Montecito Bank & Trust®

October Update | As of September 30, 2016

SEPTEMBER 2016 IN REVIEW

ECONOMY:

BOND YIELDS TO RISE. EQUITY ENVIRONMENT CHALLENGING

Economic Data

The FOMC's shift over the past year from a gradual projected pace of tightening to a very gradual pace is not a change in tactics. Instead, Fed policymakers are moving to a new strategy, one that will allow, even encourage, inflation to exceed the long-standing +2% target. This will lead long rates to trend up noticeably, steepening the yield curve. In turn, they believe this will shore up the financial sector to better face the next economic downturn when it finally emerges.

The official FOMC forecast calls for core inflation, which has already trended up to +1.7%, to remain just shy of the +2% target over the next three years. That outlook is far too sanguine. The FOMC is prepared to tolerate above-target inflation "for a while." Some, led by the San Francisco Fed's John Williams, want to raise the official inflation target to +3% to facilitate a higher "neutral" fed funds rate and a more normal yield curve. The odds are that the FOMC will eventually embrace this "Williams Rule."

On one level, this strategy to hike rates very gradually will retain extreme accommodation for an even longer period. More broadly, however, this is in keeping with a global shift away from radical experimentation by central banks. In short, the era of "throwing everything but the kitchen sink" at economic problems is ending.

FOMC Outlook: September 2016 vs. December 2015

Central tendency of forecasts, Year-end values	Fed Funds 2017	Fed Funds 2018	Real GDP 2017	Real GDP 2018	Core Inflation 2017	Core Inflation 2018	Unemployment 2017	Unemployment 2018
December 2015 First Rate Hike	**2.38%**	**3.25%**	2.15%	2.00%	1.85%	1.95%	4.80%	4.85%
September 2016 Even More Gradual Approach	**1.125**	**1.875**	2.05	1.95	1.85	1.95	4.6	4.6

In the nine months since the first rate hike of the cycle, the FOMC economic outlook has remained essentially unchanged, but the members have scaled back expected rate hikes considerably. This reflects an emerging Fed strategy to drive inflation above the +2% target which should drive long rates up to create a steeper, more 'normal' yield curve and shore up the financial system.

Policymakers overseas are speaking more skeptically about the prospects for further forays into negative rates. Those central banks that have negative rates now will not cut deeper, those that have not gone negative will not. Central banks are continuing announced QE programs, but purchases are not being ramped up. Unwinding their current extreme positions will be no easy or quick task -- a key reason they are not eager to go further -- but it should happen over time.

The FOMC has set out on a new strategy – to increase inflation above the +2% target, raise long rates and steepen the yield curve

The Bank of England faces special pressures due to Brexit. Even there, officials have so far declined to take extreme measures, though they have underscored a willingness to act if it becomes necessary.

For the U.S., the question of negative rates has always been moot. While the FOMC has discussed such a policy option in academic terms, they have been consistent that there would be no need for negative rates here. Similarly, after three rounds of quantitative easing, the FOMC has been talking only of shrinking their portfolio for the past three years. That process too will happen very gradually – with no meaningful shrinkage before the end of the decade.

Policymakers' strategies are changing for a simple reason: those policies have failed. Negative interest rates have been as problematic as most expected while delivering little or no benefits. Various permutations of QE have also had minimal positive effect. Consumer inflation has remained muted despite all these monetary policy hijinks.

After a decade of trying almost everything, the FOMC and its counterparts abroad are finally accepting that they have very limited power to improve the pace of real growth over the medium term.

For the FOMC, facing full employment and real growth proceeding at a decent pace, financial stability is becoming the more pressing concern. Central banks are returning to their traditional focus on inflation, this time by encouraging more of it. Steeper yield curves will improve financial sector function and profits, and paper over some troubling issues. The problem with this pro-inflation approach is that, eventually and inexorably, inflation will move too high. That, they have decided is a concern for another day.

