October Update | As of September 30, 2015

SEPTEMBER 2015 IN REVIEW

ECONOMY:

U.S. DATA MODERATE BUT REMAIN EXPANSIONARY

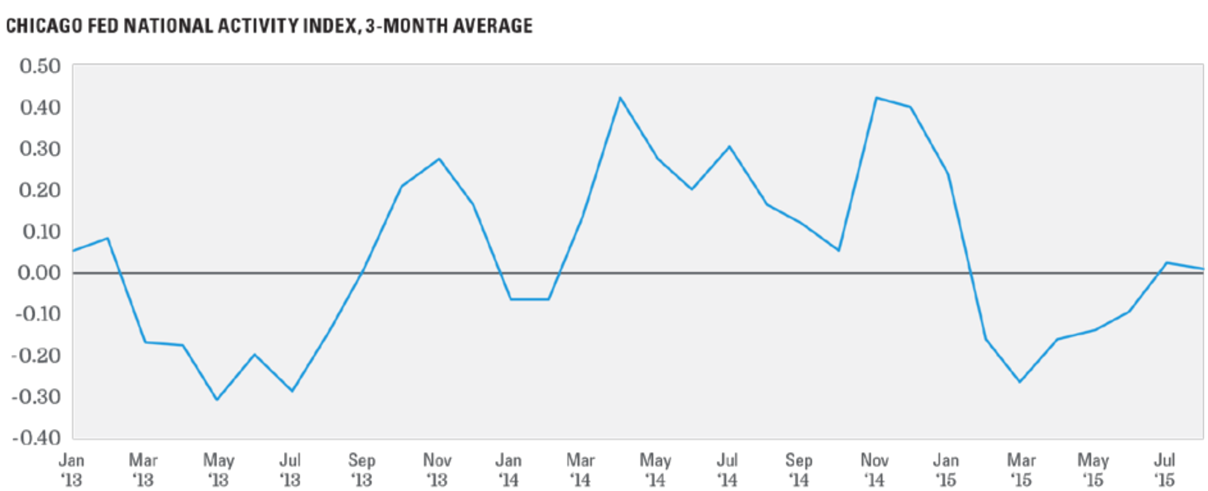
Economic Data

Economic reports received in September, which are largely based on economic activity in August, reflected steady overall U.S. economic activity and a healthy consumer, but with moderating strength in the labor market and greater weakness in the manufacturing sector, as a strong dollar and declining capital expenditures in the energy sector continued to take their toll. Some of the weakness in August can be viewed as payback from stronger July data, but structural factors also played a role. With data ranging from healthy to worrisome, but not recessionary, the Chicago Federal Reserve's (Fed) National Activity Index (CFNAI), a broad aggregate of economic indicators, provides a useful measure of overall economic health. The CFNAI's three-month average for August, the Fed's preferred measure, remained above the zero level that indicated growth at the long-term trend rate for the second consecutive month.

Nevertheless, weaker data in September reports added to uncertainty within financial markets. With increased volatility in U.S. equities carrying over from August and widening spreads between domestic high-yield bonds and Treasury rates, concerns about financial stress among market participants increased. However, levels of overall financial stress, while elevated from the calm seen in 2013 and 2014, remained well below levels considered alarming, as exhibited in the St. Louis Fed's Financial Stress Index. Current levels remain well below zero (lower levels indicate less stress) and well below levels seen during the last market correction in 2011.

