Montecito Bank & Trust® Wealth Management

JANUARY 2019 IN REVIEW

February Update | As of January 31, 2019

ECONOMY

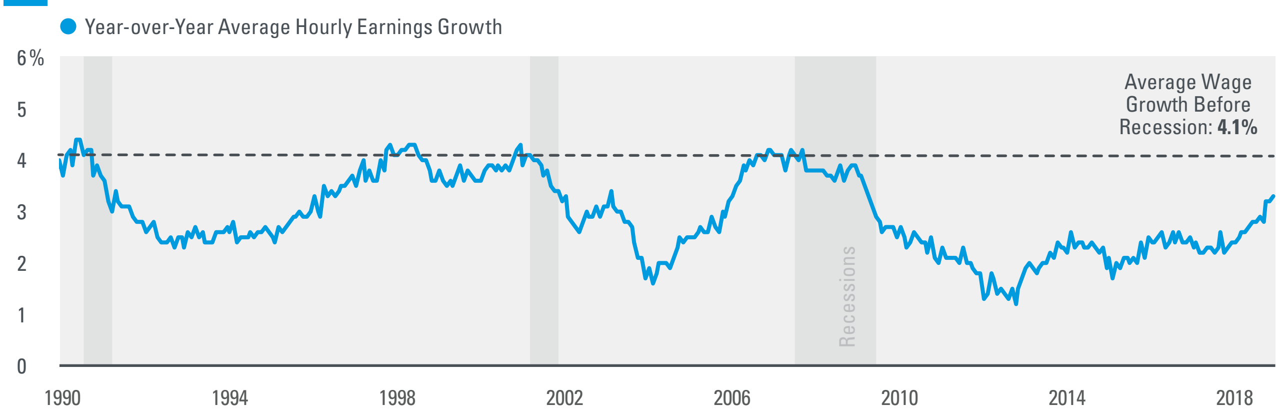
SOLID ECONOMY, BUT RISING UNCERTAINTY IN JANUARY REPORTS

January's reports painted a picture of a solid economy struggling with global uncertainty. The Conference Board's Leading Economic Index (LEI), an aggregate of ten leading indicators, declined 0.1% in December, but grew 4.3% year over year for 2018. While the LEI declined for the month, positive year-over-year momentum signaled low odds of recession in the coming year.

Still, data showed pockets of the U.S. economy weakened through the end of 2018. The Institute for Supply Management's (ISM) manufacturing Purchasing Managers Index (PMI), a gauge of U.S. manufacturing health, fell to its lowest level in two years in December. Although the level of activity was near average for the cycle, the magnitude of December's decline from the prior month was striking: The drop was the ISM PMI's biggest since October 2008. Markit's PMI fell to a 13-month low in December, confirming the decline in manufacturing. We see the ongoing trade dispute with China as the primary obstacle to corporate health, as some businesses have opted to put future expansions on hold until there is more clarity on the tangible and intangible effects of tariffs on demand and profits.

Rising economic uncertainty also weighed on business and consumer confidence data. In December, the Conference Board's Consumer Confidence Index fell the most since August 2011, while the National Federation of Independent Business's (NFIB) measure of business confidence slid for a third straight month. While the decline in confidence is discouraging, we expect eventual resolution to the U.S.-China trade dispute to help shore up consumer and business confidence.

1 SINCE 1990, NO RECESSIONS WITHOUT 4% WAGE GROWTH



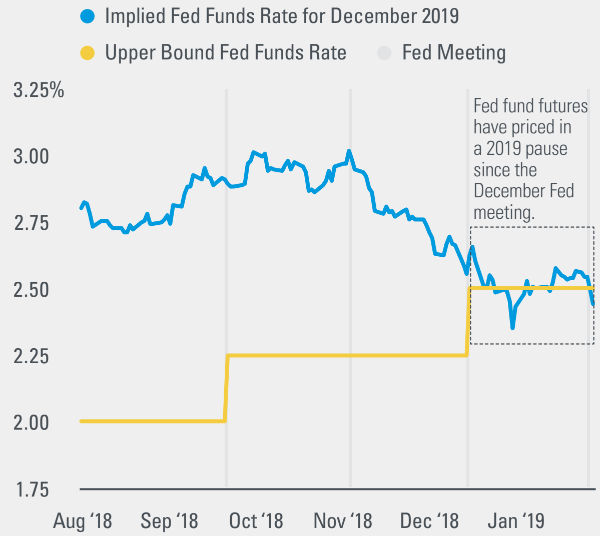
Source: LPL Research, Bureau of Labor Statistics 01/04/19

