Wealth Management

Investment Management Group

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

FOURTH QUARTER **2017**

An Exceptional Year for Equities

When 2017 began, few would have forecast the S&P 500 to have positive total returns each month and to finish the year with an impressive 21.8% return–more than double the 50-year annual average of 10.1%. Taking a longer-term perspective, average annual returns for large cap US equities have been 19.4% since the current bull market began nearly nine years ago.

While supportive monetary policy and strong corporate earnings were certainly factors behind last year's rally, another major tailwind for the market was tax reform. By year-end, a reform package representing the most meaningful changes to the tax code since the Reagan era was approved, dramatically decreasing the corporate tax rate to 21% from 35%. This fiscal stimulus should help boost corporate earnings and, by extension, stock prices—particularly for companies in the Consumer Discretionary, Consumer Staples, Industrials, Materials, and Telecom sectors which tended to pay higher-than-average tax rates.

Growth Outperformed Value

Though the market gained broadly, there were some striking differences in returns across sectors and individual assets. For example, the return on large cap growth stocks, was more than double that of value stocks. There was also an unusually wide disparity between individual sector performance during the year, with the top performing Information Technology sector (a growth sector) returning 38.8% during the year and the bottom performing Telecom sector (a value sector) losing 1.3%. Among the individual large cap names held in Broadway Bank's portfolios, growth companies such as PayPal, Facebook, and Apple outperformed, posting high double-digit returns. In contrast, companies that struggled included Allergan, Schlumberger, and AT&T.

Impressive Returns Beyond Large Cap

Mid and small cap stocks also experienced above average returns for the year, albeit below those of large cap. Mid caps were up 16.2% while domestic small caps increased 13.2%. The real standouts were on the international front where developed market stocks rose 25.7%, and emerging market stocks were up 37.5%, thanks in part to a US dollar that weakened about 10% on the year. With a meaningful allocation to international equity markets, not only did our clients tend to enjoy above average returns for the year, they did so with less risk, thanks to owning portfolios that were more diversified than those simply holding domestic stocks.

Volatility at Record Lows

Speaking of risk, last year was also notable given the lack of volatility in the equity markets. Following the 2016 presidential election, there were concerns that uncertainty and volatility could spike, but 2017 turned out to be one of the calmest years ever for stocks. During a typical year, some 30% of trading days see stock market moves exceeding 1%, yet 2017 saw only a handful of such days. On a similar note, 9 of the 10 lowest-ever readings for the VIX, a well-known volatility index, occurred during 2017. The certainty that is currently priced into the market could take some investors by surprise should volatility rear its head during the coming year.

An Inflection Point for Monetary Policy

The exact reasons for record low volatility levels have confounded market experts, but most agree that stimulative monetary policy played a part. Although interest rates are rising in some parts of the developed world, almost all remain well below long-term averages. Furthermore, central bank balance sheets, in aggregate, continued to expand last year, putting downward pressure on rates and making equities more attractive in terms of earnings yield compared to bonds.

Going into 2017, the Federal Reserve had suggested it would make four rate increases. As in the two previous years, the number of interest rate increases fell short of the Fed's initial expectations, as we ended the year with just three rate hikes. Even after five increases since the tightening cycle began in December 2015, the benchmark overnight rate–with its target of 1.25-1.50%–remains well below the 3.00% historical average. Central banks typically raise rates when the economy is strong to keep it from overheating. This cycle, however, is markedly different in that the Fed is raising rates more to normalize them than to guard against overheating.

Inflation is one key measure of overheating, but several structural factors such as automation, artificial intelligence, and e-business competitive pressures have generally kept inflation below the Fed's 2.0% target. One wildcard for inflation is employment. With the

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unemployment rate at a 17-year low of 4.1%, the US is now generally thought to be at "full employment." That has historically been the point where competition for labor heats up and employers have to raise wages to attract new workers. That, coupled with higher minimum wage laws in many jurisdictions, could push inflation rates higher, but there are few indications of this so far.

Fixed Income Posts Positive Returns

With the Fed expected to hike short-term interest rates more aggressively last year than the previous two years, investors came into the year bearish on the bond market. Bonds surprised again with healthy returns across the board. The Bloomberg Barclays US Aggregate Bond Index was up 3.5% for the year while inflation-protected securities rose 3.0%, and high yield bonds rose 7.5%.

Even as short-term rates rose during the year, longer-term rates, as measured by the 10-year Treasury bond, ended the year at 2.41%, near where they began at 2.44%. This masked a fair amount of intra-year volatility for long-term rates which peaked at 2.63% during the year. The yield curve fluctuated as short-term interest rates rose and long-term rates remained fairly steady. The result was a decreased spread between the yield on 2-year and 10-year Treasuries to 0.52% from 1.25% at the beginning of the year. When the spread on this widely followed indicator falls into negative territory (i.e. when 2-year yields exceed 10-year yields), it is highly predictive of a recession within 13 months, on average. That said, the bond market is not signaling much recession risk for 2018.

Alternative Assets Mixed

With equities now higher for nine consecutive years and bond returns normalizing, alternative assets (assets that tend to behave differently from stocks and bonds) are an increasingly attractive piece of the portfolio. Gold, typically inversely correlated with the S&P 500, was up 13.7% last year while Real Estate Investment Trusts increased 10.9% and Hedge Funds increased 6.0%. All these returns were strong on an absolute basis, easily outpacing most fixed income sectors. Only Master Limited Partnerships fell short, with a loss of 6.5% for 2017 on the back of a weak year for the Energy sector in general. As a group, alternative assets will become an even more important portfolio component should traditional assets soften.

Expectations for 2018

The equity markets just concluded a banner year, far into a long-running bull market. Might we be due for a reversal? According to Bloomberg, years following a 15% or greater stock market return post positive returns 70% of the time. Because the current bull market has had an unusually long run of about 106 months, it would be reasonable to posit we are nearing the end of the cycle. Yet, Bloomberg reports that during the only two post-WWII bull markets lasting longer, equities gained 1,150% in one and 665% in the other. Given the current one is just shy of 300%, one could argue that a meaningful continuation would be well within the bounds of historical precedent.

Any forecast is subject to change as new information becomes available; however, as of this writing, an aggregate view of the most influential economic indicators gives us cause to anticipate another year of positive returns for 2018. As capital market valuations are relatively rich, we feel it is perhaps too bold to expect returns on the order of last year's. Reversals in the markets are virtually always precipitated by unexpected developments, and no one can precisely call the timing of cyclical tops and bottoms in advance with consistency. Therefore, Broadway Bank's Wealth Management Group remains focused on managing portfolios with the individual client's situation and risk appetite front of mind, giving due consideration to the ever-present possibility of surprises.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	28.1%	28.1%	14.4%
S&P 500 Index	21.8%	21.8%	11.4%
MSCI EAFE*	25.7%	25.7%	8.4%

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

2 Year Treasury Bond Yield as of 12/31/17	1.89%
10 Treasury Bond Yield as of 12/31/17	2.41%
2 Year Muni Bond (AAA) as of 12/31/17	1.56%

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