Montecito Bank & Trust® Wealth Management

SEPTEMBER 2018 IN REVIEW

October Update | As of September 30, 2018

ECONOMY:

ROBUST SEPTEMBER ECONOMIC DATA, AS FED HIKES RATES

Economic Data

Overall, economic reports released in September—mostly reflecting economic activity in August—indicated solid U.S. economic growth without significant inflationary pressures, though wage gains bear monitoring. The Conference Board's Leading Economic Index (LEI), an aggregate of 10 leading indicators, increased 0.4% in August and 6.4% year over year, signaling low odds of recession in the coming year.

August's jobs report, released on September 7, reflected robust labor market growth. Nonfarm payrolls rose 201,000 in August, higher than consensus estimates of 190,000 and July's reading of 157,000. While growth in nonfarm payrolls is tapering off, the slowdown is expected as the economic cycle matures. Meanwhile, the unemployment rate held steady at 3.9%, the lowest level since 2000. The percentage of workers quitting their jobs jumped to a 17-year high. Generally, a high quit rate is viewed positively as it signals employees are confident about finding better job opportunities.

Pricing and wage data showed inflationary pressures remain manageable. Data for the preferred gauge of the Federal Reserve (Fed)—core personal consumption expenditures (PCE) (excluding food and energy)—remained unchanged at 2% growth year over year. This annual reading is in line with the Fed's implicit annual inflation target, but other headline inflation gauges show inflation remains well below levels reached in previous tightening cycles. The Consumer Price Index (CPI) rose 0.2% month over month, while core CPI rose 0.1% monthly and 2.2% year over year. Headline and core Producer Price Index (PPI) readings fell 0.1% month over month, but have grown 2.3% year over year. Average hourly earnings came in above consensus, rising 0.4% month over month, which tracked to 2.9% annual growth—the highest growth rate of the economic cycle. Labor is typically the largest cost component for companies, and wages can be a harbinger of building inflationary pressures. In spite of the high readings, the 2.9% annual earnings growth remains below the 4% level that has preceded recessions in the past.

1. MANUFACTURING STRENGTH IS A BELLWETHER FOR ECONOMIC GROWTH AND STOCK GAINS

ISM Peak Date	Beginning of Recession	Months from ISM Peak to Beginning of Recession	Cumulative S&P 500 Performance from ISM Peak to Beginning of Recession
Jul 1978	Feb 1980	18	12.9%
Nov 1980	Aug 1981	9	-12.6%
Dec 1983	Aug 1990	80	95.6%
Oct 1994	Apr 2001	77	164.5%
May 2004	Jan 2008	44	23.0%
	Average	45.6	56.7%
	Median	44	23.0%
	Max	80	164.5%
	Min	9	-12.6%

Source: LPL Research, Bloomberg 10/05/18

Manufacturing reports showed strength, though the impacts of tariffs are becoming visible in the data. The Institute for Supply Management (ISM) Purchasing Managers' Index (PMI), which has historically been a bellwether for economic growth, jumped to 61.3 in August, its highest level since May 2004 [Figure 1].

ISM's New Orders gauge jumped 8.1%, its strongest monthly growth since August 2014. Domestic orders drove the multi-year high in ISM PMI, while international orders declined month over month. In our view, this shows that U.S. fiscal stimulus continues to outweigh any negative implications of tariffs on manufacturing.

The ISM's Non-Manufacturing (Services) Index climbed to 58.5, recovering from disappointing July data. NFIB's Small Business Optimism gauge rose to a record 108.8 last month. Perhaps most encouraging was that the percentage of surveyed firms expecting to increase capital expenditures rose to its highest level since 2007. Capital expenditures are associated with productivity gains per unit of labor, and when worker productivity increases, wage growth tends to follow.

Economic reports reflected a healthy U.S. consumer. The Conference Board's consumer confidence survey hit an 18-year high, while personal spending rose 0.3% in August, in line with consensus expectations. Consumer spending accounts for about 70% of U.S. gross domestic product, so a healthy consumer is an important support of output.

Housing data continued to be a relative weak spot for the U.S. economy. Existing home sales, which account for 85-90% of home sales, were flat month over month at 5.34 million in August. Housing prices, represented by the S&P CoreLogic Case-Shiller 20-City Composite, rose 5.9%, lower than consensus estimates of 6.2% growth. Housing starts grew 9.2% in August, which was higher than expected, but building permits declined 5.7% month over month, the largest pullback since February 2017.

