Montecito Bank & Trust
Wealth Management

REOPENING OPTIMISM

MB&T's Monthly Global Review and Look Forward

May 2020

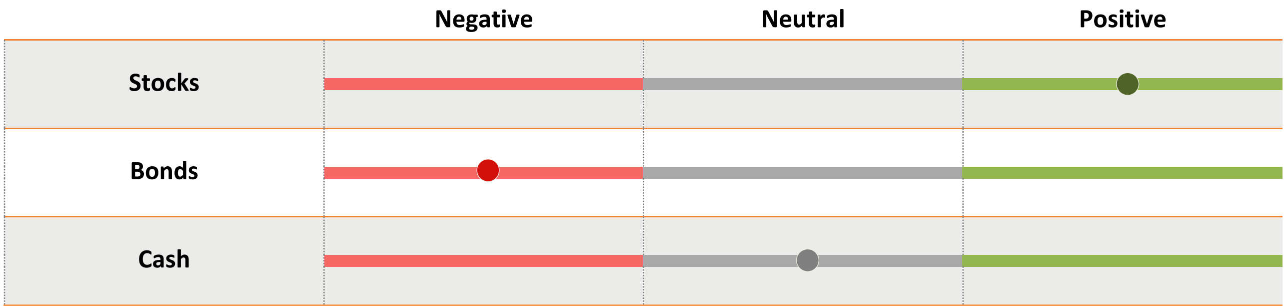
As May began, investors continued to try to reconcile the strong rebound in stocks with the devastating economic damage from COVID-19. Given the strength of the rally since the March lows, in our view, the risk of a correction in the short term has risen, supported by our *Road to Recovery Playbook*. Our intermediate- to long-term outlook for stocks remains positive.

INVESTMENT TAKEAWAYS

- **Our equities recommendation remains overweight**. Optimism around the re-opening of the US and global economies, coupled with massive fiscal and monetary stimulus, suggest a full retest of the March 23 lows may be unlikely. At the same time, however, stocks may be pricing in a V-shaped recovery that may be difficult to achieve, and a pullback appears likely.
- Our year-end 2020 fair value target for the **S&P 500 Index** of 3,150–3,200, based on a price-to- earnings multiple (PE) of 19 on $165 in normalized index earnings per share (EPS), in our view is reasonable, although the timing around achieving that level of earnings is very uncertain.*
- We favor **large cap stocks** for their greater potential resilience during the recession and recommend balanced exposure between growth and value styles in equity allocations where suitable.
- China has led the way out of the global crisis and supported **emerging market** equities, which we find attractively valued relative to **developed markets**.
- **Our fixed income view remains underweight**. While Federal Reserve (Fed) policy and current economic uncertainty may limit the risk of yields moving substantially higher, a likely second-half economic recovery may continue to support riskier assets as we look out a full year.
- We favor a blend of **high-quality intermediate bonds** with a modest underweight to **US Treasuries** and an emphasis on short-to-intermediate maturities with sector weightings tilted toward mortgage-backed securities.
- We have downgraded our views of the **financials** and **industrials** sectors and upgraded our **consumer staples** view to better position our lineup for the challenging near-term economic environment.
- We have upgraded our **mortgage-backed securities** (MBS) view from neutral to positive. Fed buying is expected to be supportive, risk from increased refinancing has receded, and spreads have not compressed as much as they did during previous periods of quantitative easing (QE).

Key changes from April's report: Upgraded consumer staples from negative to neutral; downgraded financials and industrials from positive to neutral.

BROAD ASSET CLASS VIEWS: MB&T’S VIEWS ON STOCKS, BONDS, AND CASH



OUR ASSET CLASS & SECTOR CHOICES

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
Emerging Markets Equities Large Cap Equities	Communication Services Healthcare Technology	Mortgage-Backed Securities	Precious Metals Event Driven

Data as of May 7, 2020.