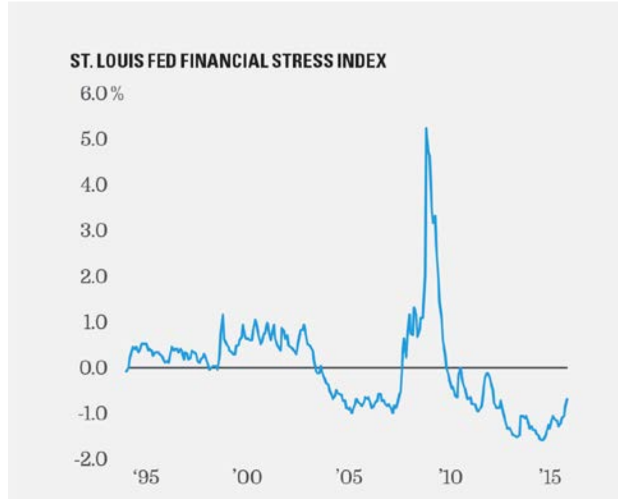
Job growth slowed in August compared with data from earlier in the year. Non-farm payrolls grew by 173,000, missing expectations, which were offset by an upward revision of July's data, while the unemployment rate fell from 5.3% to 5.1%. Labor market health was reflected in spending data. Real personal spending grew 0.4% in August, ahead of consensus expectations of 0.2% and accelerating from upwardly revised July data.

Manufacturing continues to be a weak spot in the economy, as low commodities prices lower demand for capital equipment, a strong dollar makes U.S. goods more expensive abroad, and slowing growth in China weighs on demand for commodities and construction equipment. The Institute for Supply Managements' Purchasing Managers' Index (PMI) for August fell to 51.1,



missing consensus expectations but remaining above the 50 level that indicates contraction. Capital goods orders for August also disappointed.

Early data on September economic activity and leading indicators remain positive. Markit's preliminary PMI for manufacturing in September came in just below expectations at 53, but accelerated from August, while the services PMI came in just ahead of consensus at 55.6. In addition, leading indicators—as measured by the Conference Board's Leading Economic Index (LEI)—increased a solid 4.1% year over year for August, which has historically been associated with only a 4% chance of recession in the next 12 months. Economist consensus forecasts, however, missed expectations by a slightly wider margin. The Citi Economic Surprise Index declined from -8.2 at the end of August to -20.5 at the end of September (a negative score indicating that data have been, on average, below expectations), but remains in the +25 to -25 range that indicates that economic data have been generally in-line with economist expectations.



Central Banks

Throughout much of the current expansion, bad news has been good news for U.S. equity markets on expectations of extended monetary support from the Fed. That pattern seemed to reverse when markets responded negatively to the Fed's policy statement following the September 16–17 meeting of its policy arm, the Federal Open Market Committee (FOMC). In what was broadly considered a "dovish" statement, the Fed explicitly mentioned the potential negative impact of international developments on the U.S. economy for the first time, leading markets to push back expectations of the timing of the first rate hike. While markets may have been playing off of the Fed's pessimism, the response may also indicate that markets have braced themselves for the start of moderately paced rate hikes and may no longer consider a delay advantageous. Outside of the U.S., major international central banks continue to be broadly accommodative, highlighted by European Central Bank (ECB) President Mario Draghi's September 3 comments that the ECB could expand its quantitative easing (QE) program if needed.

GLOBAL EQUITIES:

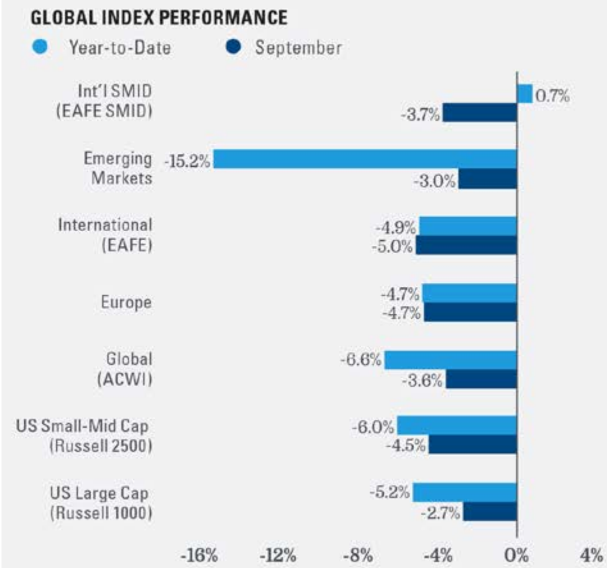
GROWTH CONCERNS DRIVE LOSSES, BUT DECLINES SLOW