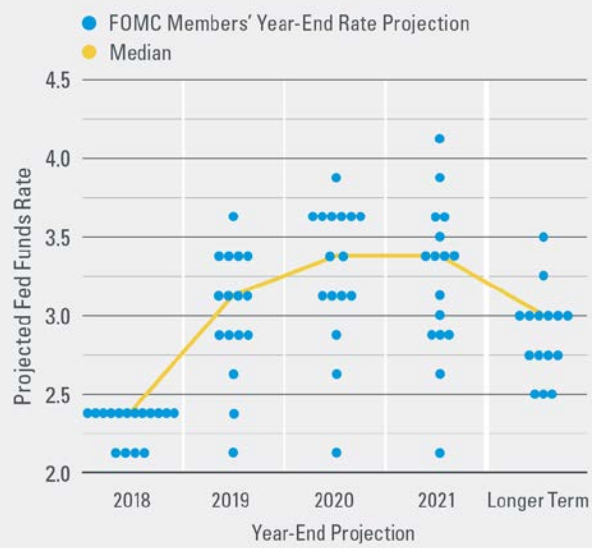
Fed Raises Key Rate, as Expected:

The Fed announced it would raise the fed funds rate to a range of 2-2.25% following the conclusion of its meeting on September 26, an outcome the markets widely anticipated. In our view, the Fed's updated rate projections and an important change in its policy statement were the more interesting takeaways.

The most recently released dot plot [Figure 2] implies that policymakers expect one more rate hike in 2018 and three more in 2019. The dots also show that members expect the fed funds rate to peak at 3.38% at the end of 2020 before declining into a "longer-term" rate of 3%.

Moreover, the Fed removed the word "accommodative" from its description of its monetary policy in the September 26, 2018, statement, another signal that rates may be approaching a neutral level. According to Fed Chair Jerome Powell, this reflects that policy is moving in line with the Fed's expectations.

2. FED'S LATEST DOTS PROJECT FOUR MORE RATE HIKES BEFORE END OF 2019



Source: LPL Research, Bloomberg 10/05/18
Economic forecasts may not develop as predicted.

GLOBAL EQUITIES:

ANOTHER SOLID MONTH FOR U.S. STOCKS AMID TRADE FEARS

U.S.

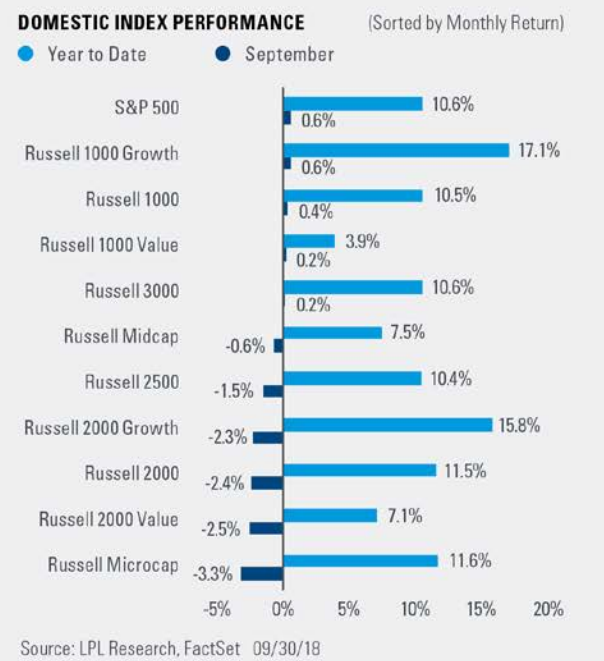
Stocks rose for the sixth straight month, as the S&P 500 Index returned 0.6% in September, capping off a solid third quarter in which the index rallied more than 7%. Among the major averages, the Dow Industrials fared best during the month with a 2.0% return, outpacing the S&P 500, Nasdaq Composite (-0.7%), and small cap Russell 2000 Index (-2.4%). The Dow's gain, which led to its first record high since January 2018, is particularly impressive given the Composite's focus on multinationals that are more impacted by tariffs. The S&P 500 returned 10.6% year to date through September, ahead of the Dow's 8.8% return, but behind gains in the Russell 2000 (11.5%) and Nasdaq (17.5%).

