September Update | As of August 31, 2016

AUGUST 2016 IN REVIEW

ECONOMY:

POCKETS OF STRENGTH IN AUGUST KEEP Q3 GROWTH FORECASTS ON TRACK

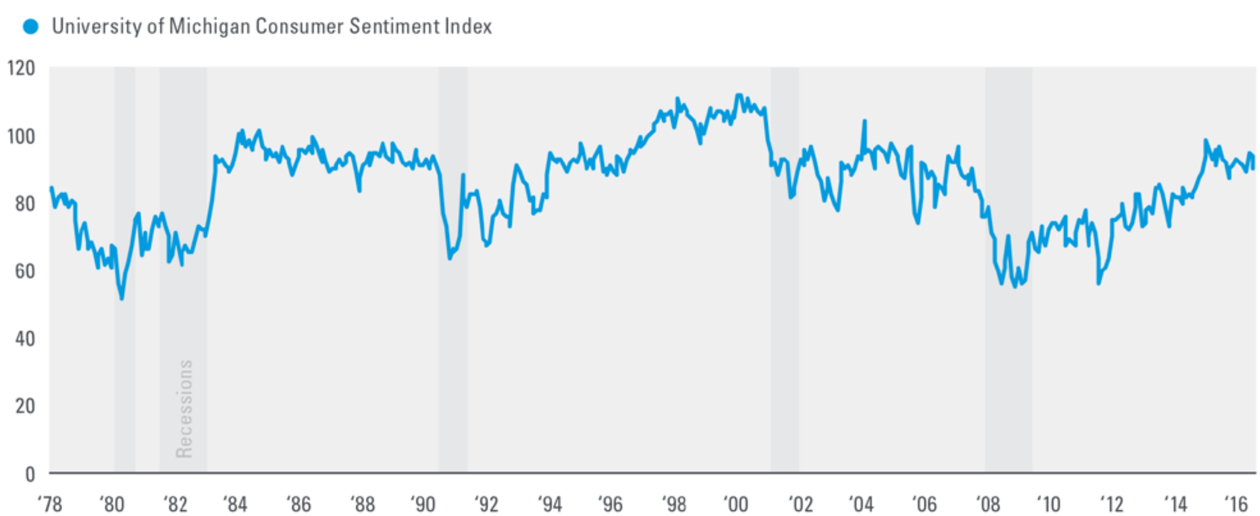
Economic Data

Economic reports received in August, which largely reflect economic activity in July, signaled the economy is on track to bounce back from the roughly 1% real gross domestic product (GDP) growth in the last three quarters. Data were consistent with possible GDP growth of 3–4% in the third quarter of 2016. In aggregate, data came in ahead of expectations for a second consecutive month, although the average size of surprises had narrowed. Although the consumer continues to be the main driver of the economy (with particular strength in the second quarter, according to GDP data), surprises in August were more evenly distributed across economic sectors, providing some signs that economic headwinds to manufacturing from a strengthening dollar and low oil prices are fading.

There were several signs of improvement in manufacturing activity in August reports. The production-related component of the Chicago Fed National Activity Index, a monthly aggregate of economic indicators, posted its best number since July 2015 and was above zero for two consecutive months for the first time since August 2014 (above zero represents growth above the long-term historical trend rate). Manufacturing data were highlighted by respectable 0.5% growth in manufacturing industrial production. While stabilization in manufacturing is a positive sign, recent strength takes place against a backdrop of slow to flat growth over the last two years.

Improving economic data and little immediate impact from the United Kingdom's referendum vote to leave the European Union ("Brexit") has intensified already heavy

CONSUMER SENTIMENT REMAINS AT LEVELS CONSISTENT WITH OTHER EXPANSIONS



Source: LPL Research, University of Michigan, Federal Reserve 09/05/16 scrutiny of the monthly employment data. According to the August Employment Situation report, the economy created 255,000 jobs in July, much higher than somewhat tempered consensus expectations of 170,000 following June's surprising addition of an upwardly revised 292,000 jobs. The unemployment rate ticked up to 4.9% in July from 4.8% in June, but that rise occurred for the "right reasons," as the labor force increased. Average hourly earnings rose 2.6% year over year in July, in-line with expectations and the June reading, probably the most disappointing aspect of an otherwise solid report.