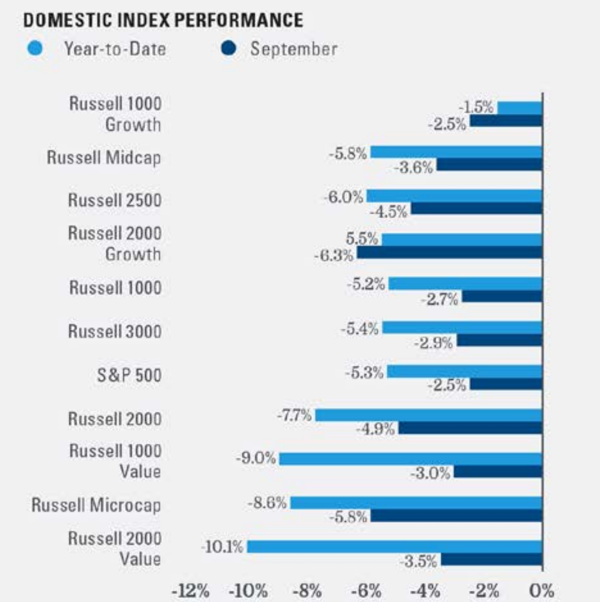
U.S.

U.S. equity markets, as measured by the S&P 500 Index, extended August declines in September, posting a total return of -2.5% compared with August's -6.0%. September's returns also did not produce the extremes seen in August: The index experienced two days of losses and one day of gains of more than 3% in August, but no moves of that magnitude in September. For the quarter, the S&P 500 had a total return of -6.4%, its weakest performance since the third quarter of 2011. Markets were primarily driven by continued concerns about global growth, especially China, uncertainty about the path of the Fed, and weak earnings expectations, which continue to be weighed down by energy sector weakness and a strong dollar.

Monthly sector performance was clearly tilted toward income-oriented defensives, given market declines and a falling 10-year Treasury yield, as utilities and staples were the only sectors to post gains. Among more cyclical sectors, consumer discretionary was the most resilient, helped by lower oil prices, labor market gains, and solid earnings prospects. Energy and materials fell to the bottom of the sector rankings as concern over the impact of slowing Chinese growth on commodities and continued oil oversupply dampened prospects. Healthcare also showed weakness, weighed down by biotech, which saw heavy selling due to high relative valuations and negative political and press attention to drug pricing strategies.

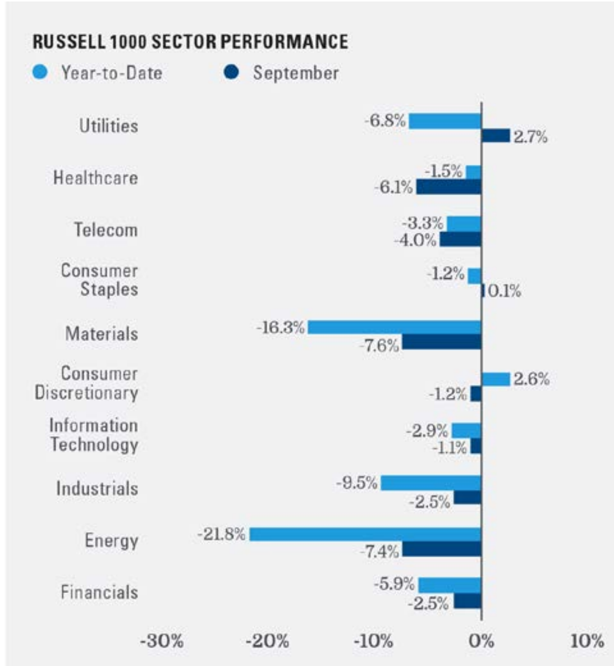
Large caps, which tend to be less sensitive to broad equity market movements than small caps, outperformed small across style tilts. The relative performance of growth and value was inconsistent across market cap, growth outperforming value for large caps but value topping growth for mid and small. The difference was largely driven by industry make-up within sectors, regional banks in mid and small caps outperforming their large cap cousins in value, while price declines among biotech and pharma were much sharper in small growth than large.