Economic recessions noted are from the National Bureau of Economic Research, which defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

Jobs data continues to be solid despite trade uncertainty. Nonfarm payrolls rose 312K in December, beating the median consensus estimate of 184K by a very healthy margin. The unemployment rate ticked up to 3.9%, but the labor force participation rate rose, indicating that more participants were enticed by solid labor market conditions to enter the workforce. Many of these new entrants are initially unemployed. Average hourly earnings grew 3.2% year over year in December, well below the 4% wage growth that has preceded economic recessions in the past [Figure 1].

Pricing gauges also showed that inflationary pressures remain manageable. The core Consumer Price Index, which excludes food and energy, increased 2.2% year over year, while the core Producer Price Index climbed 2.5% year over year. Core personal consumption expenditures, the Federal Reserve's (Fed) preferred inflation gauge, rose 1.9% year over year, just below policymakers' 2% target.

2 FED FUND FUTURES CALL FOR LONG-TERM FED PAUSE



Source: LPL Research, Federal Reserve, Bloomberg 01/31/19

The implied fed funds rate is a weighted average of fed fund futures' rate probabilities for the December 2019 Fed meeting.

Many economic releases were delayed by the partial government shutdown, adding to the uncertainty. Releases on durable goods, housing, trade, inventories, and the monthly budget statement were pushed off due to agency closures. The biggest delay was the fourth-quarter gross domestic product (GDP) report, which the Bureau of Economic Analysis postponed indefinitely. With the government now open, we expect to see the delayed data released in the coming weeks.

Fed Pauses in Response to Crosswinds

Fed policymakers reconvened in January and decided to leave interest rates unchanged. More significantly, they removed language from the Fed's policy statement that "some further gradual (rate) increases" would be consistent with economic conditions and added language that they would be "patient" when determining future rate adjustments. In the post-meeting press conference, Fed Chair Jerome Powell noted that the Fed based its decision on "crosscurrents and conflicting signals," including slowing growth in China and Europe, trade risk, elevated uncertainty, and deteriorating sentiment. However, Powell also emphasized several times that the U.S. economy is solid and inflation remains manageable.

Financial markets are now positioned for a pause in rate hikes through at least the end of this year [Figure 2]. We expect to see one or two more interest rate hikes this economic cycle, though not necessarily in 2019, if inflationary pressures build too quickly or other signs of excesses appear.

GLOBAL EQUITIES

STOCKS REBOUND IN BEST JANUARY SINCE 1987

Stocks followed an awful December with a very strong January. The S&P 500 Index returned 8% during the month, the best gain for the index since 1987. The Dow Jones Industrial Average (Dow) and Nasdaq Composite also enjoyed strong monthly gains of 7.3% and 9.8% respectively.

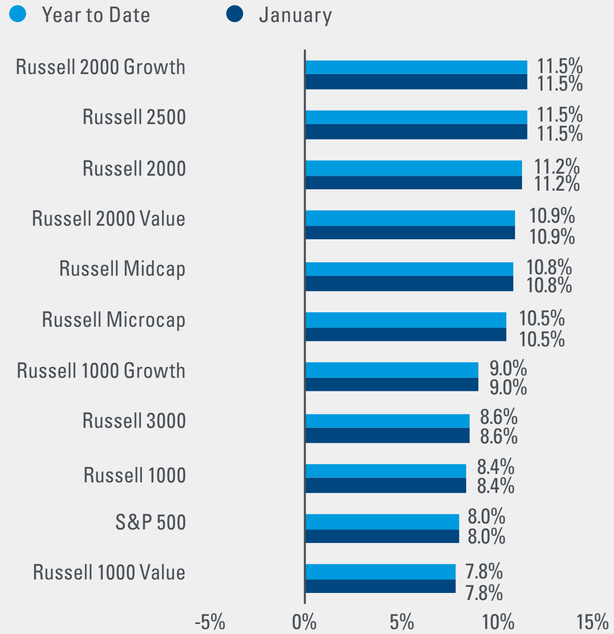
Buyers came into the market in force looking for bargains in the last week of December and throughout much of January. Stocks had reached extreme oversold levels and valuations had become attractive, enticing the bargain shoppers. A more accommodating Fed and progress on U.S.-China trade talks buoyed investor sentiment, offsetting a relatively muted start to fourth quarter earnings season, ongoing concerns about slowing economic growth overseas, and the longest government shutdown in U.S. history.

