Montecito Bank & Trust®
Wealth Management

FIRST QUARTER 2019 IN REVIEW

April 2019

STOCKS REBOUND AMID MIXED ECONOMIC SIGNAL

- U.S. economy sent mixed signals amid uncertainty. Fourth quarter gross domestic product (GDP) rose 2.2% from the prior quarter on an annualized basis, below the initial 2.6% reading reported on February 28. GDP grew 2.9% overall in 2018 and 3% year over year for the fourth quarter. Consumer spending contributed 1.7%, the biggest component of fourth quarter output growth, while business spending added 0.7%.
  First quarter data showed pockets of the U.S. economy slumped amid global trade and political uncertainty. Gauges of manufacturing health fell to multi-year lows as growth in capital investment waned. Confidence measures generally declined as consumers and businesses digested growing global uncertainty. Still, nonfarm payrolls grew solidly in the first quarter (even as February's payroll growth was far below consensus), and the unemployment rate hovered around a 48-year low. Wages grew at a healthy, manageable pace while price inflation was contained.
  Overall, leading indicators pointed to low odds of a recession over the next 12 months, even as coincident data wavered.
  The Federal Reserve (Fed) paused its gradual rate-hike campaign and committed to patience in a nod to signs of a global slowdown. Policymakers now expect rates to remain unchanged through the end of 2019, with a slight chance of a cut.

1 Q1 2019 AT A GLANCE

	Q1 2019
GDP*	1.5%
S&P 500 Index	13.6%
Bloomberg Barclays Aggregate Bond Index	2.9%
Bloomberg Commodity Index	6.3%

Source: LPL Research, Bloomberg, FactSet 03/31/19

*Bloomberg consensus as of March 31, 2019.

Figures for S&P 500 Index, Bloomberg Barclays Aggregate Bond Index, and Bloomberg Commodity Index are total returns from 12/31/19–03/31/19 (Q1).

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment.

Please note: All return figures are as of March 31, 2019, unless otherwise stated.

Past performance is not indicative of future results.

The economic forecasts set forth in the presentation may not develop as predicted.

- The S&P 500 Index returned 13.6% during the quarter, its best start to a year since 1998. Stocks rebounded sharply from fourth quarter losses, bringing the S&P 500 back to within 3% of its September 2018 record high as of quarter end. The primary concerns entering the year — trade uncertainty, Fed policy, and a global growth slowdown — subsided to varying degrees, which supported investor sentiment. The United States and China moved closer to a trade agreement, the Fed put rate hikes on pause for all of 2019, and the global growth outlook showed signs of stabilization as leading (soft) economic data outperformed coincident, "hard" data, pointing to better growth ahead. Mid-caps topped small and large cap stocks during the quarter despite not leading in January, February, or March. The Russell Midcap Index returned 16.5%, ahead of the 14% return for the large cap Russell 1000 Index and the small cap Russell 2000 Index's 14.6% gain. Growth stocks outpaced their value counterparts on strength in the technology sector, while weakness in financial stocks dragged on the Russell 1000 Value Index. Overseas, both developed international and emerging markets (EM) rose solidly but trailed the S&P 500. The MSCI EAFE and MSCI EM indexes both returned 10%.
- Rates slid further amid global search for yield. Rates across the curve slid in the first quarter as signs of a global slowdown and the Fed's rate-hike pause boosted fixed income prices and weighed on yields. The 10-year Treasury yield dropped 28 basis points (0.28%) in the quarter, falling to the lowest level in 15 months on March 27. The 2-year Treasury yield fell 23 basis points (.23%). The yield curve briefly inverted in March, as the 10-year yield fell below the 3-month yield for the first time since August 2007. Global investors' search for yield boosted fixed income returns across the board. Preferred shares climbed 9%, leading all fixed income classes we track. Corporate debt posted its best quarter since 2009, as high-yield bonds rose 7.3% and investment-grade corporates gained 4.9%. The Bloomberg Barclays Aggregate Bond Index rose 2.9% in the quarter. Treasuries rose 2.1% for the worst performance among major fixed income asset classes.
- Long/short equity delivered best quarter since 2010. The HFRX Equity Hedge Index gained 6% during the first quarter, as the industry's continued overweight to the information technology and consumer discretionary sectors supported quarterly gains. Due to the sharp move higher in equity markets, it was difficult for managers to add significant value from short positioning. The HFRX Merger Arbitrage Index (-1.8%) lagged all other subcategories, as a difficult February weighed on quarterly performance. Weakness was idiosyncratic in nature and not indicative of broader concerns about the health of the mergers and acquisitions market.
- Commodities rebounded to start the year. The Bloomberg Commodity Index gained 6.3% during the quarter, led by a rebound in oil prices amid an improving economic demand outlook, progress on U.S.-China trade talks, and the Fed's pause in its rate-hike campaign. Crude prices surged roughly 30% as global demand picked up and production fell around the world. OPEC and Russia have complied with production caps while unrest in Venezuela has curbed global supply. Trade progress boosted copper prices 11%, while precious metals lagged as investors favored more economically sensitive assets. Agriculture prices fell in aggregate, with pronounced weakness in grains despite ebbing trade uncertainty. Livestock bucked the trend, rising in the quarter on strong Chinese demand for lean hogs.

