



Montecito
Bank & Trust®
Wealth Management

January 2018 IN REVIEW

February Update | As of January 31, 2018

ECONOMY: ON SOLID FOOTING AS 2018 BEGAN

Economic Data

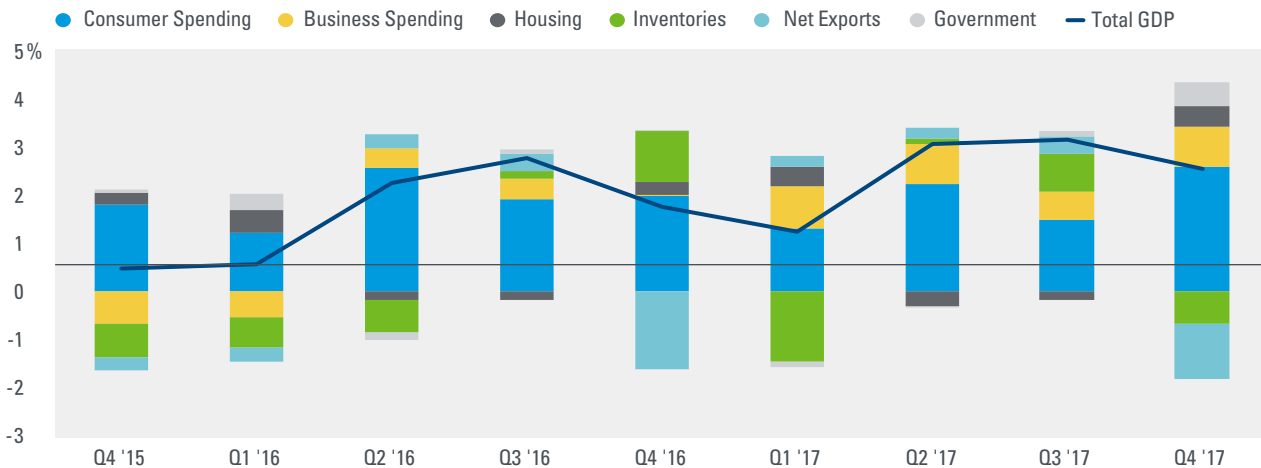
January 2018 saw December's trend of above-consensus economic reports taper off, though the data suggests strong underlying fundamentals in the U.S. economy, supported by solid consumer spending. Fourth quarter growth in real gross domestic product (GDP) of 2.6% fell short of the more optimistic 3.0% forecast by Bloomberg-surveyed consensus, dragged down largely by inventories and trade (faster growth in exports than imports). Both economic factors contributed heavily to the growth rate of GDP in the third quarter of 2017, which speaks more toward disruptions from hurricanes than a fundamental decline in momentum. Consumer spending was the standout contributor to the

GDP report, corroborated by upbeat consumer confidence reports, supported by tax cuts and the drop in the household savings rate.

Consumer-oriented data for the fourth quarter of 2017 outlined a significant acceleration relative to the third quarter. Retail sales data excluding autos were in line with expectations and the strongest since 2010. The strength, which has the potential to be inflated given post-hurricane spending, may continue in light of tax cuts and improving economic growth. Job growth (+148K) slowed and missed expectations in December (reported in January) but appeared to be dragged down by temporary factors. Wage growth at 2.5% year over year strengthened modestly. Consumers remained confident, as the University of Michigan Consumer Sentiment Index topped expectations and remains elevated.

Jobless claims posted a drop in January, though this is made less significant given the usual volatility

CONTRIBUTION TO REAL GROSS DOMESTIC PRODUCT (GDP) GROWTH BY ECONOMIC SECTOR



Source: LPL Research, Bloomberg 01/31/18

around seasonal layoffs and construction shut-ins. The ADP National Employment Report exceeded consensus, keeping pace with December's reading and indicative of tightening labor market. Bloomberg economists expect that the unemployment rate will fall below 4% by year-end. The Employment Cost Index, which outlines the cost of labor for U.S. businesses, continued upward, confirming a tight labor market and increasing wage pressures.

Consumer inflation, detailed in the Consumer Price Index (CPI), was under scrutiny given the potential for accelerating inflation to lead to a faster pace of Federal Reserve (Fed) rate hikes. Though Core CPI, which excludes food and energy, surprised to the upside at 1.8% year over year, the core goods category pickup is viewed as unlikely to be sustained. Headline CPI (including all items) came in at +2.1% year over year, meeting expectations. Inflation may become a bigger concern should the U.S. dollar weaken further, pushing up import prices.