The ongoing U.S.-China trade dispute and a potential policy mistake by the Fed were likely the two biggest market concerns heading into 2019, and progress was made on both fronts. The Fed began communicating a more balanced approach throughout the month, capped off by a pause in rate hikes at its January 30 meeting, a reference to being patient, and a willingness to maintain flexibility in its balance sheet decisions. Markets cheered the Fed's revised message, sending the S&P 500 1.7% higher on the date of the decision.

On trade, reports suggested that U.S. and China trade officials made meaningful progress at meetings in Washington, D.C., in late January. Post-meeting communications pointed to another round of meetings midmonth, which would be followed by a potential meeting between President Trump and Chinese President Xi at the end of February. The progress increased optimism that tariffs would not be increased after the March 1 deadline and helped send stocks higher.

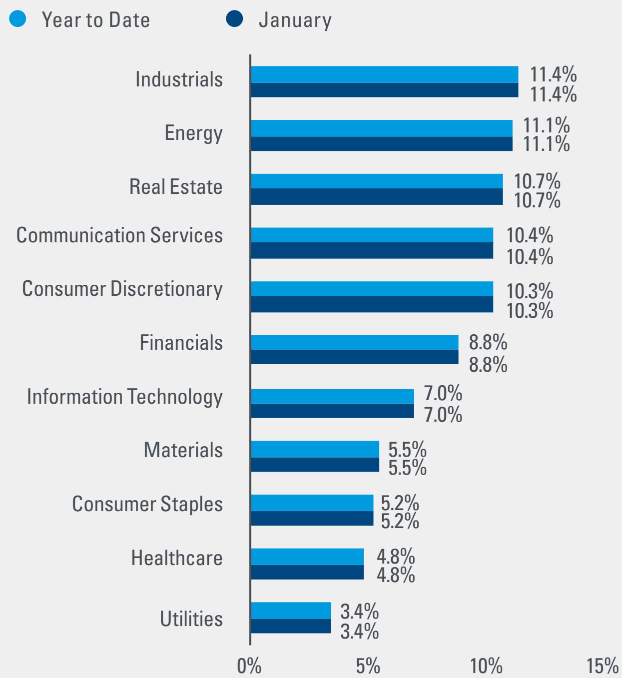
Small cap stocks outperformed their large cap counterparts in January, reflecting the

DOMESTIC INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 01/31/19

S&P 500 SECTOR PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 01/31/19

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.

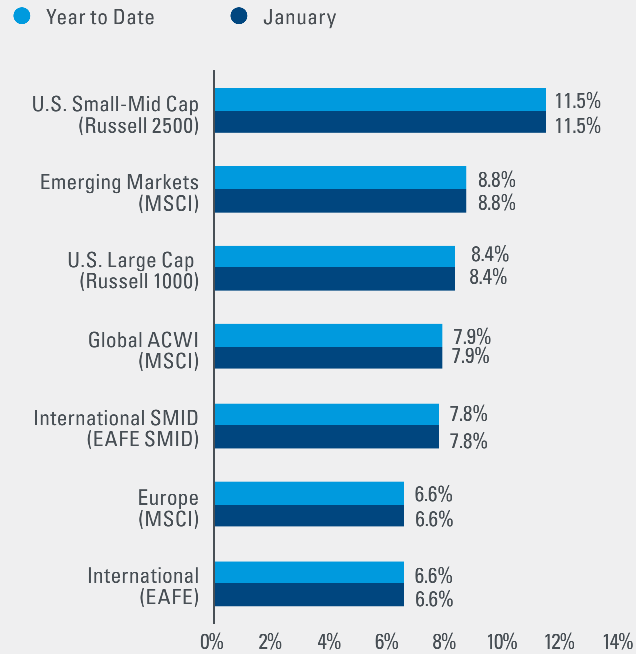
Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

market's confidence in improving economic and credit conditions. In a near-mirror image of December when large caps held up best and small caps lagged, the Russell 2000 Index returned 11.2%, above the 8.4% and 10.8% returns for the large cap Russell 1000 and Russell Midcap indexes.

