and Telecommunications sectors are down for the year (-12.6% and -10.7%, respectively). Top individual contributors to Broadway Bank Wealth Management's portfolios included: Hasbro, Cerner, PayPal, Unilever, and Oracle. Detractors, due mainly to sector performance, include: Target, Schlumberger, Verizon, Occidental Petroleum and Qualcomm.

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International Continues to Impress

International equities also continued their first quarter trend of outperforming domestic equities as both major categories rose about 6.3% during the quarter. This put developed international and emerging market stocks up 14.2% and 18.5% for the year, respectively. The dollar continued to fall during the quarter, which helped to prop up international returns in dollar terms.

Low Rates, Low Returns

Longer-term yields, as measured by the 10-year Treasury bond, fell slightly to 2.31% from 2.39% at the end of the first quarter despite the 10-year Treasury yield spending much of the month of June below 2.20%. The broad U.S. Bloomberg Barclays Aggregate Bond Index was up 2.4% for the year while high yield bonds have returned 4.9%. With inflation tame, Treasury Inflation Protected Securities (TIPS) decreased during the quarter for a 1.1% return year-to-date.

Elsewhere...

Outside of the core asset classes, REITs have returned 2.1% year-to-date as interest rates remain muted. Master Limited Partnerships (MLPs) are now 2.7% lower for the year as the aforementioned fall in crude prices have brought the sector lower; however, MLPs did dodge the double-digit losses of both the energy sector and the commodity itself. Many MLP companies renegotiated their contracts to fixed rates after the last large drop in crude so that they would be further insulated from commodity volatility. Hedge funds returned 2.6% as measured by the HFRX Global Hedge Fund Index. The return, while close to a risk adjusted-absolute return goal, is less than what the S&P 500 has returned for the year.

Monetary Policy Stays The (Tightening) Course

The Federal Reserve kept to its tightening policy and raised interest rates again in mid-June. The new overnight target range is 1.00-1.25%. As of the end of the quarter, the market anticipated a 16.0% chance that the Fed would raise interest rates again at its meeting in September. Should a rate increase fail to materialize in September, the Fed will likely begin to reduce the size of its balance sheet. While the Fed has not been buying additional bonds to depress rates, it has been buying bonds as others have matured to keep its assets at approximately the same level. Should they decide to discontinue buying new bonds when older bonds mature, the size of their assets will fall. When the Fed, as a large buyer of Treasury, Agency, and Agency Mortgage Backed Securities, stops buying these bonds, rates will likely drift higher creating another means of tightening monetary policy. While very short-term rates rose in response to the June Fed Funds hike, longer-term rates were little changed. What did raise long-term rates into the latter part of June was speculation that the European Central Bank (ECB) would soon begin to taper their bond buying. This had the immediate effect of raising long-term interest rates of European government bonds with longer-term U.S. Treasury yields rising in sympathy. Should this speculation become fact, the removal of the proverbial punchbowl of easy global monetary policy could have significant consequences.

The Economy

Slow growth continues to characterize the pace of the economy. During the first quarter, the economy grew at an annual rate of 1.4%. This lower figure was principally due to consumer spending which was up only 1.1%. Economists currently predict the economy will grow at a rate of 3.0% during the second quarter. These figures combined with expectations for growth during the second half of the year bring expectations for economic growth of 2.2% for full year 2017. Employment data during the quarter remained healthy. The U.S. added jobs in the amount of 207,000; 152,000; and 222,000 during the months of April, May, and June, respectively. During 2017, employment gains have averaged 180,000, on par with 2016's average of 187,000. The unemployment rate in June nudged higher to 4.4% driven by an increase in the labor force participation rate. This rate is still considered near full employment. The Investment Management Group at Broadway Bank continues to assess these and other economic and market factors and their impacts to our clients' portfolios.

*Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	9.3%	22.1%	11.0%
S&P 500 Index	9.3%	17.9%	9.6%
MSCI EAFE*	14.2%	20.9%	1.7%

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

2 Year Treasury Bond Yield as of 6/30/17	1.38%
10 Year Treasury Bond Yield as of 6/30/17	2.31%
2 Year Muni Bond (AAA) Yield as of 6/30/17	1.06%

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