International

Despite angst over emerging markets acting as a catalyst for September equity weakness in the U.S., emerging market stocks, as measured by the MSCI Emerging Markets Index, did not trail far behind the S&P 500, underperforming by only 50 basis points (0.5%) and outperforming large foreign stocks as measured by the MSCI EAFE. The MSCI Emerging Markets Index was buoyed by some of its larger commodity importers, especially South Korea and India but also Hong Kong. Despite a less downbeat month, emerging market stocks suffered through a very weak third quarter, falling 17.8%. Developed international stocks were weighed down by Japanese equities after a rash of disappointing economic data, along with some concern about exposure to China. The MSCI index fell 10.2% over the third quarter, outperforming emerging markets but trailing the S&P 500 by over 300 basis points (3%).



FIXED INCOME:

INTEREST RATES END FLAT DESPITE TURBULENT MONTH

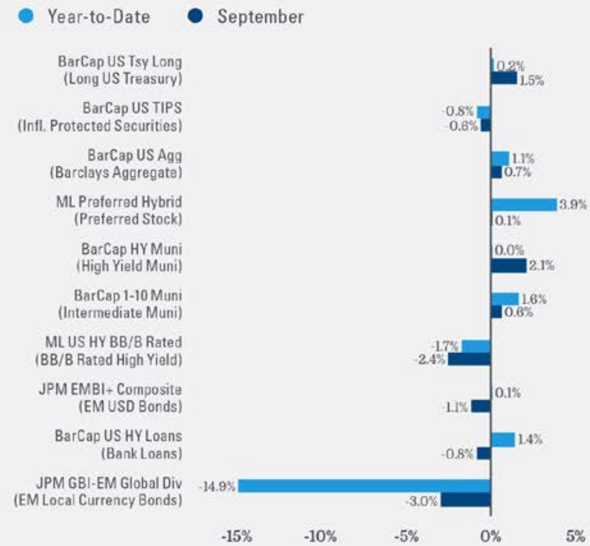
Interest rates fell across the maturity spectrum during September, with the 10-year Treasury yield falling from 2.21% to 2.06% and the yield curve flattening slightly. The backdrop of falling interest rates was a tailwind for fixed income—the Barclays U.S. Aggregate returned 0.7% on the month. Yield curve flattening over September resulted in longer-dated fixed income outperforming shorter-dated, all else equal.

A prevailing risk-off sentiment from weakness in China and declines in several emerging market currencies stoked fears of weakness across emerging markets and led to headwinds in economically sensitive sectors of fixed income. Lower credit quality lagged higher quality, high-yield returning -2.4% during the month, the index's largest loss since June 2013. Continued weakness in the price of oil and concerns over energy-related defaults led to pronounced weakness in the high-yield energy sector, which contributed to high-yield's challenging month overall.

Fears about emerging markets, driven largely by concerns of contagion from China's economic weakness, was a headwind for dollar-denominated emerging markets debt, which returned -1.1% during September, as investors demanded additional compensation for perceived risks.

Inflation expectations fell dramatically over September, partially driven by the Fed's decision not to raise interest rates, in conjunction with lower growth and inflation estimates in the Fed's economic projections. The Fed's preferred inflation indicator, the five-year, five-year forward inflation expectation rate, fell from 2% to 1.75% during September, leading to a -0.6% return for the Treasury Inflation-Protected Securities (TIPS) Index.

