Wealth
Management

Investment Management Group

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

THIRD QUARTER **2018**

What Can the Current Term Structure of Interest Rates Predict About the Future?

The third quarter logged another impressive gain in one of the longest bull markets in history. As the S&P closes in on its 10th year of positive returns, investors begin to wonder when the next bear market and recession might occur and what could foretell such an event. One measure that has been a relatively accurate indicator is an inverted yield curve.

The Treasury yield curve maps out the yield on every maturity of U.S. Treasury bond. Thus, one can see the amount of yield investors require as compensation for the interest rate risk associated with each maturity. With expected strong growth, investors typically anticipate a risk that inflation could rise. They are then compensated for this risk through extra yield. Therefore, an upward-sloping yield curve is the norm during economic expansion. Typically, when this extra compensation disappears, it is taken as a sign that the risk of higher inflation and the economic growth that can bring inflation is not expected in the near future. Thus, the curve becomes downward sloping or inverted, meaning that shorter-term U.S. Treasury notes yield more than longer-term U.S. Treasury bonds. The yield curve has inverted in advance of the last seven recessions. While it is a powerful indicator, it is not perfect. It failed to predict a recession in 1960 and falsely predicted a recession in the late 1960s. On average, the yield curve inverts 13 months before a recession occurs.

The easiest measure of the yield curve is to calculate the difference or "spread" between the most recently issued 10-year and 2-year Treasury notes. So where is this measure now? At the end of the quarter, the spread was +0.22%, having gone as low as +0.20% in late August. The spread has trended smaller lately, having started the year at just over +0.50%.

At +0.22% and with a downward trend, many wonder what might cause the yield curve to invert. We can look to the economic and interest rate environment of the last few years: short-term rates rose faster than long-term rates. The Federal Reserve controls the direction and magnitude of short-term interest rates while long-term interest rates are set by the market as influenced by inflation expectations, among other things. The trends of these two variables have not changed as the Fed recently lifted the Federal Funds Rate by another 0.25% in September while the market indicated an expected 10-year inflation rate of 2.14% (10-year break-even rate), which has remained virtually constant all year. If inflation expectations do not change dramatically, a yield curve inversion will depend predominately upon the Fed's resolve to continue to increase rates.

As with all economic and market variables, Broadway Bank's Investment Management Group is keeping a keen eye on the yield curve and how best to position clients' portfolios appropriately, with the yield curve's current and expected future state in mind. In general, we have been favoring bonds of shorter maturities whose yields are only slightly lower than bonds with much longer maturities and greater interest rate risk. Our allocation to opportunistic fixed income funds has resulted in excellent returns relative to the risk involved. While there are plenty of other indications that the next recession is distant, we recognize the possibility, not necessarily the probability, that it is not. Our mindfulness of this is reflected not only in our fixed income decisions, but in our most recent stock selection decisions as well.

Economic Review

While the yield curve may be close to signaling the possibility of recession, other measures point to an economy that is on very strong footing. Annualized economic growth for the second quarter was 4.2%, led by a surge in exports and a drop in imports. While economic growth has not been led by consumer spending in 2018, as in years past, the consumer is still strong as confidence remains near 18-year highs. Regional manufacturing and purchasing manager indices and orders surveys also show sustained growth.

The latest reading of the Leading Economic Indicators Index, which has some near-term predictive power, was up 0.4%. This supports economists' expectations for a 3.0% annual growth rate during the 3rd quarter and 2.8% consensus forecast for the 4th quarter. This brings the expected 2018 economic growth rate to 2.9%, which is predicated to slow to 2.5% in 2019.

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

Monetary Policy Review

As mentioned earlier, whether the slope of the yield curve changes direction will likely depend upon the Fed's resolve to increase interest rates. It raised the Fed Funds Rate by 0.25% to a range of 2.00% – 2.25% at its September 26th meeting. The Fed also removed the term "accommodative" from its statement, though Chairman Powell stressed during the press conference that this was not intended to indicate any particular path of future rates.

Looking forward, new forecasts from Federal Open Market Committe participants showed that median projections show one more rate increase in 2018, three in 2019, and two in 2020. The opinion of market participants, as indicated by the Fed Funds Futures Effective Rates, are expecting an increase in December 2018 as well as one from the May or June Fed meeting in 2019.

The Fed is expected to continue to increase rates due to low unemployment. In fact, the unemployment rate is 3.7%, the lowest it has been since 1969. On the other hand, inflation continues to stay near the Fed's target of 2.0%. Inflation measures that exclude food and energy indicate inflation in the 2.0% – 2.3% range.

Equity Market Review

The S&P 500 marked its best quarter since 2013 with a 7.7% increase. Growth stocks continued besting value stocks outperforming by over 13.5%. Small and mid cap stocks registered gains of 4.7% and 3.9%, respectively. For the year, small cap stocks have led the way, rising 14.5%. International stocks were mixed this quarter with developed markets rising 1.5% and emerging markets dropping 1.0%. This brings developed international stocks back to near break-even for the year, while emerging market stocks remain down about 7.5% for the year.

Information Technology and Consumer Discretionary sectors led the market this year followed by Health Care. On the other end, the Consumer Staples sector has been the laggard followed by Materials. Companies held by Broadway Bank that have experienced the largest gains include: TJX Companies, NIKE, Microsoft, Apple, and Cisco Systems. Those that detracted most include: Kraft Heinz, General Mills, Anheuser-Busch InBev, Altria Group and Dominion Energy.

Fixed Income Market Review

The 10-year Treasury bond yield was at 3.06% at the end of quarter, up from 2.86% at the beginning of the quarter. This resulting price decline from the increase in interest rates caused fixed income total returns to be flat. In fact, the Barclay's Aggregate Bond Index returned 0.0%. Treasury Inflation Protection Securities were slightly negative. Credit risk was more lucrative this quarter as high yield bonds were up by almost 2.4%.

Other Assets

Crude oil prices fell slightly during the quarter but are still near the year's highs. Increasing domestic production has driven demand for energy infrastructure which helped to propel the Alerian MLP Index higher by 6.5% this quarter. Real Estate, as measured by REITs, was flat during the quarter, having been hampered by rising interest rates. While these assets' returns have been mediocre this year, their lower correlation to stocks and bonds tend to improve our portfolios risk profiles.

Please contact your portfolio manager or email us at BWealthManagement@Broadway.Bank *with any questions or comments.*

Source: Bloomberg

Index	YTD	1 Year	3 Years**
Dow Jones	8.8%	20.8%	20.5%
S&P 500 Index	10.6%	17.9%	17.3%
MSCI EAFE*	-1.0%	3.3%	9.8%

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

2 Year Treasury Bond Yield as of 9/28/18	2.82%
10 Year Treasury Bond Yield as of 9/28/18	3.06%
2 Year Muni Bond (AAA) Yield as of 9/28/18	1.84%