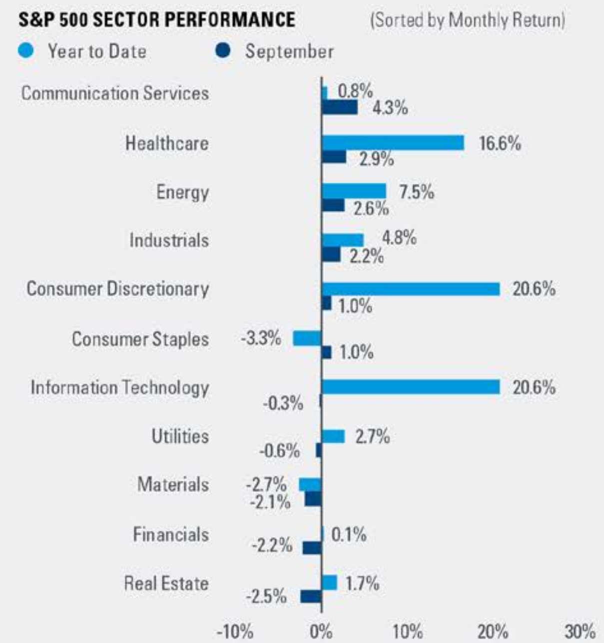
A strong U.S. economy was the key driver of the market's recent gains. GDP grew at a very strong 4.2% annualized pace in the second quarter and is expected to grow a solid 3% in the third, based on Bloomberg consensus forecasts. Manufacturing activity remains robust, business and consumer confidence is high, job growth remains steady, and corporate America continues to deliver earnings growth that is among the strongest in decades. These factors enabled stocks to offset several headwinds, notably trade tensions.

Stocks resiliently sailed through other headwinds, extending the longest bull market ever. Consider that:

- The Fed is expected to raise rates again in December after hiking in September for the eighth time this cycle.
- Long-term interest rates have risen, but the yield curve stayed flat in what some believe may be a sign of future economic weakness.
- The upcoming midterm elections bring policy risk.
- Pockets of stress are still present in emerging markets.

Turning to market leadership, large cap stocks outperformed their smaller counterparts, as the Russell 2000 Index lost 2.4% in September. Gains in more globally focused large caps likely reflected some renewed optimism that trade deals would be reached with China





Source: LPL Research, FactSet 09/30/18

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.

and our other major trading partners. Rising interest rates, which have tended to favor larger cap companies, may have also played a role. Year to date through September, the Russell 2000 Index returned 11.5%, slightly more than the larger cap S&P 500 and Russell 1000 indexes.

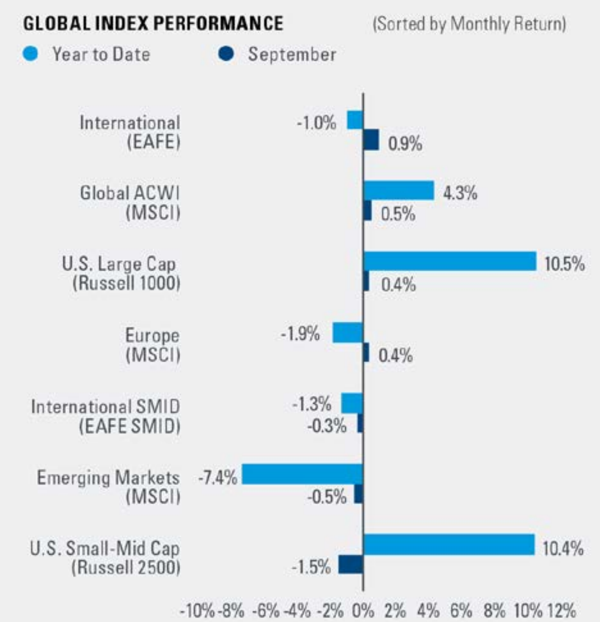
Growth stocks outperformed value for the second straight month in September, though by a slim margin. The Russell 1000 Growth Index returned 0.6%, compared with 0.2% for the Russell 1000 Value Index. The most heavily weighted sectors within growth (technology) and value (financials) both underperformed, but technology performed better in support of growth. The Russell 1000 Growth Index still holds a significant lead over its value counterpart this year, returning 17.1% through the end of September compared with 3.9% for the value index.