Growth resumed its outperformance in January, as the Russell 1000 Growth Index returned 9% compared to the 7.8% return for the Russell 1000 Value Index. Growth stocks, which have generally performed better during rising markets in recent years and have outperformed most of the nearly 10-year-old bull market, benefited from outperformance of growth stocks within the communication services and healthcare sectors. The Value index was weighed down by underperformance by the utilities sector.

Progress in trade negotiations with China and the market's increased confidence in the global economic outlook helped propel industrials to the top of the January sector rankings. Energy finished a close second thanks to a big boost from rising oil prices—West Texas Intermediate (WTI) Crude rose nearly 20% during the month after sharp losses during the fourth quarter. Utilities were the biggest laggard as market participants favored more economically sensitive segments of the market and PG&E filed for bankruptcy protections.

GLOBAL INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 01/31/19

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International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

International

Developed market international equities were unable to keep up with U.S. and emerging markets (EM) equities during January, as the MSCI EAFE Index returned 6.6% for the month. The underperformance was driven by subpar economic growth in Europe and Japan, coupled with a less economically sensitive sector mix including a smaller allocation to technology and internet companies than the S&P 500. At the country level, despite entering recession during the fourth quarter, Italy was a top performer, while markets in Japan and France lagged (based on the MSCI country equity indexes). Brexit uncertainty had little impact on the U.K. stock market, which slightly outpaced the EAFE Index.

Progress on U.S.-China trade talks, prospects for fiscal stimulus, the Fed's rate pause, and rising commodity prices all helped buoy sentiment in EM equities during January as the MSCI Emerging Markets Index returned 8.8% during the month. The best country performers included Brazil, which is benefiting from reform prospects under President Jair Bolsonaro, as well as Russia, South Africa, and China. Laggards included markets in India and Taiwan.

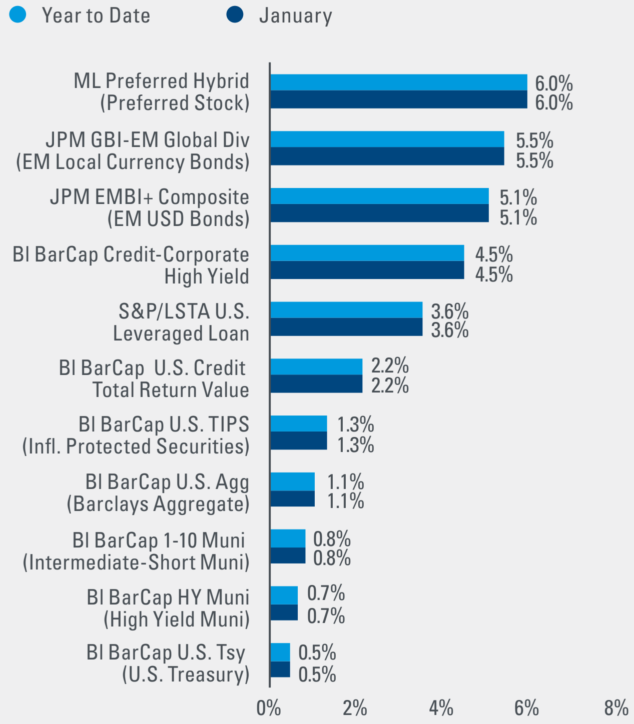
FIXED INCOME

TREASURY YIELDS DROP FOR THIRD STRAIGHT MONTH

Treasury prices jumped, while yields dropped for a third straight month in January amid the Fed's decision to leave rates unchanged and commitment to patience in tightening policy any further. The 10-year Treasury yield slid 6 basis points (bps) to end the month at 2.63%, after falling to a 12-month low of 2.55% on January 3. The yield curve flattened further, as the spread between the 2-year and 10-year yields fell to 17 bps (.17%).

All nine fixed-income classes we track rose in January (as shown in the Fixed Income Performance Table). Lower-quality fixed income generally outperformed higher-quality bonds as investors' risk appetites resurged after a rocky end to 2018. High-yield corporate bonds rose 4.5%, the sector's best month since October 2011, while bank loans gained 3.6%. Investment-grade corporate bonds, represented by the Bloomberg Barclays U.S. Aggregate Credit Index, rose 2.2%, while the broad Bloomberg Barclays U.S. Aggregate Bond Index increased 1.1%. Mortgage-backed securities climbed 0.8%, and Treasury prices rose 0.5%. EM debt climbed 4.4% in its best month since July 2012.