Productivity contracted 0.1% in the fourth quarter, though this was largely attributed to weather disruptions and is expected to normalize in the first quarter of 2018. Productivity has seen slow gains over the last few years due largely to demographic headwinds as the labor force ages, but may accelerate due to rising wage pressures and increasing labor scarcity.

Business investment continued to pick up in the fourth quarter, increasing 6.8% from the third quarter. Manufacturing surveys for December, released in January, largely came in ahead of expectations. The ISM Manufacturing Index reading for December, at 59.7, exceeded expectations. A reading above 50 indicates economic expansion.

Regional surveys showed strength as well: Dallas, Chicago, and Kansas City beat expectations though Richmond and Philadelphia surveys fell short. Businesses remain confident based on strength in the NFIB Small Business Optimism Index.

Central Banks

Fed Chair Janet Yellen presided over her last Federal Reserve Open Market Committee meeting as markets prepared for the transition to incoming Fed Chair Jerome Powell. As expected, the Fed left monetary policy unchanged, keeping the fed funds target rate between 1.25% and 1.50%, while allowing Treasuries and mortgage-backed securities to roll off its balance sheet. The central bank also upgraded its economic assessments, noting solid gains in employment, household spending, and business fixed investment, while taking a more hawkish stance on inflation. Markets continued to price in a very high likelihood of a March rate hike at the conclusion of the meeting.

Turning to other central banks, as expected, the European Central Bank (ECB) made no changes to interest rates or forward guidance on its quantitative easing program. The ECB is still expected to begin tapering bond purchases in September but remains flexible. The strong euro currency remained a focus for its potential risk to European exports.

The Bank of Japan (BOJ) left policy unchanged on January 23. Markets had been pricing in a slight chance of a near-term taper in the BOJ's asset purchase program, following reports early in the month that it adjusted purchases of intermediate- and long-term bonds. That move was more operational in nature.

GLOBAL EQUITIES: BEST JANUARY FOR THE S&P 500 SINCE 1997

U.S.

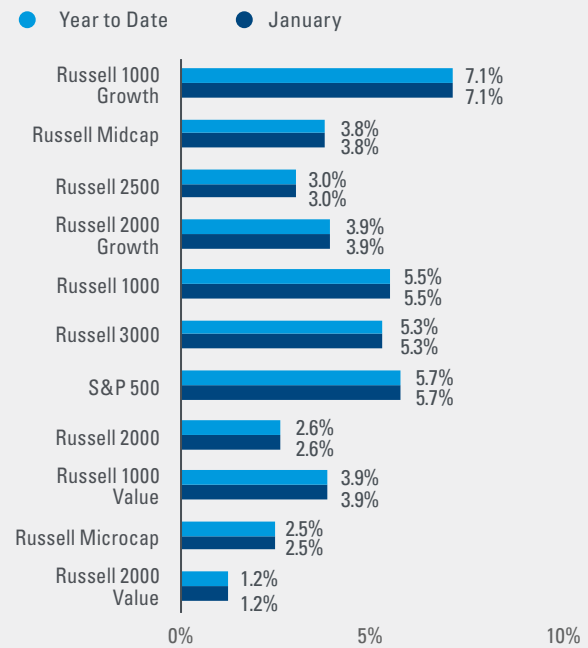
The S&P 500 returned a strong 5.7% in January, which is the best start to a year since 1997 and the 11th best January since 1950.* The gain brought the S&P 500's total return win streak to a remarkable 15 months, while the index has risen 10 straight months on a price basis. The Dow produced a similar monthly return (+5.9%), while the Nasdaq fared even better with a 7.4% gain bolstered by strong gains in the technology sector.

After such a strong 2017 with record-breaking low volatility, it was logical to anticipate a choppy start to 2018. However, those concerns were misplaced, at least in January (though February is off to a rocky start as we write this), as the rally continued through month end. The late-December passage of the tax law clearly supported investor sentiment during the month, although the continued stream of strong global economic data, a strong start to fourth quarter earnings season, and January's historically strong seasonal performance also played a role. Markets generally looked past the temporary factors that led to the shortfall in fourth quarter U.S. GDP, focusing on strong consumer spending and business investment. Political uncertainty had limited impact on markets despite a short government shutdown mid-month.

