Wealth Management

Investment Management Group

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

FIRST QUARTER **2018**

Return to Normalcy?

In our May 2017 Market Update we remarked about the unusually low level of volatility the stock market was experiencing. That trend ended during the first quarter of 2018. While the S&P 500 was only down less than 1.0%, volatility in the stock market jumped significantly. Volatility, as measured by the VIX Index, started near 10 during the quarter and doubled to 20 by 3/31/18. At its peak in early February, it reached a level near 40. The cause of the newfound volatility can be attributed to several factors. Initially, concerns over wage inflation caused a surge in long-term interest rates, which increased the level of the VIX. An outsized bet against volatility made by hedge fund managers and others was unwound as a result. This caused the volatility index to spike even higher, and subsequently several exchanged-traded products that held large positions against volatility were liquidated. Other factors contributed to higher volatility as well. These include, but are not limited to: anticipation of trade wars involving new and increased tariffs, geopolitical concerns, domestic political concerns, monetary policy uncertainty, and increased regulation of social media companies.

What does increased volatility mean for investors? Put simply, it means the market will experience sharper movements than what was experienced in 2017. During the first quarter of 2018, the S&P 500 has had a daily move of more than 1.0% 23 times — almost three times the number of such occurrences in all of 2017. At this rate, we would be on track for almost twice the average number of annual 1.0% percentage movements experienced from 1958-2015.

How does Broadway Bank Wealth Management address the possibility of increased market volatility? First, we allow for the ever-present potential for higher volatility into the range of possibilities as we establish a long-term investment objective for our clients. Our strategy of investing in higher-quality companies typically pays off during patches of heightened volatility. When investors are spooked by volatility, they tend to sell their lower-quality stocks in favor of higher-quality ones. Because we keep a constant quality bias, we anticipate that our clients will experience relative outperformance as demand for what they already hold grows. Our attention to diversification seeks to mollify risk during downdrafts in the stock market as various asset classes move in different magnitudes at different times.

It is important to note that the recent stock market volatility is closer to the long-term historical average than was the case during 2017. If the increased volatility of recent months, as a more accurate reflection of long-term averages, has butted against the boundaries of your comfort level, this is a strong indication that it is time to reconsider your investment objective in conversation with your portfolio manager. The current market environment serves as a good test of an investor's resolve as we move into what most professional investors would characterize as the late stages of the market cycle. If your tolerance for market volatility has not been exceeded, then take the reminder that the recent level of volatility is to be expected as a normal part of a long-term investment program. Sticking with a well-conceived plan has historically proven to be one of the most, if not, *the* most important prerequisite to long-term investment success.

Equity Markets

The S&P 500 hit an all-time high in late January, only to endure a correction, fully retracing its historic levels to end slightly lower for the first quarter. Both small cap and mid cap stocks followed in a similar fashion as they ended near flat for the quarter. Developed international stocks were down 1.4%, buffered against deeper losses by a weaker dollar. Emerging markets were the only major equity asset class to end the quarter in positive territory, up just over 1.3%. The accelerated gains witnessed in January were driven in part by optimistic expectations and positive guidance from company management as investors digested the impacts of tax reform on corporate annual earnings reports. Many companies opted to apply their tax savings to stock buybacks, dividend increases, debt reduction and acquisitions. In fact, we saw the greatest-ever period of merger and acquisition activity globally in the first quarter, totaling $1.2 trillion. Furthermore, dividend payments by S&P 500 companies set a record in the first quarter according to S&P Dow Jones Indices. Even more surprisingly, there were no dividend cuts in the S&P 500 during the first quarter.

Information Technology companies continued to lead the market as they rose by more than 3.5%. Consumer Discretionary was the only other sector that finished in positive territory for the quarter. Higher yielding sectors fell hardest as interest rates rose. The Telecommunications sector fell almost 7.5%, followed by Consumer

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Staples and Energy, down 7.1% and 5.9%, respectively. As these results show, value companies underperformed growth companies by over 5.0%. Companies that added to and detracted the most from client portfolios fell along sector lines. Among our top-performing holdings were: Raytheon, Intel, Cisco Systems, Thermo Fisher and Microsoft. The greatest detractors were: General Mills, Kraft Heinz, Enbridge, Dominion Energy and Cerner Corp.

Bond Markets

The 10-year Treasury bond yield ended the quarter at 2.74% after starting the year at 2.41%. Yields reached a closing high of 2.95%, more than one-half a point higher than at year-end. This increase in interest rates accelerated after a strong report on wage inflation in the January jobs report. The increase over the quarter drove total returns of bond indices lower. The Bloomberg Barclays Aggregate Bond Index fell 1.5%. Treasury Inflation-Protected Securities fell 0.8% and High Yield bonds fell 0.9%.

Alternative Assets

With the aforementioned uptick in volatility, alternative assets proved themselves by providing protection on the downside as markets turned lower. The Hedge Fund HFRX Global index was 1.0% lower during the quarter; however, it achieved this return with significantly less risk than traditional asset classes. Crude oil gained 7.5% while gold, used as a hedge for volatility and inflation, gained 1.0%. The Alerian MLP Index fell 11.1% while Real Estate fell 6.7%, impacted by rising interest rates.

Economic Review

Official statistics show that the U.S. economy grew 2.3% in 2017. This was led by consumer spending which grew 2.8%. The U.S. economy is expected to grow by 2.8% this year; however, economic growth apparently will not be led by consumer spending for the first time in 4 years. Consumer spending has been strong due in part to strong consumer sentiment which hit its highest level since 2004 during the month of March. The economy added almost 300,000 jobs during the month of February as the unemployment rate remained constant at 4.1%. This trend of added jobs and a constant unemployment rate was achieved due to a rising labor force participation rate. Simply put, more able workers joined the workforce than in previous months. Economists view this trend as a healthy sign for employment and the overall economy. While wage increases tripped the bond markets during the quarter, most measures of inflation remained tame. Core producer prices rose 2.5%, core consumer prices rose 1.8%, and the more important core personal consumption expenditures (PCE) rose 1.6%. Treasury spreads indicate the market is pricing in very little inflation in the years to come.

Monetary Policy Review

As Jerome Powell took over chairmanship of the Federal Reserve, the Federal Open Market Committee continued along its course of 0.25% increases to the Fed Funds rate, now in the range of 1.50%-1.75%. Current futures pricing indicates an expectation of two more rate hikes this year; however, a third rate hike remains a possibility. Quantitative tightening is continuing as the Fed's first $20 billion of combined treasury and agency monthly maturities are not being reinvested. In April, the Fed will reinvest only amounts exceeding $30 billion in maturities, expanding their quantitative tightening. While some of the posturing of the Federal Reserve appears hawkishly geared toward higher rates, we expect the Fed to stick to its stated path as the economy continues to expand at a healthy pace and unemployment remains low.

Sources: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	-2.0%	19.4%	13.5%
S&P 500 Index	-0.8%	14.0%	10.8%
MSCI EAFE*	-1.4%	15.3%	6.1%

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

2 Year Treasury Bond Yield as of 3/31/18	2.27%
10 Treasury Bond Yield as of 3/31/18	2.74%
2 Year Muni Bond (AAA) as of 3/31/18	1.67%

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