2020 MARKET FORECASTS

COVID-19 Creates Significant Earnings and Interest Rate Uncertainty

	Previous Forecast	Base Case	Bear Case
10-Year Treasury Yield	1.25–1.75%	1.25–1.75%	0–0.5%
S&P 500 Earnings per Share	$158-162	$120-125	$110-115
S&P 500 Fair Value	3,150–3,200	3,150–3,200	2,400 or lower

2020 ECONOMIC FORECASTS

COVID-19 May Have Sparked a Global Recession

	April GPS Forecast	Base Case	Bear Case
U.S.	1.25–1.75%	-2% to -4%	-4% to -6%
Developed ex-U.S.	0.75–1%	-3% to -5%	-5% to -7%
Emerging Markets	3.75–4%	flat to 2%	-2% to flat
Global	2.5–2.75%	-2% to flat	-4% to -2%

EQUITIES ASSET CLASSES: FAVOR US LARGE CAPS AND EMERGING MARKETS

With a challenging road ahead for the US economy recovering from the pandemic, we favor large cap stocks with better balance sheets and greater earnings stability. Small caps possess early-cycle characteristics that historically have helped performance in bear market rallies, but we expect the economic recovery to be choppy. In the near term, growth stocks appear better positioned than value, but value may get support once the economic rebound gains steam. We believe the United States remains well positioned for a recovery, but China is leading the way out of the global economic crisis, which we expect to support emerging market equities.

	Asset Class	Neg	Neutral	Pos	Rationale
Market Cap	Large Caps			●	With a challenging road ahead for the US economy recovering from the pandemic, we favor **large cap stocks** with better balance sheets and greater earnings stability. **Small caps** possess early-cycle characteristics that historically have helped performance in bear market rallies, but we expect economic recovery to be choppy and continue to emphasize high- quality companies in our asset allocation. Small caps may lag in a potential correction following the latest rally, which we believe may have come too far, too fast.
	Small Caps	●			
Style	Growth		●		We maintain a balanced view of growth and value, with a slight preference for growth in the very short term as the market's bottoming process continues and the US economy begins to open. Relative valuations may help support **value** stocks as economic growth potentially begins to ramp up this summer.
	Value		●		Currently, with the US economy almost certainly in recession, the ability to grow earnings without much help from the economy and relatively stronger balance sheets favor **growth**. Growth companies may be in a better position to get through to the other side of this crisis stronger and take advantage of market opportunities.
Region	United States		●		Among developed markets, we remain US focused. We believe the US economy, bolstered by massive fiscal and monetary stimulus, is better positioned to recover from the COVID-19 pandemic in the second half of the year than Europe or Japan. US earnings growth is being significantly impaired by the lockdowns and social distancing, but we would anticipate US earnings outpacing those of Europe in a potential global economic recovery scenario.
	Developed International	●			We expect economies in **Europe** to contract more than the United States or Japan in 2020, although recent progress toward containing the COVID-19 pandemic in Italy, Spain, and especially Germany has been encouraging. In an eventual post-crisis economic recovery, fiscal deficits and populism may continue to weigh on sentiment, spending, and investment. Bloomberg's consensus forecasts for gross domestic product (GDP) growth in **Japan** are calling for a smaller contraction in 2020 than in Europe, even though structural reforms have had limited success and Japan came into the outbreak weaker than many of its major global peers. A return to growth may come later this year, supported by aggressive fiscal and monetary stimulus.
	Emerging Markets			●	**China** has led the way out of the global crisis and supported emerging market equities, which we find attractively valued relative to developed markets. They should return to pre- crisis economic growth rates before Europe, Japan, or the United States. We favor Asia over Latin America, where the pandemic recovery is much more challenged.

EQUITIES SECTORS: REPOSITIONING FOR CHALLENGES AHEAD

We have made several changes to our sector views this month to better position for a very challenging near- term economic environment. We have downgraded our financials and industrials views to neutral to reflect a significantly weaker earnings outlook than previously anticipated. Heightened risk of underperformance in a potential market correction and technical weakness are also concerns. We have also upgraded our consumer staples view to neutral due to the sector's earnings stability and improved relative valuations. We believe communication services, healthcare, and technology are the best positioned sectors for the current environment as the US economy begins to reopen amid unprecedented challenges.