FIXED INCOME PERFORMANCE



US TREASURY YIELDS

Security	8/31/15	9/30/15	Change in Yield
3 Month	0.08	0.00	-0.08
2 Year	0.74	0.64	-0.10
5 Year	1.54	1.37	-0.17
10 Year	2.21	2.06	-0.15
30 Year	2.95	2.87	-0.08

AAA MUNICIPAL YIELDS

Security	8/31/15	9/30/15	Change in Yield
2 Year	0.65	0.65	0.00
5 Year	1.40	1.37	-0.03
10 Year	2.38	2.31	-0.07
20 Year	3.84	3.77	-0.07
30 Year	4.49	4.45	-0.04

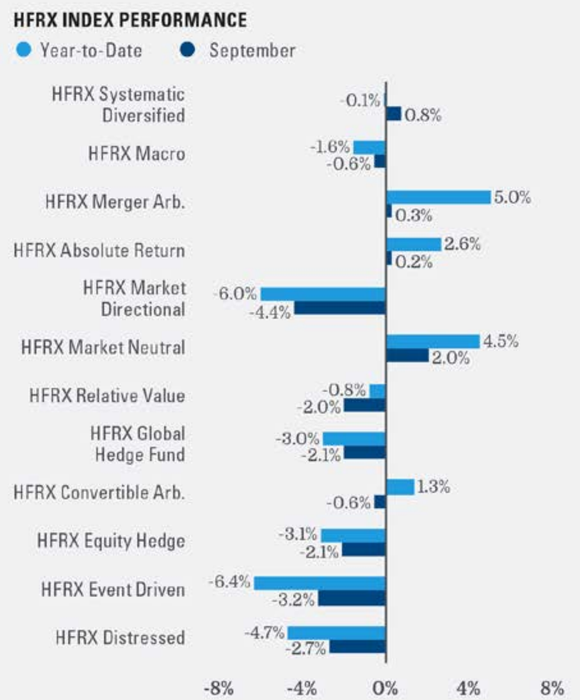
ALTERNATIVES:

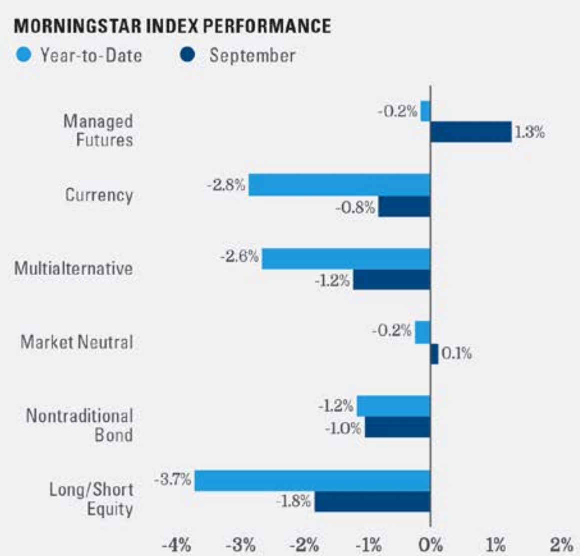
DEFENSIVE POSTURE LEAD GAINS

A second straight monthly sell-off across global equity markets left more directionally sensitive alternative investment strategies in negative territory. Event driven managers were among the strategies most impacted (HFRX Event Driven down 3.2%), as exposure to biotech and healthcare-related events weighed on overall returns. Political pressure related to prescription drug pricing exacerbated the broad sell-off, with concerns surrounding a potential increase in industry regulation. Given the risk-off sentiment, distressed debt strategies also encountered losses, with the HFRX Distressed Debt Index down 2.7%.

Equity market neutral managers continue to perform very well, returning 2.0% during the month and 4.5% year to date. Overall, managers in the space maintain a defensive posture, with a month-end beta of only 0.07. Short positioning in emerging markets, energy, and materials provided strong gains. Macro strategies have also developed a more defensive outlook of late, as per data from Bank of America Merrill Lynch, macro hedge funds have increased their shorts in the S&P 500 and the Nasdaq 100 to the highest levels since May 2013. This stance was well timed, as the HFRX Macro Index only fell 0.6% during the quarter. Global macro managers have also tactically reduced their long U.S. dollar positioning recently, as market participants continue to push out the anticipated increase in the federal funds target rate to a further date.