FIXED INCOME PERFORMANCE (Sorted by Monthly Return)



U.S. TREASURY YIELDS

Security	12/31/18	01/31/19	Change in Yield
3 Month	2.45	2.41	-0.04
2 Year	2.48	2.45	-0.03
5 Year	2.51	2.43	-0.08
10 Year	2.69	2.63	-0.06
30 Year	3.02	2.99	-0.03

AAA MUNICIPAL YIELDS

Security	12/31/18	01/31/19	Change in Yield
2 Year	1.82	1.70	-0.12
5 Year	2.05	1.93	-0.12
10 Year	2.51	2.43	-0.08
20 Year	3.03	2.97	-0.06
30 Year	3.17	3.11	-0.06

Source: LPL Research, Bloomberg, FactSet 01/31/19

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. 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.

ALTERNATIVE INVESTMENTS

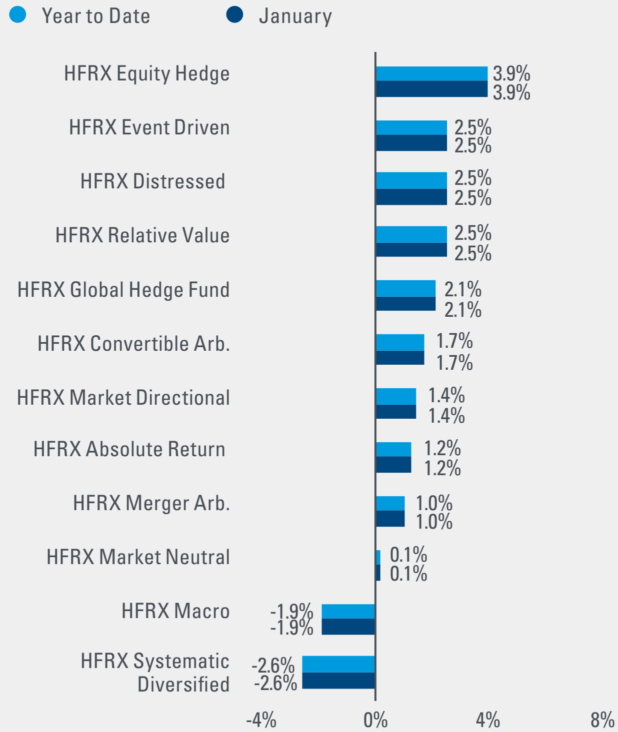
CONSTRUCTIVE START TO 2019

During January, long/short equity strategies performed in line with long-only benchmarks on a risk-adjusted basis, as the HFRX Equity Hedge gained 3.9% compared to the S&P 500 8% return. This represented an up-capture ratio of 48.6%, above the industry's beta of approximately 0.40, which indicates managers' added alpha. From a sector perspective, an overweight to industrials (11.4% during January) supported performance. The smaller performance gap between value (Russell 1000 Value Index, up 7.8%) and growth sectors (Russell 1000 Growth Index, up 9%) was also notable, as the recent outperformance of value by growth-related stocks has been a consistent headwind facing many strategies.

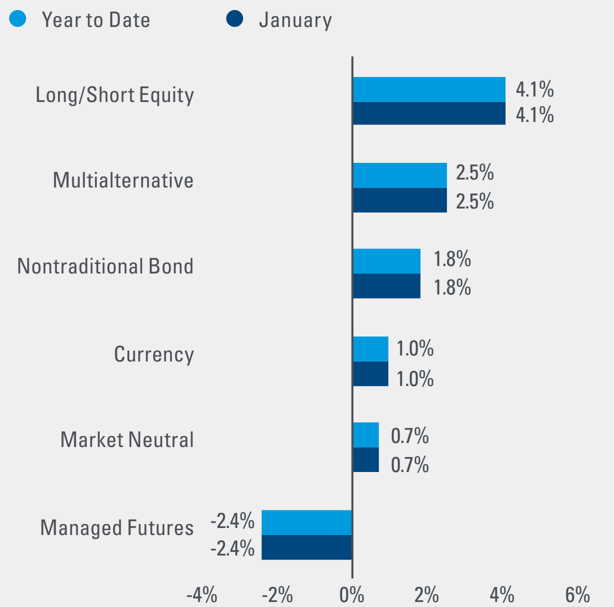
The HFRX Merger Arbitrage Index gained 1% during January. After receiving the proceeds of several large transactions at the end of 2018, managers have been slowly adding capital to new investments. Additionally, the U.S. government shutdown caused delays in the timetable of regulatory approvals, which has added additional uncertainty surrounding the pace of deal closings this year. Overall, the merger and acquisitions environment remains healthy; however, we're aware of the potential weakening impact of U.S. tax reform and ongoing trade conversations between the United States and China.