Despite a strengthening labor market, July retail sales were flat versus expectations of 0.4% growth. The number was even weaker excluding automobiles (-0.3%) and excluding automobiles and gas (-0.1%). The disappointing data were somewhat mitigated by an upward 0.2% revision to the June data. The contrasting employment and retail data were reflected in the University of Michigan's Consumer Sentiment data. The August survey remains at a level consistent with prior expansions, but missed expectations. There was a marked contrast, however, between a rising but somewhat depressed expectations index, which might be reflecting continued job market improvement, versus a decline in the assessment of current conditions, which may have restrained retail sales.

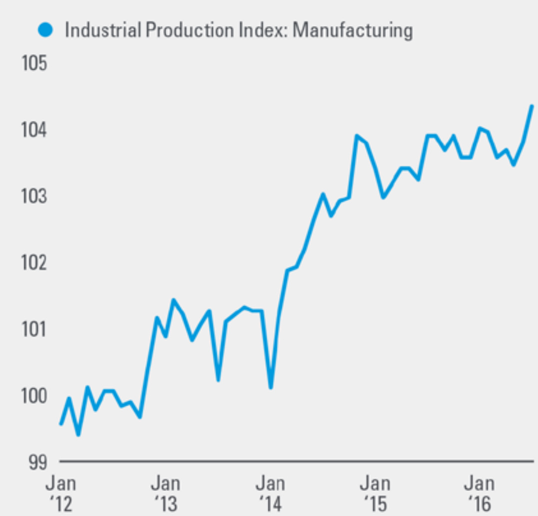
Forward-looking indicators in August signaled the possibility of stronger growth in the third quarter. Aggregate economic surprises, as measured by the Citi Economic Surprise Index, flattened in August but remained above the zero level that represents net positive aggregate surprises. The Conference Board's Leading Economic Index (LEI) for July, an aggregate of key economic data points that tend to lead the overall economy, rose 0.4%. At the end of August, Atlanta and New York Fed GDP NowCast models, which forecast GDP growth based on data released to date, had third quarter GDP growth at 3.5% and 2.8%, respectively.

Central Banks

The Federal Reserve (Fed) does not hold a policy meeting in August (the next policy meeting will take place September 20–21), but the minutes from the July 26–27 policy meeting were released on August 17 and Fed Chair Janet Yellen was a featured speaker at the Fed's August 26 annual policy symposium in Jackson Hole, Wyoming. The Fed minutes indicated somewhat heightened internal division among policymakers in late July, as they weighed strong employment data against continued slow economic growth. With little explicit support for a September hike and the possibility of lowered long-term expectations, the 10-year Treasury yield fell modestly in response to the release.

While the minutes reflected the Fed's mood back in late July, Yellen's Jackson Hole speech reflected an additional month of continued economic improvement and strong jobs data. Yellen sounded relatively upbeat about the prospects for both the U.S. and global economies, and while she didn't make any promises, she noted that the case for a rate hike "has strengthened in recent months." The speech complemented a parade of Fed speakers over the month emphasizing that a rate hike in September was a live possibility, if only, perhaps, to move the market to start adjusting to the likelihood of a December hike. While a September hike remains a possibility, based on current economic data and this recent messaging from Fed members, we continue to expect the Fed to raise rates in December 2016.

JULY MANUFACTURING PRODUCTION DATA SHOWED SIGNS OF ACCELERATION



Source: LPL Research, Federal Reserve 09/05/16

GLOBAL EQUITIES: CLOSE BUT NO CIGAR: U.S. EQUITIES' MONTHLY WINNING STREAK SNAPPED AT 5 IN AUGUST

U.S.

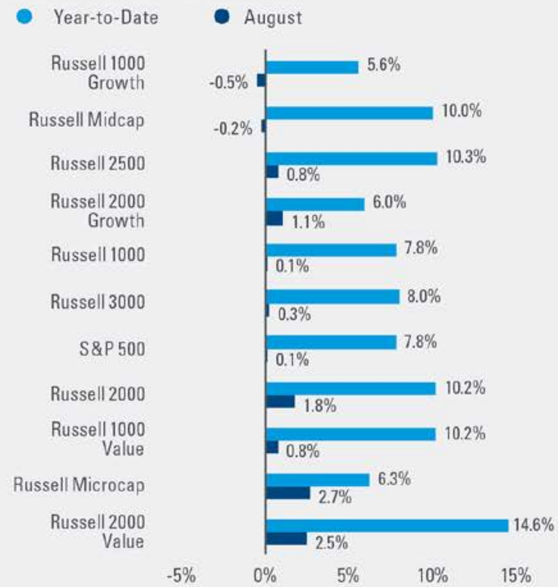
The S&P 500 Index finished down 0.1% in August, ending the five-month winning streak. On a total return basis, the month produced a marginal positive return; interestingly, the previous monthly loss back in February 2016 was also only 0.1%, putting the S&P 500 very close to a seven-month winning streak.