Systematic macro strategies also continued to perform well, as long fixed income exposure was the main contributor to the HFRX Systematic Diversified Index return of 0.8% for the month. Equity gains in the space were mixed, as short-term trend following models were positioned short. However, many managers employing long-term trend following systems maintained a small amount of long equity exposure, which detracted from performance.





REITS ARE ONE OF FEW BRIGHT SPOTS IN LIQUID REAL ASSETS

As is now becoming somewhat normal, liquid real assets in general had another negative month in September. The U.S. dollar appreciated modestly and contributed to the poor performance of real assets. One of the few positives for the month were real estate investment trusts (REIT), which benefited from the 10-year yield falling from 2.21% to 2.06% after the Fed delayed its decision to hike rates.

MLPs & Global Listed Infrastructure

Master limited partnerships (MLP) had their worst month since 2008, with the Alerian MLP Index losing 15.3% in September. Daily trading proved extremely volatile, especially the final three days of the month, which all saw swings of more than 5%. MLPs have positive returns in just two months of 2015 and now are on a streak of five straight months of negative returns. The losses in September came on the back of no new material news and most likely were driven simply by continued concern over oil prices, which MLPs have been extremely sensitive to of late. Early October will see third quarter distribution announcements, which may provide an impetus for further losses or a reversal of the trend.

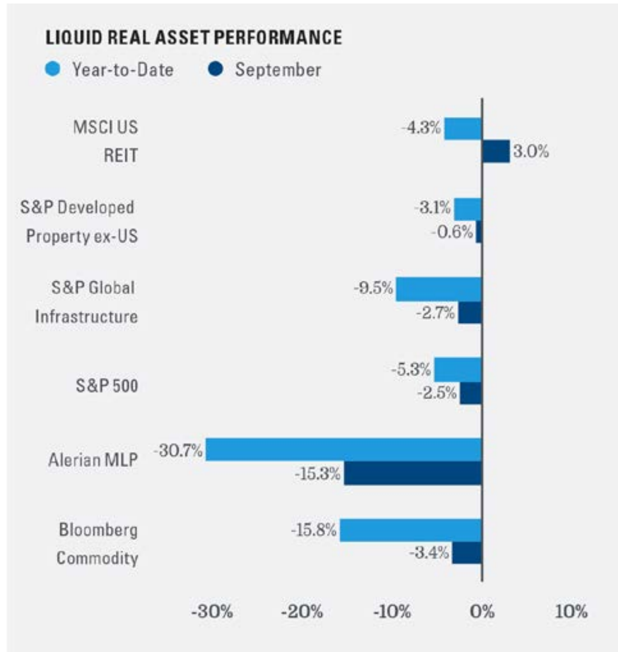
Global infrastructure, as measured by the S&P Global Infrastructure Index, returned -2.7% for the month. This marks the second straight month of declines and four out of the last five months with negative returns.

REITs

On a positive note, U.S. REITs performed well in September, with the MSCI U.S. REIT Index returning 3.0% and outperforming the S&P 500 by 5.5%. REITs undoubtedly benefited from the Fed's decision to hold off on raising rates. The inaction of the Fed contributed to the 10-year yield falling 15 basis points (0.15%) during the month. The yield on the index now stands at 4.2%, offering income-oriented investors a relatively attractive option.

Commodities

The overall commodity complex, as measured by the Bloomberg Commodity Index, returned -3.4% in September. WTI crude oil perhaps had the worst month among its peers, returning -5.7%. Previous gains were partially given back after a strong final week of August, which saw sharp swings upward in the price of oil. The oil markets continue to seek a balance as U.S. production falls and OPEC maintains its supply levels. Grains were able to eke out gains bolstered on the final day of the month by lower than expected harvest forecasts for wheat. The Bloomberg Agriculture subindex returned 2.2%. Precious metals ended the month down modestly and industrial metals were roughly flat.



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.