	Sector	Neg Neutral Pos	S&P 500 Weight(%)	Rationale
Cyclical	Materials		2.6	China is holding up relatively well amid the global pandemic, but pressure on commodity prices due to the global demand shock is significant.
	Energy		2.9	COVID-19 demand shock created perhaps the biggest oil imbalance ever, leading to the first negative price for a WTI crude futures contract. We urge caution as defaults are poised to rise.
	Industrials		8.1	Significant hits to capital spending have led to a weaker-than-expected earnings outlook, while the technical analysis picture is negative.
	Communication Services		10.5	Several industries benefit from stay-at-home orders. Earnings outlook is relatively healthy and valuations are fair. Regulatory risk for internet companies remains.
	Consumer Discretionary		9.8	Excluding e-commerce, this is one of the most challenged sectors in the services-led recession. Fiscal stimulus and lower energy and interest costs provide a partial offset.
	Technology		25.0	Among best earnings outlooks of all equity sectors, it's supported by productivity enhancements via mobile, cloud, automation, and artificial intelligence (AI). Strong relative performer so far in 2020.
	Financials		11.4	Difficult environment with near-record-low Treasury yields, the fed funds rate at zero, and the US economy contracting. Tough downgrade given attractive valuations, but we prefer to be on the sidelines for now.
Defensive	Utilities		3.6	Valuations have become a bit more reasonable, but we expect interest rates to rise and favor healthcare and consumer staples among defensives.
	Healthcare		15.2	The pandemic strengthens an already bullish case, based on a strong healthcare spending outlook, favorable demographics, and steady earnings growth with high visibility.
	Consumer Staples		7.7	Among the best-positioned sectors to ride out the COVID-19 storms with attractive yields, relatively resilient revenue streams, and more reasonable relative valuations than in recent years.
	Real Estate		3.2	Fundamentals have deteriorated, particularly for the retail groups, and for office as well. There are pockets of strength in the healthcare, technology, and industrial segments.

FIXED INCOME: LIMIT RATE SENSITIVITY WITH INTERNMEDIATE FOCUS

We suggest a blend of high-quality intermediate bonds in tactical portfolios. We expect modestly higher long-term rates in 2020 as economic activity recovers in the second half of the year. Compensation for longer-maturity bonds remains unattractive, in our view, supporting our positive view of MBS over Treasuries. We still see incremental value in corporate bonds over Treasuries, but risks temper our view. We favor municipal bonds as a high-quality option for taxable accounts. Supply dynamics still look supportive, and valuations relative to Treasuries are historically attractive. Economic risks are elevated, and we are biased toward higher quality issuers.

Fixed Income Positioning		Low / Medium / High	Rationale
	Credit Quality		Valuations are attractive, but uncertainty merits some caution.
		Short / Intermediate / Long	Rationale
	Duration		We prefer below-benchmark interest-rate sensitivity due to historically low longer-maturity Treasury yields and prospects of a second-half economic rebound.

Sectors		Neg. / Neutral / Pos	Rationale
	U.S. Treasuries		Yield spreads to international sovereigns remain elevated but have narrowed. Valuations have become very expensive on COVID-19-related demand.
	MBS		Fed buying is supportive, spreads are wider than other QE periods, and risks from refinancing have receded. Remains a diversifying source of yield among high-quality options.
	Investment-Grade Corporates		Risks are elevated due to economic uncertainty, but valuations remain attractive. Favor high-quality non-cyclical issuers. Some support from the Fed.
	Preferred Stocks		Higher credit quality among the riskier fixed income options. Bank fundamentals firm prior to pandemic, but distributions optional and at increased risk.
	High-Yield Corporates		Fed support announced in April resulted in spread tightening. Valuations remain attractive, but we believe equities have more upside and high-quality options may be better diversifiers. More attractive for income-oriented investors.
	Bank Loans		Weaker investor protections and the end of rate hikes have reduced attractiveness, especially during a period of economic stress.
	Foreign Bonds		Rich valuations, interest-rate risk, and potential currency volatility are among the negatives.
	Emerging Markets Debt		Dovish central banks improve the valuation picture but may be vulnerable to COVID-19-related risk. Positive bias for second half of 2020.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk. **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. For the purposes of this publication, **intermediate-term bonds** have maturities between 3 and 10 years, and short-term bonds are those with maturities of less than 3 years.

All bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. **Corporate bonds** are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Investing in **foreign and emerging market debt (EMD)** 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. **High-yield/junk bonds** are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. **Municipal bonds** are subject to availability, price, and market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. **Mortgage-backed securities (MBS)** are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

COMMODITIES: FAVOR PRECIOUS METALS

We continue to favor **precious metals**, which are benefiting from safe-haven buying, lower interest rates, and massive stimulus from the Fed. Although the **US dollar** has generally been strong this year, it has weakened as stocks rallied off their March lows and may weaken further, potentially adding more support for precious metals, particularly **gold**.

Our neutral **industrial metals** view reflects near-term global recession risk; however, China appears to be leading the global economy out of the current crisis and may help provide near-term support for the industrial metal complex.

Our **crude oil** outlook remains negative despite progress in recent weeks toward balancing global supply and demand through production cut agreements from OPEC, Russia, and others. The lockdowns and travel restrictions remain a significant drag on global oil demand, while the economic recovery is likely to be choppy, particularly for travel. Although the latest rebound in WTI crude is encouraging and a global economic recovery in the second half of the year could shore up demand, the US supply overhang should eventually cap price gains if the rally goes much further.

ALTERNATIVE INVESTMENTS: EVENT-DRIVEN REBOUND FROM WEAK MARCH

The event-driven industry, which remains our preferred alternative strategy, rebounded from a weak March with its best monthly performance in more than seven years, as the HFRX Event Driven: Merger Arbitrage Index gained 5.2% in April. Managers in the space benefited not only from the broader equity market's gains but also from the recognition that many announced merger targets were trading at levels consistent with deals being terminated. As market participants gradually began to view the March selling in merger names to have been exaggerated, deal spreads tightened, and target stock prices moved up to reflect a more fundamental view of deal risk.

A LOOK BACK AT THE PRIOR MONTH

Economy: “Great Lockdown” Recession Reflected in Latest Data

Economic data released in April reflected the significant hit to the economy from the lockdowns related to containing the COVID-19 pandemic.