Sector leadership during the month was pro-cyclical, as would be expected in such a strong month for stocks. The sharp increase in interest rates also played a role, as the interest rate sensitive real estate and utilities sectors suffered losses for the month while telecommunications barely finished in positive territory. Consumer discretionary topped the sector rankings on strength in retail (both internet and traditional), while technology finished second, driven by market-beating gains in the software and internet groups.

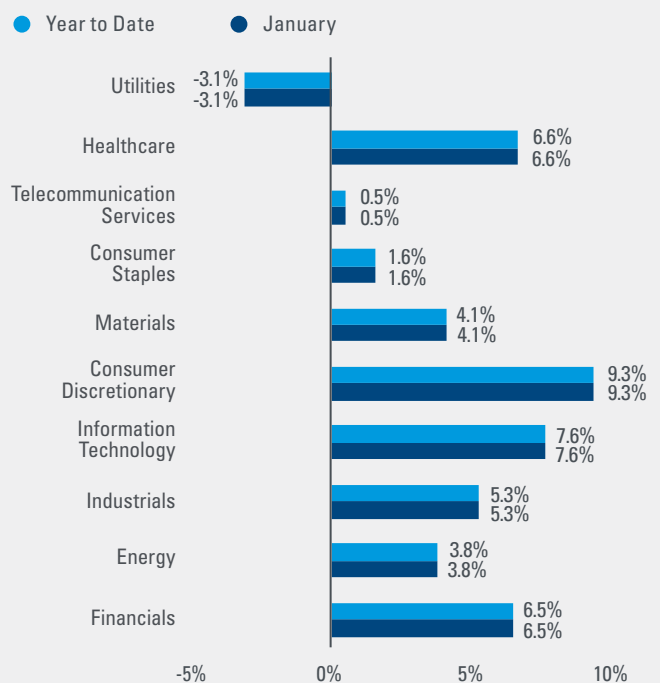
* The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

DOMESTIC INDEX PERFORMANCE



Source: LPL Research, FactSet 01/31/18

S&P 500 SECTOR PERFORMANCE



Source: LPL Research, FactSet 01/31/18

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.

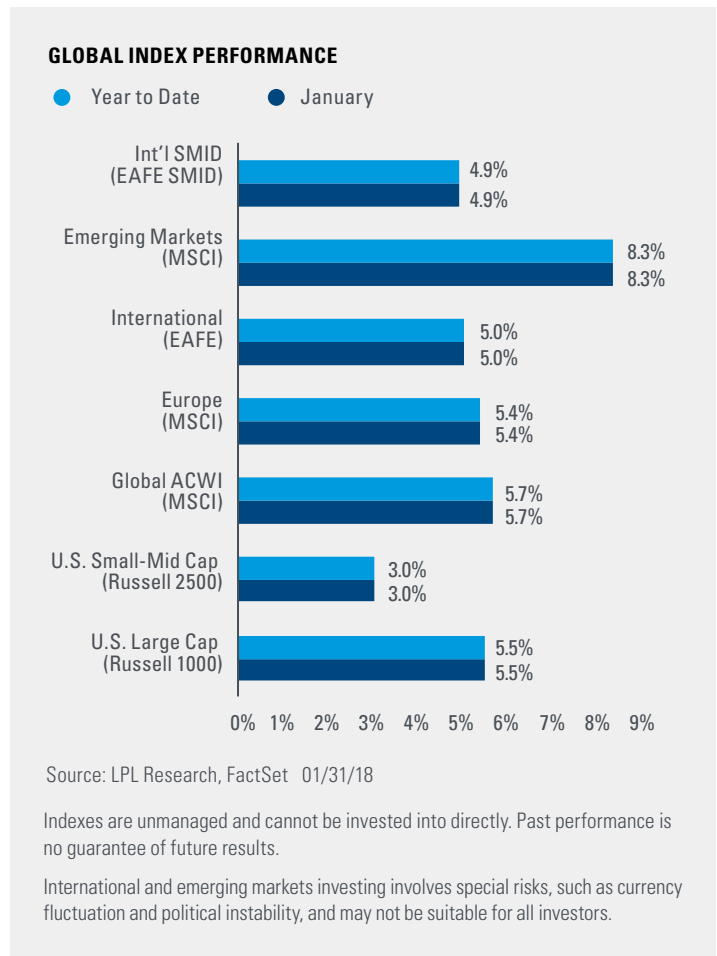
Relative underperformance continued for small caps, which struggled to keep up with large caps in 2017, despite the fact that smaller companies tend to pay higher tax rates and therefore generally benefit more from the reduction in corporate tax rates. Small caps returned 2.6% for the month, based on the Russell 2000 Index, trailing the 5.5% return for the large cap Russell 1000 Index benchmark.