Sector performance was mixed during the month, with six up and five down. Interestingly, telecom topped all sectors during its first month after a significant revamp. Renamed and reconstituted as communications services, the sector returned 4.3% in September, outpacing healthcare (2.9%) and energy (2.6%), based on S&P GICS sectors. On the flip side, financials lost 2.2% for the month as banks continue to struggle with the flat yield curve, while rising interest rates weighed on real estate.

International

The international developed equity benchmark, the MSCI EAFE Index, produced a modest September gain of 0.9%, slightly outpacing the S&P 500. A rebound in economic growth in Japan and a weakening yen currency—which helps Japanese exporters—drove much of the gain in the international index, although the U.K. also provided support despite ongoing Brexit uncertainty. On the flip side, German stocks fell during the month as economic growth in the Eurozone slowed and tariffs weighed on the auto sector. The 1% year-to-date loss for the MSCI EAFE Index, which is well behind the S&P 500, has been driven mostly by weakness in the U.K., Germany, and Japan.

After a rough August, emerging markets (EM) stabilized in September as currencies firmed. The MSCI EM Index was still down, losing 0.5% for the month, adding to a difficult year that has seen the asset class lose 7.5% year to date amid U.S. dollar strength and pockets of stress. Turkey, Russia, and Brazil were September's top EM performers, while Russia, Taiwan, Thailand, and Mexico have been among the best performing EM countries this year. Recession has led to substantial year-to-date losses—over 20%—in South Africa, while weakness in China and South Korea has also weighed on the broad EM index in 2018.



Source: LPL Research, FactSet 09/30/18

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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.

FIXED INCOME:

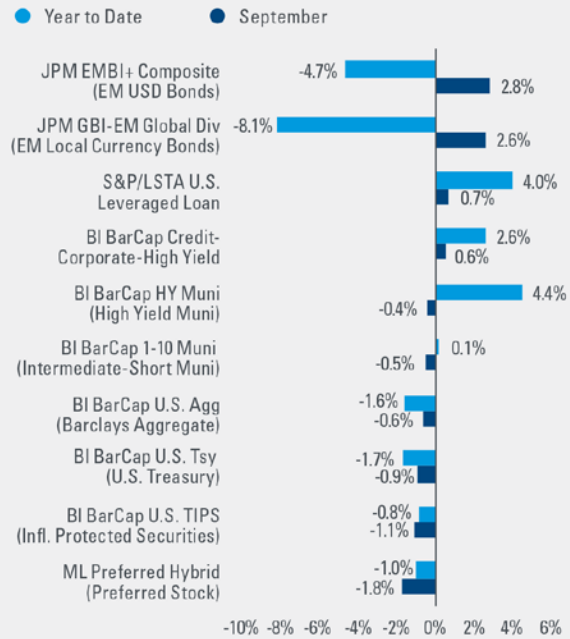
TREASURY YIELDS SURGE AMID STRONGER WAGE GROWTH, TRADE TENSIONS

Rates across the Treasury curve rose in September. The 10-year Treasury yield climbed 20 basis points (bps) in the month, reaching a high of 3.10% on September 25. Longer-term yields benefitted from data showing an acceleration in wage growth in August and a renewed appetite for risk at the end of last month. On September 18, the 10-year yield jumped the most since May after the United States threatened to raise the rate on $200 billion in tariffs if no trade deal is reached by the end of the year, encouraging investors that a U.S.-China trade agreement would be reached by then. The curve flattened further, as the spread between the 2-year and 10-year yields fell to 24 basis points (0.24%) through the end of the month.

The move higher in rates last month weighed on high-quality fixed income. Treasuries dropped 0.9%, their biggest slide since January, while the Bloomberg Barclays Aggregate Bond Index slid 0.6% in the month. Mortgage-backed securities

fell 0.6%, and investment-grade corporates decreased 0.3%. Economically sensitive, lower credit quality sectors were boosted by strong equity market performance. High yield climbed 0.6% in September for a fourth straight monthly gain, while bank loans climbed 0.7%. Emerging-market (EM) debt rose 1.3%, rebounding after currency turmoil and trade tensions weighed on EM debt in August. Unhedged foreign bonds were the worst performer, declining 1.1% as pronounced dollar strength was a headwind on returns.