August was unique in that the S&P 500 did not move up or down more than 1% on any trading day during the month, while the trading range for the index based on closing prices was the tightest of any month in over a decade. Stocks are still poised for a 13th positive quarter out of the past 14, although September has historically been among the worst months on the calendar for stocks.

Despite the calm, market participants remained intensely focused on the Fed as Yellen and other Fed officials reminded the market throughout the month that a September rate hike, and certainly a December hike, remained on the table. And while overseas economies have not delivered any unwelcomed surprises in recent weeks, they still could, with issues like Brexit and China's debt problem hovering over the market. In the U.S., second quarter earnings season offered few signs of improvement for corporate America and U.S. presidential election uncertainty remains. Despite all this, stocks remained near record highs with historic low volatility.

Rising interest rates on increasing expectations of a Fed rate hike were clearly evident in the sector performance rankings. Financials, a big beneficiary of rising interest rates, topped the sector leaderboard in August with a total return of 3.8%, while the sectors most negatively correlated to interest rates, telecom (-5.7%) and utilities (-5.6%), suffered the biggest losses. Gains in the most economically sensitive sectors, including technology, energy, and industrials, suggest an improving macroeconomic backdrop.

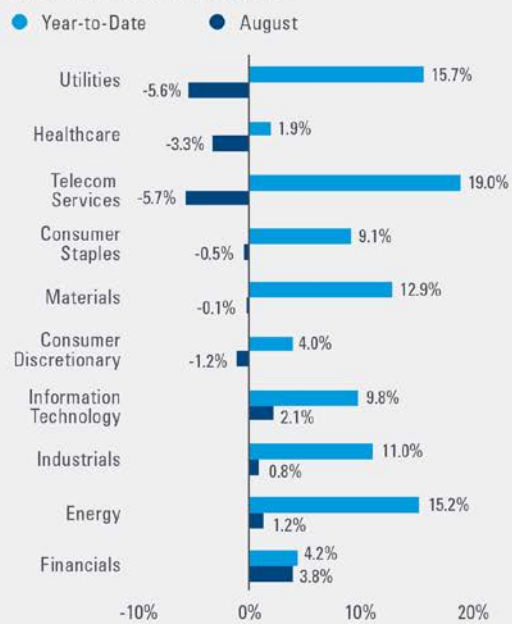
DOMESTIC INDEX PERFORMANCE



Source: LPL Research, FactSet 08/31/16

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

S&P 500 SECTOR PERFORMANCE



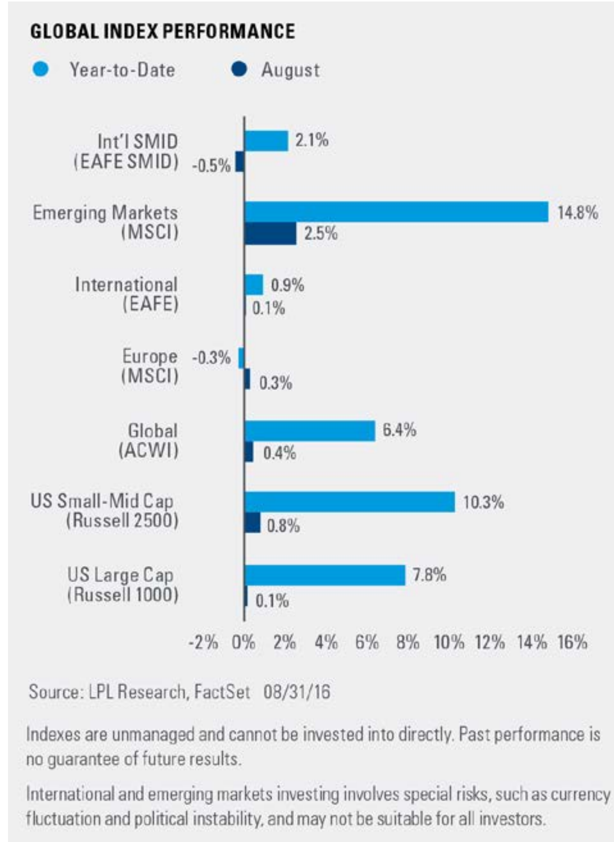
Source: LPL Research, FactSet 08/31/16

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Stock investing involves risk, including loss of principal.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Small cap leadership was also encouraging as the most economically and market sensitive segment of the market cap spectrum outperformed based on the Russell 2000 Index. Although stock valuations based on price-to-earnings ratios are elevated and many fear that the bull market is too old, the composition and broad distribution of the market's recent gains are encouraging.