Markets

Equities

The S&P 500 Index posted a 3.9% total return during the third quarter, following up a solid July with flat returns in August and September. Central bank support was the dominant theme, helping buoy investor sentiment as Fed rate hike expectations were pushed out to December 2016 amid continued slow economic growth, while market participants generally expected further actions from overseas central banks. Markets largely shrugged off political uncertainty in the U.K. post-Brexit vote and in the U.S. ahead of the November presidential election. Market leadership shifted from defensive dividend-paying sectors to cyclicals, as technology and financials topped the quarter's sector rankings; while consumer staples, telecom, and utilities suffered losses.

MARKET LEADERSHIP SHIFTED TOWARD CYCLICALS IN Q3

S&P 500 Sector Performance, Ranked by Third Quarter Returns

Sector	Q3 2016
Technology	12.9%
Financials	4.6%
Industrials	4.1%
S&P 500	3.9%
Materials	3.7%
Consumer Discretionary	2.9%
Energy	2.3%
Healthcare	0.9%
Consumer Staples	-2.6%
Telecom	-5.6%
Utilities	-5.9%

EMERGING MARKETS AMONG TOP EQUITY ASSET CLASSES IN Q3

Domestic & International Asset Class Performance, Ranked by Third Quarter Returns

Asset Class	Q3 2016
U.S. Small Growth	9.2%
Emerging Markets	9.2%
U.S. Small Value	8.9%
Large Foreign	6.5%
U.S. Mid Growth	4.6%
U.S. Large Growth	4.6%
U.S. Mid Value	4.4%
U.S. Large Value	3.5%

Fixed Income

Economically sensitive sectors continue to rally as yields rise. Treasury yields, which started the quarter at depressed levels due to the surprise Brexit vote, rose steadily over the quarter to end higher across the yield curve. Despite the Fed opting not to hike interest rates in September, global central bank action during the quarter was hawkish on balance, helping to drive global yields higher. The Barclays Aggregate Bond Index returned 0.5%, with corporate bonds returning 1.2%. Economically sensitive, lower-credit quality sectors continued to rally, with high-yield returning 5.6% (Barclays U.S. Corporate High Yield Index), emerging markets debt returning 3.7% (JP Morgan Emerging Markets Bond Index), and bank loans returning 3.3% (Barclays U.S. High Yield Loan Index). A meaningful pickup in inflation expectations was a tailwind for TIPS, which returned 1.0% (U.S. Treasury Inflation Protected Notes Index) during the quarter.

RALLY IN ECONOMICALLY SENSITIVE FIXED INCOME SECTORS CONTINUED IN Q3

Bond Market Performance, Ranked by Third Quarter Returns

Sector	Q3 2016
High-Yield Bonds	5.6%
Emerging Markets Debt	3.7%
Bank Loans	3.3%
Municipal High-Yield	1.3%
Investment-Grade Corporates	1.2%
TIPS	1.0%
Preferred Securities	0.7%
Mortgage-Backed Securities	0.6%
Foreign Bonds (Hedged)	0.6%
Barclays U.S. Aggregate	0.5%
Foreign Bonds (Unhedged)	0.1%
U.S. Treasuries	-0.3%
Municipal Bonds	-0.3%

Alternatives

Distressed debt leads in the third quarter. The 5.8% return from the HFRX Distressed Debt Index led third quarter alternative investment category gains, as a higher trading range for oil prices supported performance within the energy and basic materials sectors. While long/short equity strategies (HFRX Equity Hedge +3.4%) marginally underperformed the 3.9% S&P 500 gain on an absolute basis, from a risk-adjusted view performance was very strong. The index maintained a beta profile of roughly a third of that of the broader market, indicating managers were able to add alpha from both their long and short positioning. As measured by the 0.8% decline in the HFRX Systematic Diversified Index, performance from managed futures strategies was lackluster, as the increase in U.S. Treasury rates weighed on portfolios.

Commodities

Oil prices vacillate but end the third quarter lower. In a quarter with extreme energy price volatility, WTI crude oil prices ended down 1.5%. U.S. crude oil production fell during the quarter, but ended off the lows. News of a potential OPEC production cut late in the quarter buoyed prices. The Bloomberg Commodity Index returned -4.8% in the quarter with agricultural commodities leading to the downside. The trade-weighted U.S. Dollar Index was down marginally, returning -0.2%.

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