U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. They are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

See page 4 for list of indexes used to represent the referenced asset classes.

A LOOK FORWARD

Expectations for solid but slower growth in the U.S. economy; fiscal tailwinds of government spending, reduced regulation, and lower taxes; and another year of record corporate profits support our year-end 2019 fair value target for the S&P 500 of 3,000. As noted in our *Outlook 2019* publication, our target is derived from 6–7% S&P 500 earnings growth and a target price-to-earnings ratio (PE) of 17.5. However, with stocks having approached our target after strong first quarter performance, the risk-reward profile for equities has become more balanced, in our view.

We are looking for U.S. GDP growth of 2.5% in 2019, supported by higher consumer spending, business investment, and government spending.

We do not anticipate a recession in 2019, thanks to the fundamentally driven economic momentum and fiscal incentives. But given the length of the current expansion and where we are in the economic cycle, it is natural that investors are looking for signs of recession.

We expect a gradual increase in the 10-year Treasury yield over the full year. A pickup in U.S. economic growth and tight labor markets accompanied by steady wage gains should help prop up yields and steepen the yield curve. Our forecast calls for a 10-year Treasury yield range of 3–3.25%, which may moderate potential returns that high-quality bonds can deliver.

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Please see our *Outlook 2019: FUNDAMENTAL: How To Focus on What Really Matters in the Markets* publication for additional descriptions and disclosures.

2 TECHNOLOGY LED SECTOR RANKINGS

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

Sector	Q1 2019
Technology	19.9
Real Estate	17.4
Industrials	17.2
Energy	16.4
Consumer Discretionary	15.7
Communication Services	14.0
S&P 500	13.7
Consumer Staples	12.0
Utilities	10.8
Materials	10.3
Financials	8.6
Healthcare	6.6

3 MID-CAP GROWTH STOCKS OUTPERFORMED

Domestic and International Asset Class Performance, Ranked by First Quarter Returns

Asset Class	Q1 2019
Mid Growth	19.6
Small Growth	17.1
Large Growth	16.1
Mid Value	14.4
Russell 3000	14.0
S&P 500	13.7
Large Value	11.9
Small Value	11.9
Large Foreign	10.1
Emerging Markets	10.0

4 ALL BOND SECTORS RALLIED

Bond Market Performance, Ranked by First Quarter Returns

Sector	Q1 2019
Preferred Stocks	9.01
High-Yield Corporates	7.26
EM Debt	6.59
Bank Loans	5.10
Investment-Grade Corporates	4.87
High-Yield Munis	3.83
TIPS	3.19
Foreign Bonds (Hedged)	3.10
Bloomberg Barclays U.S. Agg	2.94
Munis	2.90
MBS	2.17
U.S. Treasuries	2.11
Foreign Bonds (Unhedged)	1.52

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Bond Market Asset Class Indexes: Foreign Bonds (hedged) – Citigroup Non-U.S. World Government Bond Index Hedged for Currency; Preferred Securities – Merrill Lynch Preferred Stock Hybrid Securities Index; Treasury – Bloomberg Barclays U.S. Treasury Index; Mortgage-Backed Securities – Bloomberg Barclays U.S. MBS Index; Investment-Grade Corporate – Bloomberg Barclays U.S. Corporate Bond Index; Municipal – Bloomberg Barclays Municipal Bond Index; Municipal High-Yield – Bloomberg Barclays Municipal High Yield Index; TIPS – Bloomberg Barclays Treasury Inflation-Protected Securities Index; Bank Loans – Bloomberg Barclays U.S. High Yield Loan Index; High-Yield – Bloomberg Barclays U.S. Corporate High Yield Index; Emerging Market Debt – JP Morgan Emerging Markets Global Index; Foreign Bonds (unhedged) – Citigroup Non-U.S. World Government Bond Index (unhedged)

Sources: LPL Research, FactSet 03/31/19

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The sectors are represented by the 10 S&P 500 Global Industry Classification Standard (GICS) indexes.

Asset classes based on Russell 1000, Russell 3000 Growth and Value Indexes, Russell 2000, Russell Midcap Index, MSCI EAFE, and MSCI Emerging Markets Index.