International

August was a good month for international investing as both foreign developed and emerging markets equities outperformed U.S. equities based on the MSCI EAFE and MSCI Emerging Markets (EM) indexes. Not only were European markets only minimally disrupted by the United Kingdom vote to exit the European Union in late June, in dollar terms they have actually outperformed the U.S. since the vote, as markets appear to have been relieved by the stability of the European economies. Prospects for more stimulus from the European Central Bank (ECB) and Bank of Japan also continue to buoy sentiment in developed overseas markets while keeping interest rates extremely low. Leading developed foreign markets included the Netherlands, Germany, and Sweden, while Australia lagged. The U.K. market gained in British pounds, but was lower in U.S. dollars.

Despite the market's pricing in higher odds of a Fed rate hike and the related rise in the U.S. dollar, EM equity markets outperformed the U.S. benchmarks, helped by a rally in commodity prices in the first half of the month. Among the best performing EM country markets were China, Thailand, and South Korea, while South Africa lagged.

FIXED INCOME:

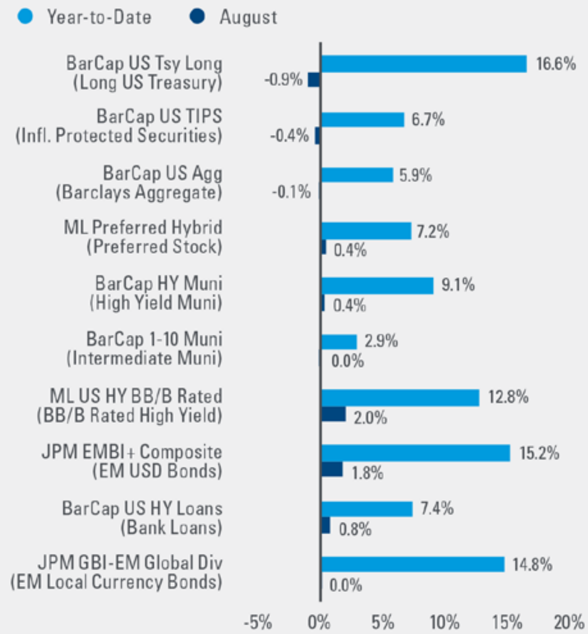
SOLID ECONOMICALLY SENSITIVE SECTORS RALLY WHILE YIELDS RISE

Interest rates were up during August, with yields rising across the yield curve. The yield on the 2- and 10-year Treasuries rose by 0.13% and 0.12%, respectively. Longer-term yields were depressed at the beginning of the month due to a weak second quarter GDP figure and gradually rose over the course of the month. Hawkish comments by Fed members throughout August, hoping to keep markets honest about the potential for near-term rate hikes, pushed Treasury yields higher in the short end of the curve. The rising rate backdrop was a headwind for high-quality bonds, as the Barclays U.S. Treasury Index returned -0.6% during August. The Barclays U.S. Aggregate returned -0.1% for the month.

More economically sensitive, lower credit-quality bonds rallied, as global investors continued their search for yield in a low-yielding environment. The rebound in the price of oil, up 7.5% during the month, was an additional tailwind for high-yield and emerging markets debt (EMD), which were notably strong during the month. High-yield and EMD returned 2.0% and 1.8% during August, bringing their year-to-date returns to 12.8% and 15.3%, respectively.

The rise in yields was a tailwind for preferreds, as financial stocks are beneficiaries of higher interest rates. The rise in Libor (London interbank offered rate), a short-term global benchmark interest rate, was a benefit for bank loans, which returned 0.8% during August.