- **Conference Board’s Leading Economic Index (LEI)** fell 6.7% in March, registering the largest decline in the 60-year history of the indicator. The biggest detractors included jobless claims and falling stock prices. Leading indicators tumbled despite shutdowns affecting only the second half of the month.
- **Payrolls and Labor**. Nonfarm payrolls fell 20.5 million in April, following a historic and devastating stretch of job losses in which 33 million people filed for unemployment insurance in a seven-week period through May 1. The unemployment rate soared to nearly 15%, which may understate the true rate.
- **Inflation**. The demand shock caused by lockdowns pushed inflation lower in March. The core Consumer Price Index (CPI), excluding food and energy, declined 0.1% month over month in March—marking the first monthly decline since January 2010. Headline CPI fell 0.4% as oil prices tumbled. The headline Producer Price Index (PPI) fell 0.2% in March, while core PPI rose 0.2%. The annual increase in core personal consumption expenditures (PCE), the Fed’s preferred inflation gauge, dropped from 1.7% in February to 1.3% in March, well below the Fed’s 2% target.
- **US Consumer**. The Conference Board’s Consumer Confidence Index dropped sharply in April to 86.9, falling more than 30 points from the prior month. The expectations component of the report actually improved, reflecting increasing optimism surrounding reopening plans and stimulus measures. The most recent retail sales data for March revealed a month-over-month decline of 8.7%, reflecting the devastating impact of stay-at-home orders, business shutdowns, and travel restrictions.
- **US Manufacturing**. The effects of COVID-19 have not been limited to consumers, as April’s Institute for Supply Management (ISM) Purchasing Managers’ Index (PMI) plummeted 7.6 points to 41.5, a level consistent with prior recessions. Supply chain disruptions, which ordinarily are a sign of strong demand, propped up the reading, though the disruptions were caused by global lockdowns. The new orders component of the report narrowly missed the December 2008 record low.
- **US Business**. Capital investment fell sharply in March, though some measures were better than expected. US durable goods orders sank 14.4%, surpassing the consensus expectation of 11.9%. Excluding the hard-hit transportation sector, data improved slightly. Core capital goods orders (excluding transportation and defense) were the lone bright spot, rising a better-than-expected 0.1%. Several regional Fed surveys declined for the month, capturing the rapid decline in business sentiment.
- **Policy**. A $484 billion stimulus package was passed into law April 24 in support of small businesses and a stressed healthcare system. As part of its broad effort to support the economy, the **Fed** continued to expand its lending facilities while shifting its focus to municipalities and small businesses ailing from the effects of the lockdowns. Despite their active role in mitigating the economic impact of the lockdowns, Fed Chair Jerome Powell—and other central bankers—noted that while monetary support for the economy has proved beneficial, additional fiscal stimulus might be needed.

EQUITIES: IMPRESSIVE REBOUND

After a historic drop in March, the **S&P 500 Index** staged an impressive recovery in April. The index's 12.8% return for the month was its best since January 1987. Market sentiment was boosted by bold stimulus measures from policymakers, developing plans to reopen economies amid stabilizing COVID-19 case growth, and growing optimism surrounding possible treatments and vaccine candidates.

Stocks began the month deeply oversold from a technical analysis perspective while bargain hunters were likely attracted to low valuations.

Style/Capitalization

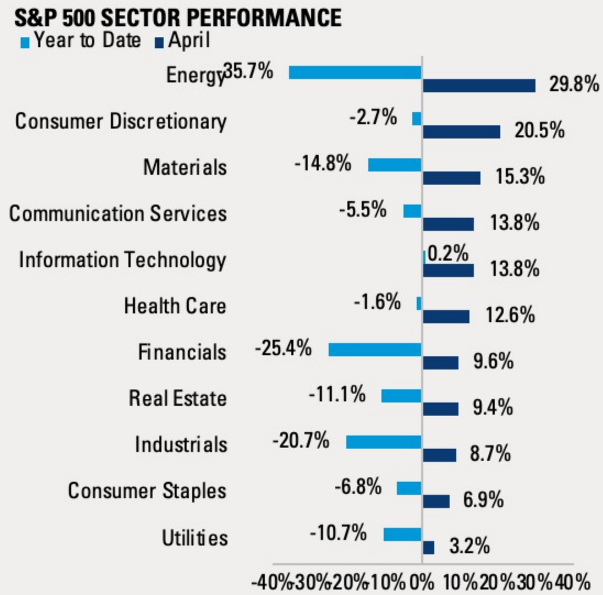
Large cap and **small cap** stocks posted similar gains in April despite small caps' generally greater economic and market sensitivity and tendency to bounce strongly from major market lows. **Growth** stocks paced the rally amid outperformance from key growth sectors— communication services, healthcare and technology—despite strong performance from **value**-oriented energy.

Global Equities

International developed and **emerging market** equities lagged behind the gains in the United States despite a weaker US dollar.

Emerging markets outpaced developed international markets, buoyed by strength in several key Asian countries.

International developed equities gained 6.5% for the month, based on the MSCI EAFE Index. Based on the MSCI EAFE country indexes, laggards included **France**, **Japan**, and **Switzerland**, while stocks in **Australia** and **Germany** outperformed. Emerging markets equities gained 9.2%, based on the MSCI Emerging Markets Index, led by markets in **India** and **Taiwan**, while **Brazil** lagged.