In terms of style, growth’s dominance over value continued in January, based on the Russell 3000 Growth and Value indexes. Growth’s 6.8% return nearly doubled value’s 3.7% gain for the month, as the top two growth sectors—technology and consumer discretionary—topped the month’s sector rankings. Growth has now outpaced value in 11 of the past 13 months and for the majority of the ongoing bull market.

International

Developed international and emerging market (EM) equities both posted solid gains in January, based on the MSCI EAFE and EM indexes, though only the MSCI EM Index outpaced the S&P 500 (in U.S. dollar terms). The MSCI EAFE and MSCI EM indexes returned 5.0% and 8.3%, respectively, compared with the near 6.0% return for the U.S. based S&P 500 Index. A weak U.S. dollar was the biggest driver of the monthly gains, with the U.S. Dollar Index falling more than 3.0%, though the currency was whipsawed by mixed messages from Treasury Secretary Mnuchin and President Trump about their views on the currency. Additional evidence of strong and steady global economic growth, the rebound in overseas corporate profits, ongoing monetary policy support from the ECB and BOJ, and relatively lower valuations all helped attract global investors to international markets.

Gains in developed international markets were broad based. The major MSCI regional and country indexes, including Europe, Asia-Pacific, United Kingdom, Germany, and Japan, all rose between 4–6% for the month, led by the Asia-Pacific region. The MSCI France Index performed particularly well on strength in financials and aerospace stocks, while



Brexit-related political uncertainty and a slight softening of the economic outlook weighed on the MSCI United Kingdom Index.

Strong EM performance in January was driven primarily by China and Brazil, with both MSCI country indexes producing double-digit gains, while South Africa and India lagged. Trade tensions, exacerbated by fresh U.S. tariffs on solar panels and washing machines, had little impact on the Chinese equity market but did contribute to some underperformance in South Korea. China continued to report generally solid economic data, while Brazilian stocks were buoyed by a rebounding economy, signs of political clarity, and rising commodity prices. The ongoing risk that the United States could pull out of NAFTA failed to meaningfully impact Mexican stocks, as the MSCI Mexico Index gained 7.8% during the month.

FIXED INCOME: INFLATION WORRIES LED TO HIGHER YIELDS

Treasury yields rose considerably across the Treasury yield curve during January. Longer-term yields were pressured upward by higher inflation expectations and higher real yields. The increasing belief over the month of an upside surprise to inflation made investors skittish that the Fed could become more aggressive in response to higher inflation. This sent short-term yields higher as well. The 2-year Treasury yield increased by 25 basis points (0.25%), while the 10- and 30-year Treasury yield increased 32 (0.32%) and 21 (0.21%) basis points, respectively, steepening the Treasury yield curve.

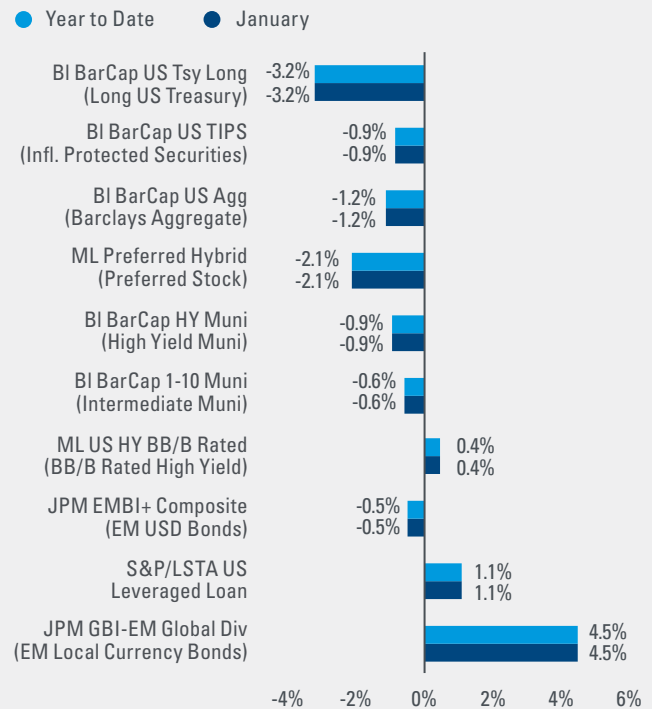
The upward move in interest rates at all maturities created strong headwinds for high-quality fixed income. The broad Bloomberg Barclays Aggregate Bond Index returned -1.2% during the month, with Treasuries underperforming, returning -1.4% (Bloomberg Barclays U.S. Treasury Index). Mortgage-backed securities and investment-grade corporates returned -1.2% and -1.0%, respectively.