FIXED INCOME PERFORMANCE



US TREASURY YIELDS

Security	07/31/16	08/31/16	Change in Yield
3 Month	0.28	0.33	0.05
2 Year	0.67	0.80	0.13
5 Year	1.03	1.19	0.16
10 Year	1.46	1.58	0.12
30 Year	2.18	2.23	0.05

AAA MUNICIPAL YIELDS

Security	07/31/16	08/31/16	Change in Yield
2 Year	0.61	0.63	0.02
5 Year	1.03	1.03	0.00
10 Year	1.78	1.75	-0.03
20 Year	3.09	3.07	-0.02
30 Year	3.80	3.68	-0.12

Source: LPL Research, Bloomberg, FactSet 08/31/16

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

ALTERNATIVES:

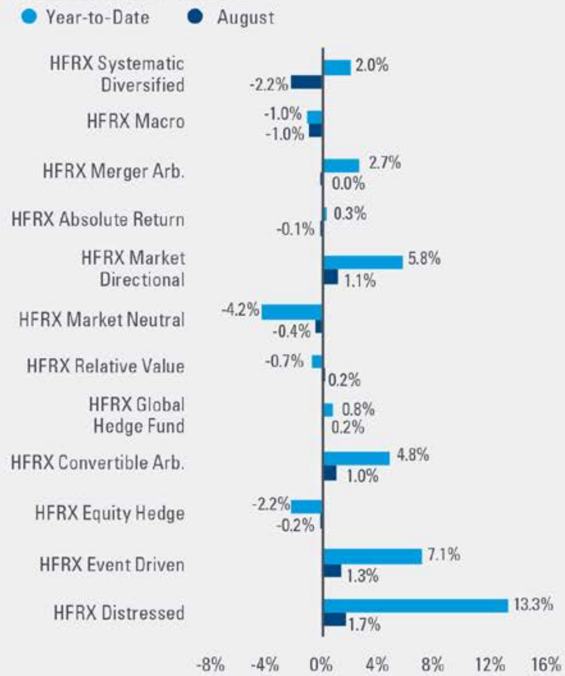
DISTRESSED DEBT ADDS TO 6-MONTH RALLY

As measured by the 0.2% August decline in the HFRX Equity Hedge Index, equity-related strategies were marginally lower during a month characterized by extremely low levels of volatility. However, even while the S&P 500 traded in a tight range, there was significant performance dispersion between cyclical and defensive sectors, with financial, technology, and energy-related firms delivering gains, while healthcare, telecom, and utilities names declined. On balance, given the hedge fund industries' technology overweight and aversion to bond proxy sectors such as telecom and utilities, sector performance acted as a tailwind. Net equity exposure remained relatively unchanged from previous months, averaging 47%, while gross exposure increased approximately 5% to 157%. This net exposure figure remains well below the five-year average, with many managers growing increasingly reluctant to add market exposure.

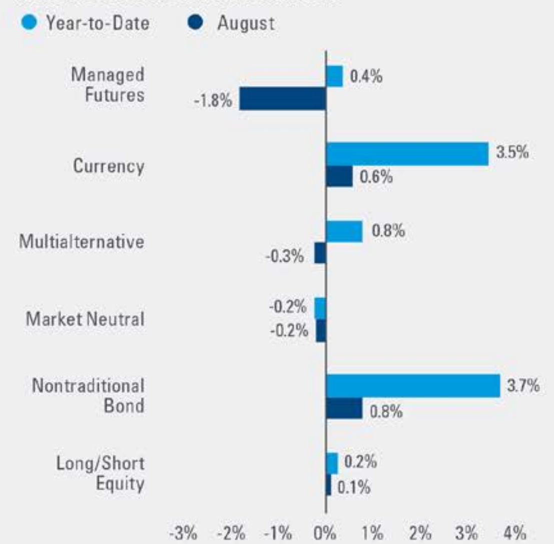
The impressive stretch of performance in the distressed debt industry also persisted into August, as the HFRX Distressed Index returned 1.7% and has now gained 20.0% since the beginning of March. This represents the benchmark's best stretch of performance since inception. Again, positions were supported by energy market gains, as WTI crude oil returned 7.45%.

Managed futures strategies were the main laggard during the month, as the HFRX Macro: Systematic Diversified Index declined 2.2%. Long exposure to U.S. Treasury contracts and the Japanese yen weighed on returns, as the long-term trend in both assets reversed, with a moderate increase in domestic rates and a weaker yen against the U.S. dollar. To a small extent, these losses were offset by profits in the agriculture markets, as short cotton and wheat exposure proved beneficial. Year to date, the index has now gained 2.0% and has experienced consistently large fluctuations in performance on a month-to-month basis.

