Wealth Management

Investment Management Group

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

THIRD QUARTER **2017**

Retail Therapy

The retail industry has underperformed its counterparts both in its sector (Consumer Discretionary) and the broader market (S&P 500). The S&P 500 Retail Select Industry Index is down over 4.0% so far this year, even after rebounding over 7.5% from mid-August through the end of September. In comparison, the Consumer Discretionary Sector is up almost 12.0% and the S&P 500 is up over 14.0%. Supply and demand can be analyzed to find the reasons for this underperformance.

Demand for goods sold by the retail industry is generated almost entirely by the consumer. The return numbers above may cause concern about U.S. consumers, but recent data show the consumer is quite strong. Consumer spending was up over 3.0% during the second quarter of this year and is on pace for another year of 2.7% growth. Consumer spending has been doing the heavy-lifting of keeping the economy growing as it makes up about seven-tenths of GDP. According to the Bureau of Economic Analysis, personal spending has grown every month since January 2015. So far this year, retail sales (excluding autos and gas) have averaged growth of 0.2% monthly. On an even more positive note, Consumer Confidence is higher than it has been since 2001.

With the strongest consumer the U.S. has seen since the Great Recession, supply must be at play in driving down retail stock prices. The switch from brick-and-mortar stores to e-commerce sales has been a significant factor. Foot traffic, especially at malls, has declined dramatically as more consumers shop online and have their purchases delivered to their doorsteps in days, if not hours. As it closed on its Whole Foods acquisition this quarter, Amazon has led the way in e-commerce. Not only does Amazon sell from its own inventory, but it allows third parties to use its platform and warehouses to sell to online customers. Because of their gargantuan sales volume, Amazon can thrive even on razor-thin profit margins. Their competitors struggle in trying to match prices, hampered by the expense of maintaining brick-and-mortar storefronts. Retailers who have been unable to differentiate themselves—large department stores, in particular—have had the most trouble. Many are closing locations and reducing staff in order to cope. Many retailers are also engaging in self-help to right their companies' directions by focusing more on the consumers' in-store experience and investing in more proprietary products that cannot be found in the e-commerce universe. The capital structure of retailers is now more important than ever. Some that were taken private through massive borrowing are filing for bankruptcy. Those with minimal debt are currently faring better. Niche retailers have often seen their values drop significantly as news or rumors of Amazon entering their retail space proliferate. Grocers, once thought to be Amazon-proof, were a prime example. When Amazon announced its intention to buy Whole Foods, grocery company values fell and have still not recovered.

With retailers in both the Consumer Discretionary and Consumer Staples Sectors accounting for over 20.0% of the S&P 500, it is tough to avoid the industry. When Broadway Bank Wealth Management invests in companies in the retail space, we look for differentiated players that compete in places where Amazon is unlikely to focus. One such area is in the discount space, where discounters' volumes allow them to compete successfully. This area also plays into an experience as consumers hunt to find retail "treasure" at a great price. Companies that produce, as well as distribute, name-brand apparel that can be sold through multiple physical and e-commerce channels can be more resistant to damage from competitors. Finally, retailers that offer a unique experience for which consumers are willing to pay a premium also have a place in our portfolios. While Broadway Bank's Investment Management Group has, from time to time, reviewed Amazon as a candidate for a spot in our clients' portfolios, we have not found it to be within the bounds of our criteria for risk versus potential return.

Record Highs Continue

Strong corporate earnings and tax reform expectations have helped the markets "melt up." This allowed the S&P 500 to end the quarter at yet another record high. Its increase during the quarter was 4.5%, bringing its return for the year to 14.2%. Within the S&P 500, Information Technology and Health Care are still leading. Energy and Telecommunications still lag with negative returns year-to-date; however, Energy rose by almost 7.0% as oil prices rebounded. Small cap and mid cap stocks were also positive during the quarter, but only the former outpaced the S&P 500. Both indexes are sitting just below double-digit returns for the year. Growth stocks led by Information Technology again outperformed value stocks during the quarter. So far this year, the spread in performance between the two is about 10.8%.

Jeffrey Nelson, PhD, CFA, CFP® Brian Korb, PhD, CFA, CFP® Kelly Rice, CFP® Bruce Walker, CFA Kelly Colotla, CFA, CMT Donna Bridge Catherine Weiser

Among our holdings that have led the way in performance include: PayPal Holdings, Cerner Corp, Facebook Inc., Unilever, and Check Point Software Technology. Laggards include: General Electric, QUALCOMM, Target, and General Mills.

International Continues to Impress

International stocks continued to outperform domestic stocks. Developed international and emerging market stocks returned 5.5% and 8.0% respectively during the quarter. A 2.0% drop in the value of the dollar provided tailwinds. So far this year, these two groups of stocks have performed exceedingly well. Developed international stocks are up 19.7%, while emerging markets stocks are up 28.1%.

Fixed Income

The 10-year U.S. Treasury bond yield ended near where it started the quarter at 2.33%, rising from 2.30%. While there has been some movement in interest rates, the 10-year bond yield has been abnormally stable. In fact, the range of interest rates this year is the narrowest it has been since 1965. The Bloomberg Barclays U.S. Aggregate Index nudged higher for a return of 3.1% year-to-date. The return on high-yield bonds rose to 7.0%.

Other Markets

As previously mentioned, oil prices were higher, jumping 12.1% during the quarter. Gasoline and crude oil markets became highly volatile during the weeks when Hurricane Harvey came ashore, as a healthy amount of the nation's refining capacity was shutdown. As refiners came back on-line, gasoline and crude prices reverted back to their previous trends. Though oil prices rose, Master Limited Partnerships fell about 3.0%. Gold registered a relatively modest gain of 3.2% during the quarter.

Monetary Policy…The Changes They Are A Comin'

The Federal Reserve followed through with its much-anticipated move to continue to normalize monetary policy. It stopped reinvesting principal and income payments, starting with a cap of $6 billion in Treasury securities and $4 billion in mortgage-backed securities. At its September meeting, the Federal Reserve anticipated raising interest rates once more during 2017, three times during 2018, twice during 2019 and once again in 2020. As of this writing, Fed Fund traders were anticipating the rate increase in 2017 to occur during the Fed's December meeting. Traders were split on whether the following rate increase would occur during the August or September meeting in 2018. While the September jobs decrease may initially give Fed governors pause, the decline is largely a result of hurricanes Harvey and Irma. In fact, the September jobs report signaled the lowest unemployment rate (4.2%) since 2001 and showed wage gains.

Over the next few months, the makeup of the Federal Reserve Board and Federal Open Markets Committee (FOMC) could change significantly. In early October, the Senate confirmed Randal Quarles as the Federal Reserve's Vice Chairman for Supervision, which may open the door to lighter regulations for banks. With Quarles confirmed, there will still be four open seats on the Fed board as Vice Chairman Stanley Fischer steps down in mid-October. Even more significant, President Trump has interviewed multiple candidates for the Fed Chair position. The president said he will announce his nominee in mid-October.

These changes in the Fed Board and FOMC could have pronounced impacts on interest rates and capital markets. The Investment Management Group at Broadway Bank is taking these and other potential changes and their effects into account when adjusting client portfolios in the current environment of constant change.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	15.5%	25.5%	12.3%
S&P 500 Index	14.2%	18.6%	10.8%
MSCI EAFE*	20.5%	19.7%	5.6%

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

2 Year Treasury Bond Yield	1.49%
10 Treasury Bond Yield	2.33%
2 Year Muni Bond (AAA)	1.02%

(All returns and yields as of 9/30/17)