In the macro space, after a tremendous end to 2018, short equity exposure weighed on trend-following strategies, as the HFRX Systematic Diversified Index declined 2.6% during the month. Long bond exposure helped offset losses to a small extent, however, short equity exposure across most global indexes was difficult to overcome during such a broad-based rally. Relative value strategies continue to perform well on a risk-adjusted basis, as the HFRX Relative Value and HFRX Convertible Arbitrage Indexes gained 2.5% and 1.7%, respectively.

HFRX INDEX PERFORMANCE (Sorted by Monthly Return)



MORNINGSTAR INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 01/31/19

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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:
BROAD-BASED STRENGTH

The liquid real asset categories we track were all solidly positive in January, reversing December's declines. Master limited partnerships (MLP) and U.S. real estate investment trusts (REITs) delivered the biggest gains, while commodities lagged with a more modest advance.

Master Limited Partnerships

MLPs broke a four-month losing streak with sharp January gains, as the Alerian MLP index returned 12.6% during the month and outpaced the broad equity markets. The sharp rebound in oil prices was the primary catalyst for the advance, while the end of tax loss selling, a more stable interest rate outlook, and attractive valuations also provided support.

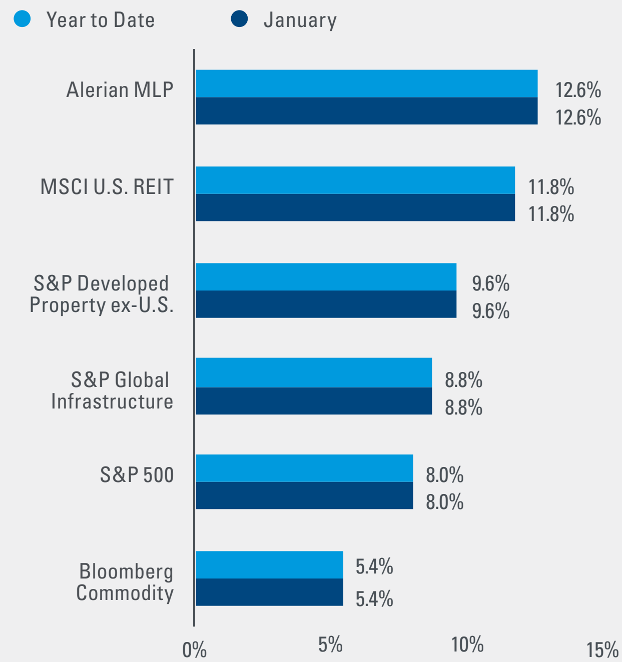
REITs and Global Infrastructure

In January domestic REITs rallied nearly 12%, outpacing the S&P 500, after struggling throughout most of 2018. Cyclical real estate sectors outperformed the domestic REIT index, with the industrials and office segments both outperforming by several percentage points. Residential and retail both underperformed the MSCI U.S. REIT index for the month, with retail continuing to face fundamental headwinds as more department stores announced store closures in January. International real estate, measured by the S&P Developed Property ex U.S. index, outperformed broad U.S. and global equities but trailed domestic REITs for the month.

The S&P Global Infrastructure Index roughly matched the broad U.S. equity market in January with its 8.8% return, marginally outperforming the S&P 500 while trailing domestic REITs by 3%. The sector was able to offset a modest performance headwind from lagging European and Japanese equity markets.

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.

