Wealth
Management

Investment Management Group

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

FOURTH QUARTER **2018**

Why Do I Feel So Bad?

We have enjoyed one of the longest bull markets in history. The S&P 500 stock index rose 384.4% between March 2009 and its most recent peak in September 2018 for an impressive annualized return of 17.9%. Shouldn't I be elated? The stock market ended 2018 on a down note with increased volatility and sharp losses in the fourth quarter. That made me feel really bad and wiped out the positive feelings I had during most of the bull market. Why?

One reason is a number of well-documented psychological biases affecting investors. In their seminal work, Nobel laureate Daniel Kahneman, and Amos Tversky found losses generally feel about twice as bad as wins feel good. We may also have a recency bias, meaning whatever happened most recently impacts our views more heavily than earlier experiences. Do you remember how the stock market did in 2016 and 2017? The total returns of the S&P 500 were 12.0% and 21.8%, respectively, for a 9.3% annual average over the last three years. Shouldn't we have known the stock market was going to go down? That could be "hindsight bias" talking, when we believe that a recent event should have been predictable, even when there was little or no objective basis for predicting it. These biases all focus us in the wrong direction--backward instead of forward.

Another reason for that pit we feel in our stomach when the stock market goes down is we believe it reflects badly on our decision making. Who hasn't made a decision that resulted in a bad outcome and felt that the decision must have been a poor one? Annie Duke in her bestseller, *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts,* would beg to differ. She points out that good decisions can result in bad outcomes. Because we make decisions based on incomplete information, there will be unknown factors (a.k.a., luck) that will influence the outcome. Simply put, the future is uncertain, so the outcome of a decision may be good or bad; however, that does not mean the decision involved flawed thinking.

All this begs the question of how we can invest successfully when we are subject to biases as we make decisions with incomplete information. The solution lies in realizing that investing is a process. Having a process that forces you to act against your emotional biases can add to your investing success. For example: who is comfortable rebalancing their portfolio by buying stocks when the market is down? A sound investment process will also include a commitment to diversification. Why? Because we don't have complete information about the future performance of any asset class, so we build a diversified portfolio to manage risk and target a specific return. Many find it helpful to hire a professional money manager, such as Broadway Bank. This takes the emotions out of investing by delegating decision making to a team that follows a clearly defined, disciplined process that has been proven through all kinds of market conditions.

Economic Review

In contrast to the stock market, the economy remained solid. The final estimate of third quarter economic growth came in at a solid 3.4%. The Federal Reserve expects 2018 growth to come in at 3.0% for the full year, slowing to 2.3% in 2019. The consumer remains strong with retail sales for 2018 expected to be the best since 2011. Consumer sentiment remains well above its long-term average. Jobs and wages are driving this positive sentiment. Unemployment hovers at its lowest level since 1969, and average hourly wages are growing at the fastest pace since 2009, which bodes well for future consumer spending.

The weakness in the economy is housing. While housing prices rose a respectable 5.2% year-over-year, that increase combined with tight inventory and increasing mortgage rates is slowing the trend. Pending home sales have been dropping and are at their lowest level since 2014.

Manufacturing and services indexes have also declined recently, but they are still signaling expansion. Finally, the Conference Board's Leading Economic Index rose in November after a drop in October, indicating an expanding, but slower growing economy in the coming months.

Monetary Policy Review

As expected, the Fed increased the federal funds target to 2.25-2.50% in December but dropped its "neutral" rate to 2.75% from 3.0%. The neutral rate is the interest rate it believes will neither expand nor contract the economy. With its dual mandate of full employment and price stability (2% inflation) accomplished, it is hard to imagine the Fed bumping rates up much in 2019, absent an inflation shock. The

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Fed's consensus at the December meeting suggested just two rate increases in 2019; however, the market is not pricing in any increases.

The yield curve continues to flatten with the difference in yields between long-term Treasury bonds and short-term Treasury notes shrinking. You can now get a higher yield on a one-year note than on a seven-year. As discussed in our last newsletter, yield curve inversions often precede recessions by a year or so, though they are not perfect indicators.

Equity Market Review

The fourth quarter was a roller-coaster for stocks with the S&P 500 declining 7% in October, rebounding 2% in November, then dropping 9% in December to end the quarter down 13.5%. That broke a nine-year streak of positive returns, ending 2018 with a 4.4% loss. Increasing interest rates, trade wars, Brexit-related uncertainty, and the government shutdown added to investors' anxieties.

There was no place to hide in equities. Mid and small cap stocks fell 17.3% and 20.1% for the quarter, and 11.1% and 8.5% for the year, respectively. Thanks to slowing growth and a rising U.S. dollar, international stocks did no better, with developed and emerging market stocks declining 12.5% and 7.6% for the quarter, and 13.3% and 14.5% for 2018, respectively.

The Health Care and Utilities sectors led the market this year with positive returns, while the Energy and Materials sectors lost the most. Stocks we held that experienced the largest gains in 2018 included: Merck, Eli Lilly, Pfizer, Microsoft, and TJX. Those that detracted the most included: Schlumberger, Kraft Heinz, Albemarle, International Paper, and Constellation Brands.

Fixed Income Market Review

The 10-year Treasury yield ended the year at 2.68%, down from 3.06% at the beginning of the quarter, but up from 2.41% on 12/31/17. The price increase from the decline in longer-term interest rates caused fixed income total returns to rise 1.6% in the quarter, bringing their 2018 return just above breakeven at 0.01% (Bloomberg Barclays Aggregate Bond Index), narrowly dodging something that hasn't happened in 40 years – both stocks and bonds ending the year with losses. Treasury Inflation Protected Securities lost 0.4% in the quarter and were down 1.3% for the year. High-yield bonds gave up 4.5% in the quarter, erasing their year-to-date gains to end the year with a 2.1% loss.

Other Assets

Crude oil prices plummeted 38.0% during the quarter, ending the year down 24.8%. Increasing supply and slowing global demand were the main culprits. Real Estate, as measured by REITs, lost 6.7% during the quarter, and was down 4.5% for the year. Gold shone in the quarter with a 7.5% return, though it ended the year down 2.1%. The hedge funds we use for our clients with alternative asset exposure performed as expected during difficult stock market conditions with better quarterly and annual performance than the stock market.

Summary

From a long-term investor's perspective, a year such as 2018 comes with the territory, though it makes us thankful that, since 1950, positive annual stock market returns occur roughly three times as often as negative ones. The fourth quarter underscored the importance of maintaining a diversified investment portfolio, allocated to accurately reflect your risk tolerance. If the markets are causing you to lose sleep, it's a sure sign that it's time to discuss your risk tolerance with your portfolio manager.

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

Index	2018	3 Year	5 Years**
Dow Jones	-3.5%	12.9%	9.7%
S&P 500 Index	-4.4%	9.2%	8.5%
MSCI EAFE*	-13.3%	3.4%	1.1%

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

2 Year Treasury Bond Yield as of 12/31/18	2.49%
10 Treasury Bond Yield as of 12/31/18	2.68%
2 Year Muni Bond (AAA) as of 12/31/18	1.80%

Source: Bloomberg