Economically sensitive sectors of fixed income were boosted by equity market strength and a continued rally in the price of oil. High-yield bonds returned 0.4% and bank loans 1.1%. Preferred securities, with their above average interest rate sensitivity, were hit the hardest during the month, returning -2.1%. Unhedged foreign bonds, with the tailwind of a 3.3% decline in the dollar, returned 3.2%.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

FIXED INCOME PERFORMANCE



U.S. TREASURY YIELDS

Security	12/31/17	01/31/18	Change in Yield
3 Month	1.39	1.46	0.07
2 Year	1.89	2.14	0.25
5 Year	2.20	2.52	0.32
10 Year	2.40	2.72	0.32
30 Year	2.74	2.95	0.21

AAA MUNICIPAL YIELDS

Security	12/31/17	01/31/18	Change in Yield
2 Year	1.32	1.56	0.24
5 Year	1.58	1.81	0.23
10 Year	2.10	2.31	0.21
20 Year	2.64	2.83	0.19
30 Year	2.76	2.98	0.22

Source: LPL Research, Bloomberg, FactSet 01/31/18

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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.

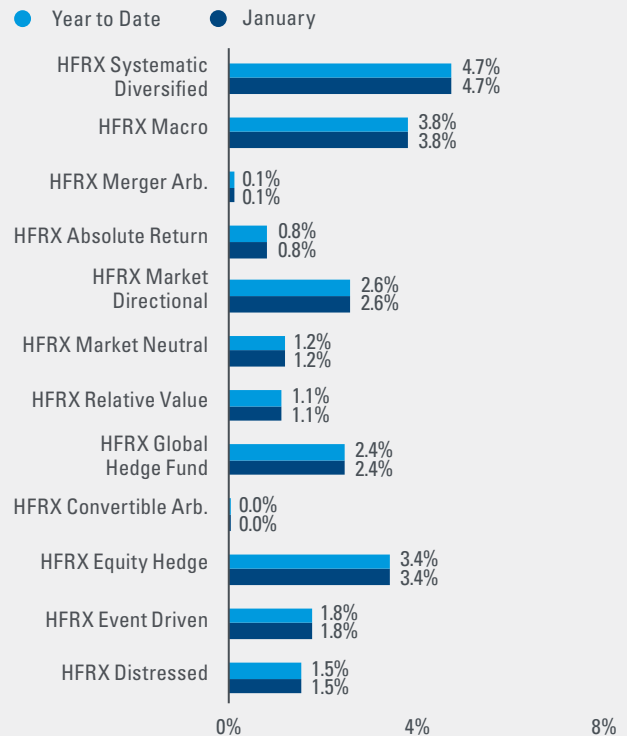
ALTERNATIVES: ALTERNATIVE STRATEGIES BEGIN 2018 IN THE GREEN

All alternative investment categories delivered positive returns to begin 2018, with the HFRX Systematic Diversified CTA Index (+4.7%) and the HFRX Equity Hedge Index (+3.4%) leading individual category gains.

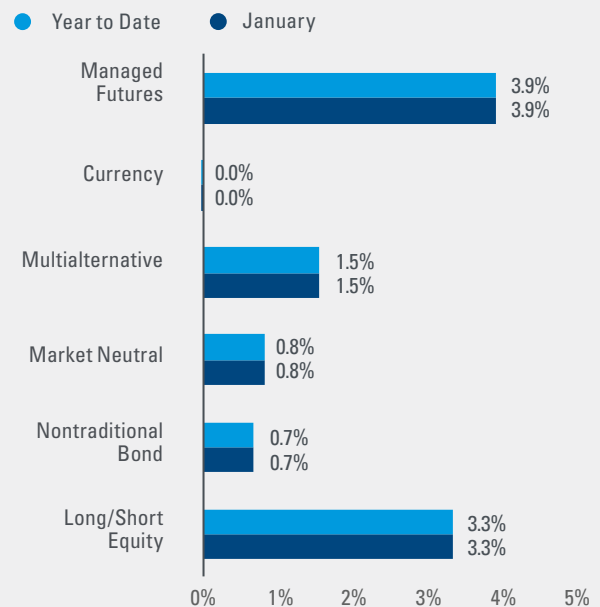
Returns within the long/short equity space were in line with the industries approximately 60.0% net long market exposure. Long exposure to the financials, consumer discretionary, and information technology sectors supported overall gains. Short exposure to more defensive, low-volatility sectors such as consumer staples and utilities also proved beneficial, as both underperformed the broader market. Gross market exposure, which consists of a fund's long positioning, plus their short exposure, has been marginally reduced, as many strategies have looked to cover short positioning due to the global market strength. The 3.4% return was the largest monthly return since December 2010 and 8th straight month of positive performance.