LIQUID REAL ASSET PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 01/31/19

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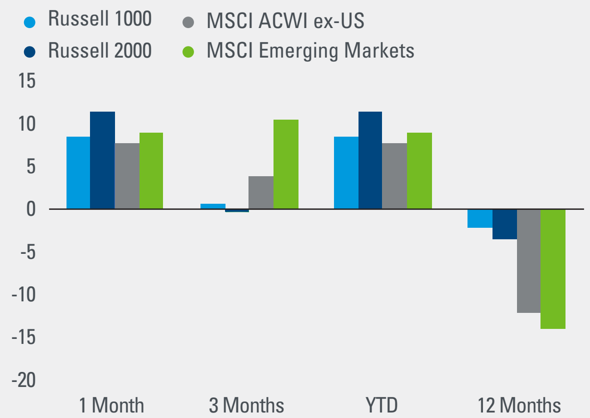
Commodities

The Bloomberg Commodity Index rose 5.5% in January, rebounding from a disappointing end to 2018. Crude oil again dominated the price action of other commodities. OPEC production cuts, the Venezuelan uprising, optimism over a U.S.-China trade resolution, and increased global fiscal stimulus prospects all pushed oil prices up 18.5% during the month. The latter two catalysts also drove modest gains in industrial metals. Precious metals continued their momentum higher, buoyed by residual volatility fears, rising inflation expectations, and an improving technical picture. Natural gas prices were the main detractor, down 4.3%, largely due to expectations of warmer February weather. Agriculture prices were flat to modestly positive, including soybeans, which have been one of the central elements in China trade negotiations.

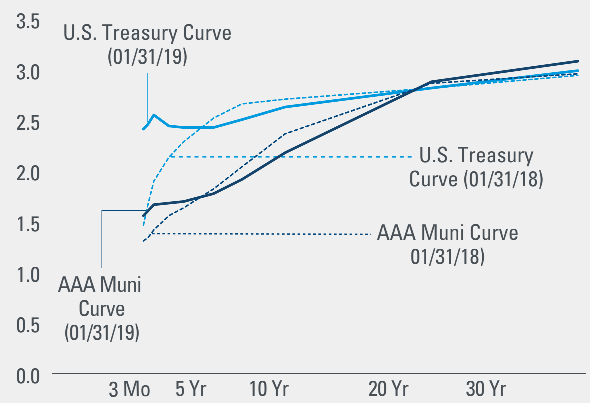
MONTHLY PERFORMANCE REPORT

EQUITY PERFORMANCE



Source: LPL Research, Bloomberg, FactSet 01/31/19

DOMESTIC YIELD CURVE



Source: LPL Research, Bloomberg, FactSet 01/31/19

		1 Mo	3 Mos	YTD	12 Mos
Large Cap	S&P 500	8.01	0.26	8.01	-2.31
	DJIA	7.29	0.14	7.29	-2.19
	Russell 1000	8.38	0.51	8.38	-2.17
	Russell 1000 Value	7.78	0.34	7.78	-4.81
	Russell 1000 Growth	8.99	0.68	8.99	0.24
Small/Mid Cap	Russell 2000	11.25	-0.41	11.25	-3.52
	Russell 2000 Value	10.94	-0.90	10.94	-4.51
	Russell 2000 Growth	11.55	0.06	11.55	-2.63
	Russell Microcap	10.49	-3.44	10.49	-6.26
	Russell Midcap	10.79	2.25	10.79	-2.90
	Russell Midcap Value	10.29	1.08	10.29	-5.43
	Russell Midcap Growth	11.49	3.95	11.49	0.51
All Cap	Russell 3000	8.58	0.45	8.58	-2.26
	Russell 3000 Value	8.00	0.26	8.00	-4.76
	Russell 3000 Growth	9.18	0.63	9.18	0.03
International Markets	MSCI EAFE	6.59	1.32	6.59	-12.07
	MSCI ACWI ex US	7.57	3.73	7.57	-12.14
	MSCI Europe	6.61	0.78	6.61	-13.35
	MSCI Japan	6.10	-0.56	6.10	-11.31
	MSCI AC Asia Pacific ex Japan	7.29	9.00	7.29	-13.22
	MSCI EAFE SMID	7.80	0.68	7.80	-14.34