HFRX INDEX PERFORMANCE



MORNINGSTAR INDEX PERFORMANCE



Source: LPL Research, FactSet 08/31/16

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

MIXED RESULTS FOR REAL ASSETS IN AUGUST

Real asset returns in August were varied with some assets posting strong returns while others dropped significantly. The U.S. dollar trade-weighted index was up 0.50% while the 10-year Treasury yield rose from 1.46% at the end of July to 1.58% on August 31. The Bloomberg Commodity Index returned -1.8% and the S&P 500 Index returned 0.1%.

MLPs & Global Listed Infrastructure

Master limited partnerships (MLP) were down modestly in August, with the Alerian MLP Total Return Index returning -1.3%. The yield on the index stands at 7.4% and the yield spread versus the 10-year Treasury stands more than 2% wide of the long-term average (3.39%). The index's yield spread versus BBB corporate bonds is still attractive as well, standing at greater than 3% versus the long-term average of 0.84%. Although production declines for oil have slowed and even reversed, slowing production remains a risk for those MLPs whose business models depend largely on transporting crude oil. This segment of the market, however, is not the majority and we believe that fundamentals are still solid for much of the universe. We are encouraged that the correlation between the index and WTI crude oil has come down since February of this year. The correlation of the index and WTI crude oil was 0.62 from the period of August 1, 2014, to January 31, 2016; this compares to a correlation of 0.48 from February 1, 2016 to August 31, 2016.

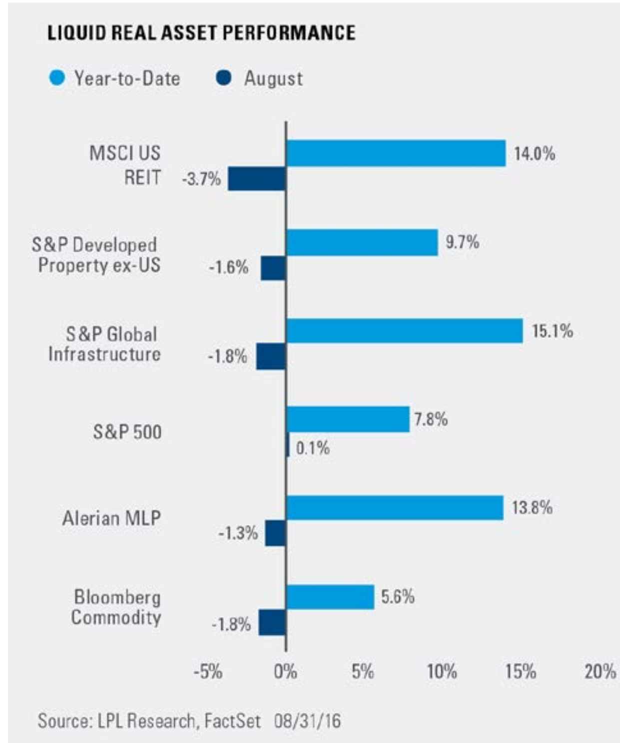
Global listed infrastructure, as measured by the S&P Global Infrastructure Index, returned -1.8% in August. This month broke the trend of five straight positive months for the index, which has rallied significantly year to date.

REITs

The REIT rally took a pause in August as the MSCI U.S. REIT Index returned -3.7%. Interest rate increases during the month certainly had an impact in stalling the index's rally as rates rose across the entire U.S. Treasury yield curve.

Commodities

The Bloomberg Commodity Index returned -1.8% for the



month, with energy as the most significant positive contributor. WTI crude oil prices increased 7.45%. Natural gas prices also increased, albeit modestly, by 0.38%. Energy bounced back from a rough July as hope grew over a potential OPEC supply freeze agreement. Agricultural commodities continued their losing streak from July even as net positioning by hedge funds turned slightly less bearish toward the end of the month. Wheat futures hit a 10-year low in August as large expected grain harvests in the U.S. continue to put pressure on the complex. Gold returned -3.40% and silver -8.06% as precious metals took a break from their year-to-date rally. Interest rate increases once again had an impact on the metals

This information is not meant as a guide to investing, or as a source of specific investment recommendations, and Montecito Bank & Trust make no implied or express recommendations concerning the manner in which any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's investment objectives. The information is general in nature and is not intended to be, and should not be construed as, legal or tax advice. In addition, the information is subject to change and, although based upon information that Montecito Bank & Trust consider reliable, is not guaranteed as to accuracy or completeness. Montecito Bank & Trust make no warranties with regard to the information or results obtained by its use and disclaims any liability arising out of your use of, or reliance on, the information.