Within the managed futures category, long global equity exposure continued to drive gains, while short exposure to intermediate- and long-term fixed income holdings added to profits as interest rates continued their ascent. The recent increase in oil prices also contributed to gains and has acted as a strong source of positive diversification for many strategies. Suitable investors should remain mindful of the long equity exposure in most managed futures programs; this positioning is expected to remain in place to some degree until the market experiences a protracted drawdown. Historically, managed futures have delivered attractive returns relative to the equity market during sell-offs; however, until a more sustained negative trend develops, we expect there to be a positive correlation to equities for many of the intermediate-term trend followers. As previously mentioned, we continue to favor either multi-managers or a combination of uncorrelated trading strategies to smooth and diversify return profiles.

HFRX INDEX PERFORMANCE



MORNINGSTAR INDEX PERFORMANCE



Source: LPL Research, FactSet 01/31/18

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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.

REAL ASSETS: STRONG MONTH FOR MLPs AND INTERNATIONAL REAL ESTATE

January was a strong month for liquid real assets overall, though most had a hard time keeping up with the strong gains in global equities. Investors generally favored more economically sensitive investments over defensive, yield-oriented choices while a weaker U.S. dollar supported overseas returns. Master limited partnerships (MLP) and international real estate produced the category's best gains, while U.S. REITs suffered declines.

MLPs

Following up on a strong December, MLPs had another solid month in January as oil prices rose, investors got clarity on the tax law changes, and markets became increasingly comfortable with the industry's ongoing transition to self-funding models (rather than relying on the capital markets). Gains came despite slowing distribution growth prospects and rising interest rates.

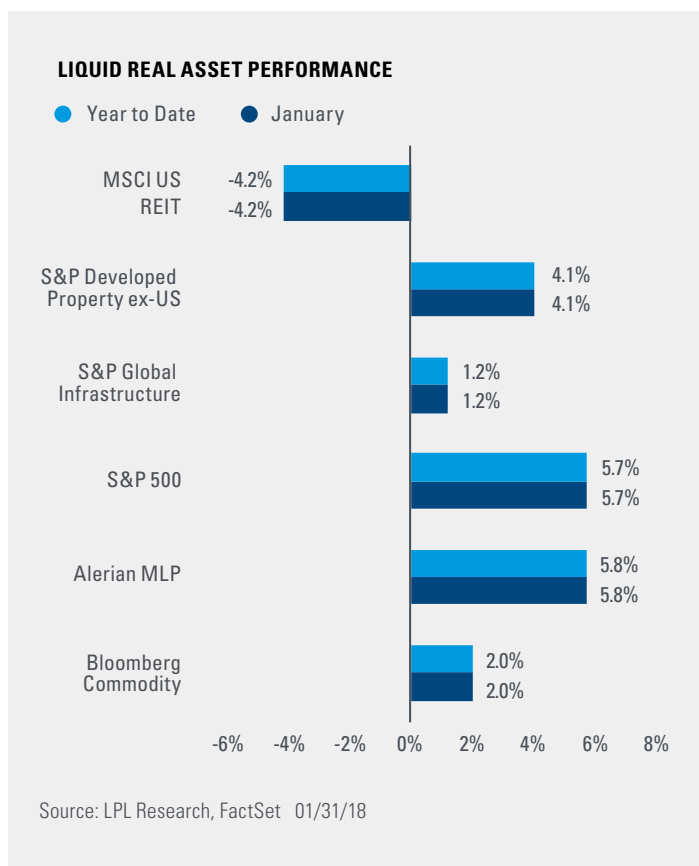
REITs & Global Listed Infrastructure

Domestic REITs significantly underperformed the broad equity markets to start the year, posting negative returns in January as cyclical sectors outperformed interest rate sensitives. The hotel/lodging sector, the only sector with a positive return for the month, performed relatively well, due in part to the sector's shorter-duration assets relative to other property types given the market's preference for less interest rate sensitivity as interest rates rose. Retail was the worst performing sector, particularly regional malls, which is a trend that persisted throughout most of 2017.