		1 Mo	3 Mos	YTD	12 Mos
Int'l - Continued	MSCI ACWI ex US SMID	7.86	2.64	7.86	-14.41
	MSCI Emerging Mkts	8.76	10.32	8.76	-13.90
	MSCI EMEA	10.81	14.09	10.81	-11.82
	MSCI Latin America	14.96	11.63	14.96	-4.74
	MSCI Frontier Markets	4.76	3.90	4.76	-16.98
Sectors - S&P 500 GICS	Consumer Discretionary	10.30	3.90	10.30	1.71
	Communication Services	10.37	1.66	10.37	-3.99
	Consumer Staples	5.19	-2.54	5.19	-5.13
	Energy	11.11	-4.56	11.11	-12.34
	Financials	8.84	-0.73	8.84	-11.10
	Healthcare	4.84	2.57	4.84	4.67
	Industrials	11.41	3.32	11.41	-8.26
	Information Technology	6.96	-3.93	6.96	-0.90
	Materials	5.49	2.19	5.49	-13.59
	Real Estate	10.71	8.25	10.71	10.64
	Utilities	3.43	2.82	3.43	11.08

Source: LPL Research, Bloomberg, FactSet 01/31/19

(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
Fixed Income	BI BarCap US Agg	1.06	3.53	1.06	2.25
	BI BarCap US Credit Total Return Value	2.16	3.63	2.16	0.94
	BI BarCap 1-10 Muni	0.83	2.58	0.83	2.94
	BI BarCap HY Muni	0.67	2.25	0.67	6.46
	BI BarCap Inv. Grade Credit	2.35	3.68	2.35	0.75
	BI BarCap Muni Long Bond (22+)	0.56	3.22	0.56	2.79
	BI BarCap US Agg Securitized MBS	0.79	3.55	0.79	3.00
	BI BarCap US TIPS	1.35	2.39	1.35	0.93
	BI BarCap US Treasury Interm	0.43	2.64	0.43	2.85
	BI BarCap US Treasury	0.47	3.54	0.47	2.73
	S&P/LSTA US Leveraged Loan	3.56	-0.82	3.56	1.82
	ML Preferred Stock Hybrid	5.98	3.68	5.98	3.16
	BI BarCap Credit-Corporate-High Yield	4.52	1.40	4.52	1.73
	ML US Convert ex-Mandatory	6.91	3.31	6.91	4.53
	JPM GBI Global ex US Hedged	1.11	3.19	1.11	5.16
	JPM GBI Global ex US Unhedged	1.93	4.79	1.93	-2.84
	JPM GBI-EM Global Div	5.46	9.83	5.46	-5.33
	JPM ELMI+	2.71	5.15	2.71	-3.49
	JPM EMBI+ Composite	5.08	6.63	5.08	-0.01

		1 Mo	3 Mos	YTD	12 Mos
Alternatives	HFRX Absolute Return	1.22	-0.16	1.22	-0.08
	HFRX Market Directional	1.42	-0.68	1.42	-13.52
	HFRX Convertible Arb.	1.73	0.08	1.73	0.62
	HFRX Distressed	2.48	-0.53	2.48	-8.65
	HFRX Equity Hedge	3.92	-1.11	3.92	-8.97
	HFRX Market Neutral	0.13	-1.84	0.13	-4.18
	HFRX Event Driven	2.53	0.44	2.53	-11.00
	HFRX Merger Arb.	0.98	1.58	0.98	-1.05
	HFRX Relative Value Arb.	2.48	-0.25	2.48	0.19
	HFRX Global Hedge Fund	2.13	-0.46	2.13	-7.01
	HFRX Macro Index	-1.91	-1.34	-1.91	-8.57
	HFRX Systematic Diversified	-2.59	-1.65	-2.59	-11.72
	Bloomberg Commodity	5.45	-2.37	5.45	-8.23
	DJ Select US REIT	11.41	6.77	11.41	11.11
	Alerian MLP	12.64	1.25	12.64	-6.73

		Latest Mo End (01/31/19)	3 Mos Ago (10/31/18)	Latest Yr End (12/31/18)	12 Mos Ago (01/31/18)
Currency	U.S. Dollar Index Value	95.58	97.13	96.17	89.13
	USD vs. Yen	108.90	112.95	109.65	109.19
	Euro vs. USD	1.14	1.13	1.15	1.24
Cmdtys	Gold ($ per Troy Ounce)	1320.70	1214.10	1282.10	1345.00
	Crude Oil ($ per Barrel)	53.79	65.31	45.41	64.73

Source: LPL Research, Bloomberg, FactSet 01/31/19