Source: FactSet 04/30/20
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.

FIXED INCOME: CORPORATE STRENGTH

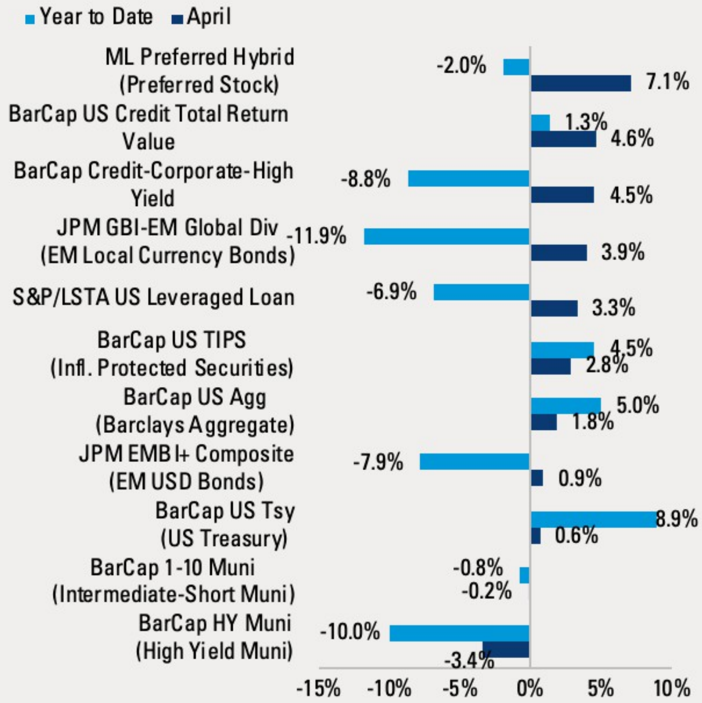
While equities rallied in April, Treasury yields barely budged. The **10-year Treasury yield** actually declined 6 basis points (0.06%) to end April near a record low of 0.64%. The Treasury yield curve remained relatively stable and remains upward sloping following the Fed's actions to lower short-term rates earlier in 2020.

The Fed's policy actions to support bond market liquidity seemed to spark a risk-on environment in fixed income markets. Investors favored spread opportunities in **investment-grade corporate bonds**, as shown in the Fixed Income Performance Table. The Bloomberg Barclays US Aggregate Bond Index (Agg) rallied 1.8% on corporate bond strength, while **Treasuries** were unable to keep pace. **Lower-quality bond sectors** rebounded in April, particularly high yield, emerging markets local currency debt, and bank loans. **Municipal bonds** lagged the returns of taxable bonds during April, as investors may have been looking for additional details on how the Fed would provide support to municipal bond markets.

COMMODITIES: CRUDE COLLAPSE

Commodities fell slightly overall in April. Most major agricultural prices were down for the month, while prices of other major commodity subsectors, both economically sensitive and defensive, rose amid increasing economic optimism among investors, bolstered by bold stimulus globally. Crude **oil** was the glaring exception, as a dramatically imbalanced market showed an unwillingness to accept physical delivery due to limited storage capacity, causing the near-term futures contract (May) to turn negative right before expiration.

FIXED INCOME PERFORMANCE



US Treasury Yields

Security	3/31/20	4/30/20	Change in Yield
3 Month	0.11	0.09	-0.02
2 Year	0.23	0.20	-0.03
5 Year	0.37	0.36	-0.01
10 Year	0.70	0.64	-0.06
30 Year	1.35	1.28	-0.07

AAA Municipal Yields

Security	3/31/20	4/30/20	Change in Yield
2 Year	1.27	1.06	-0.21
5 Year	1.31	1.31	0.00
10 Year	1.62	1.81	0.19
20 Year	2.08	2.33	0.25
30 Year	2.21	2.45	0.24

Source: FactSet 04/30/20

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.

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