Although the S&P Global Infrastructure Index produced a positive return and outperformed REITs for the month, it also significantly underperformed the broad equity markets due to its greater interest

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Investing in MLPs involves additional risks as compared with the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights.



rate sensitivity and defensive characteristics. The index's industrials component generated positive returns, offset by weakness in the energy and utilities components.

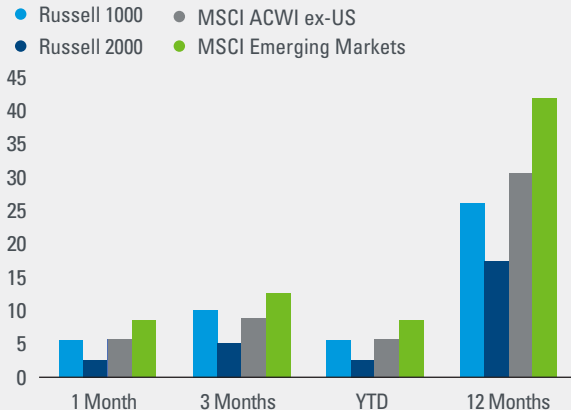
Commodities

The Bloomberg Commodity Index gained 2.0% in January driven by strong performance in energy and grains, supported by a weak U.S. dollar. Oil was particularly strong, with crude up more than 7% on continued solid demand, inventory drawdowns, and capped production overseas. Gasoline and natural gas were also higher. Agriculture, corn, soybeans, and wheat all positively contributed to overall performance in the index, while agriculture softs, including sugar and coffee were weak. Metals prices were mixed with modest gains for gold, while silver was little changed and copper and aluminum fell.

MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLP funds.

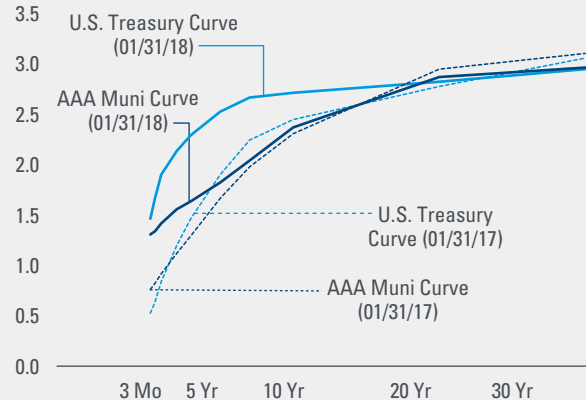
MONTHLY PERFORMANCE REPORT

EQUITY PERFORMANCE



Source: LPL Research, Bloomberg, FactSet 01/31/18

DOMESTIC YIELD CURVE



Source: LPL Research, Bloomberg, FactSet 01/31/18

		1 Mo	3 Mos	YTD	12 Mos
Large Cap	S&P 500	5.73	10.18	5.73	26.41
	DJIA	5.88	12.49	5.88	34.80
	Russell 1000	5.49	9.92	5.49	25.84
	Russell 1000 Value	3.87	8.61	3.87	17.22
	Russell 1000 Growth	7.08	11.19	7.08	34.89
Small/Mid Cap	Russell 2000	2.61	5.14	2.61	17.18
	Russell 2000 Value	1.23	3.17	1.23	9.95
	Russell 2000 Growth	3.90	7.00	3.90	24.90
	Russell Microcap	2.45	4.47	2.45	17.72
	Russell Midcap	3.76	8.25	3.76	20.08
	Russell Midcap Value	2.30	7.06	2.30	14.03
All Cap	Russell 3000	5.27	9.55	5.27	25.16
	Russell 3000 Value	3.67	8.20	3.67	16.65
	Russell 3000 Growth	6.84	10.87	6.84	34.11
International Markets	MSCI EAFE	5.02	7.86	5.02	28.20
	MSCI ACWI ex US	5.58	8.86	5.58	30.27
	MSCI Europe	5.41	7.28	5.41	30.35
	MSCI Japan	4.58	8.49	4.58	25.42
	MSCI AC Asia Pacific ex Japan	6.72	10.74	6.72	38.51
	MSCI EAFE SMID	4.92	8.76	4.92	32.83

		1 Mo	3 Mos	YTD	12 Mos
Int'l -Continued	MSCI ACWI ex US SMID	4.94	9.37	4.94	31.94
	MSCI Emerging Mkts	8.34	12.52	8.34	41.49
	MSCI EMEA	6.14	17.48	6.14	30.16
	MSCI Latin America	13.17	14.75	13.17	30.55
	MSCI Frontier Markets	5.73	10.33	5.73	31.17
Sectors -S&P 500 GICS	Consumer Discretionary	9.34	17.64	9.34	29.00
	Consumer Staples	1.59	9.72	1.59	13.42
	Energy	3.81	10.80	3.81	6.60
	Financials	6.48	12.36	6.48	29.79
	Healthcare	6.65	9.05	6.65	27.33
	Industrials	5.31	11.45	5.31	25.68
	Information Technology	7.63	8.87	7.63	43.11
	Materials	4.14	7.21	4.14	23.26
	Telecom Services	0.55	12.77	0.55	1.81
	Utilities	-3.07	-6.52	-3.07	7.32

Source: LPL Research, Bloomberg, FactSet 01/31/18

(Data continued on following page.)

All data represent total returns, where applicable. Information contained in this report is from sources deemed to be reliable. We cannot guarantee the accuracy or completeness of such information and we assume no liability for damages resulting from or arising out of the use of such information. Further, please note that past performance is not indicative of future results.

	1 Mo	3 Mos	YTD	12 Mos
BI BarCap US Agg	-1.15	-0.83	-1.15	2.15
BI BarCap 1-10 Muni	-0.40	-0.81	-0.40	1.83
BI BarCap HY Muni	-0.94	0.60	-0.94	7.16
BI BarCap Inv. Grade Credit	-0.96	-0.20	-0.96	5.08
BI BarCap Muni Long Bond -22+	-1.84	-0.12	-1.84	5.56
BI BarCap US Agg Securitized MBS	-1.17	-0.99	-1.17	1.31
BI BarCap US TIPs	-0.86	0.18	-0.86	1.27
BI BarCap US Treasury Intern	-0.98	-1.25	-0.98	-0.04
Fixed Income				
BI BarCap US Treasury Long	-3.23	-0.86	-3.23	4.62
BI BarCap US High Yield Loans	1.07	1.47	1.07	4.07
ML Preferred Stock Hybrid	-2.11	-1.15	-2.11	6.77
ML US High Yield BB/B Rated	0.43	0.37	0.43	6.23
ML US Convert ex Mandatory	2.94	2.84	2.94	15.84
JPM GBI Global ex US Hedged	-0.41	-0.01	-0.41	2.99
JPM GBI Global ex US Unhedged	3.15	5.46	3.15	11.83
JPM GBI-EM Global Div	4.48	8.39	4.48	17.72
JPM ELMI+	2.89	5.53	2.89	12.68
JPM EMBI+ Composite	-0.50	-0.69	-0.50	6.20

	1 Mo	3 Mos	YTD	12 Mos
HFRX Absolute Return	0.81	0.51	0.81	3.91
HFRX Market Directional	2.58	3.78	2.58	4.68
HFRX Convertible Arb.	0.01	0.90	0.01	6.44
HFRX Distressed	1.52	2.93	1.52	4.35
HFRX Equity Hedge	3.41	5.39	3.41	12.78
HFRX Market Neutral	1.19	0.51	1.19	2.18
Alternatives				
HFRX Event Driven	1.76	1.80	1.76	7.22
HFRX Merger Arb.	0.11	0.60	0.11	2.63
HFRX Relative Value Arb.	1.09	1.51	1.09	4.28
HFRX Global Hedge Fund	2.45	3.27	2.45	8.04
HFRX Macro Index	3.80	4.50	3.80	7.43
HFRX Systematic Diversified	4.73	8.21	4.73	12.03
Bloomberg Commodity	1.99	4.55	1.99	3.58
DJ Wilshire REIT	-3.96	-0.98	-3.96	0.51
Alerian MLP	5.76	9.28	5.76	-5.75

	Latest Mo End (01/31/18)	3 Mos Ago (10/31/17)	Latest Yr End (12/31/17)	12 Mos Ago (01/31/17)
Currency				
U.S. Dollar Index Value	89.13	94.55	92.12	99.55
USD vs. Yen	109.19	113.64	112.71	112.78
Euro vs. USD	1.24	1.16	1.20	1.08
Cmtyys				
Gold (\$ per Troy Ounce)	1345.00	1270.40	1302.50	1210.30
Crude Oil (\$ per Barrel)	64.73	54.38	60.42	52.81

Source: LPL Research, Bloomberg, FactSet 01/31/18

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