FIXED INCOME PERFORMANCE (Sorted by Monthly Return)



U.S. TREASURY YIELDS

Security	08/31/18	09/30/18	Change in Yield
3 Month	2.11	2.19	0.08
2 Year	2.62	2.81	0.19
5 Year	2.74	2.94	0.20
10 Year	2.86	3.05	0.19
30 Year	3.02	3.19	0.17

AAA MUNICIPAL YIELDS

Security	08/31/18	09/30/18	Change in Yield
2 Year	1.66	1.84	0.18
5 Year	1.99	2.16	0.17
10 Year	2.46	2.58	0.12
20 Year	2.93	3.07	0.14
30 Year	3.07	3.19	0.12

Source: LPL Research, Bloomberg, FactSet 09/30/18

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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.

ALTERNATIVES:

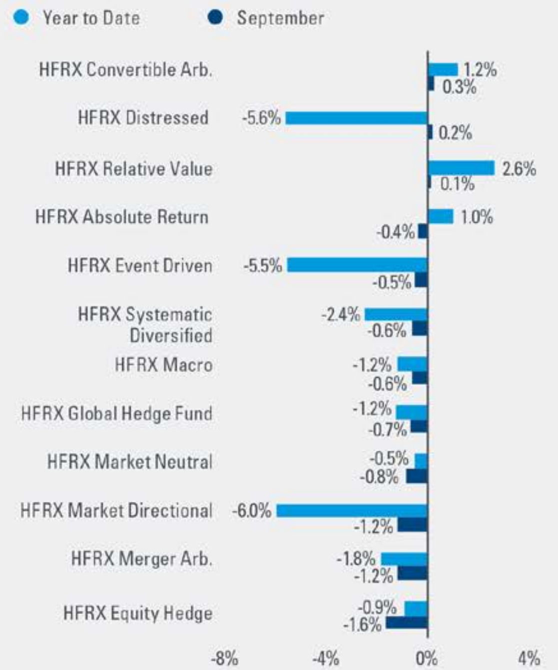
CONVERTIBLE ARB HOLDS UP WELL AS RATES INCREASE

Overall, alternative investment performance was disappointing in September, with only the HFRX Convertible Arbitrage Index (+0.3%) and HFRX Distressed Securities Index (+0.2%) delivering noteworthy gains at the subcategory level. With interest rates backing up over the course of the month, convertible arbitrage's limited duration profile held up well, while the interest received on cash from short positioning also increased alongside broader market rates. Gains in the distressed space were more idiosyncratic in nature and not specific to any one sector. Positive performance in Puerto Rican–related debt continued to add value for the managers who maintain those positions.

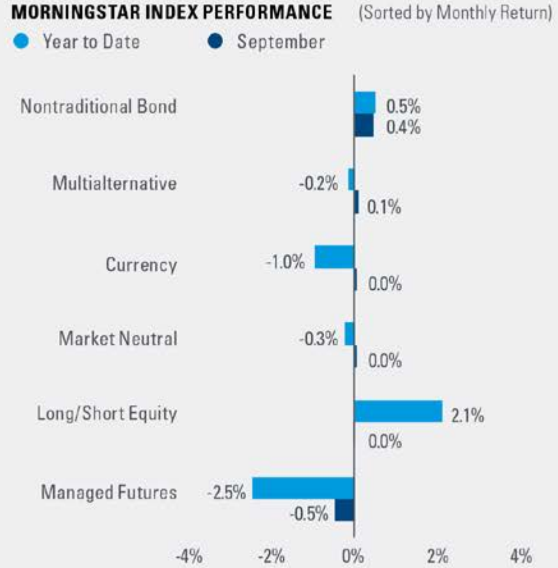
On the macro front, the HFRX Systematic Diversified CTA Index gave back much of the previous month's positive performance as the index fell 0.6% and has now declined 2.4% for the year. Losses were concentrated in equity and bond allocations, as short equity positioning in select developed European and emerging markets weighed on performance. Additionally, long holdings across intermediate and longer-dated U.S. Treasuries led to losses. Long positioning across the energy complex helped offset these losses to a small extent as crude and heating oil futures contracts increased in value.

As measured by the 1.6% loss in the HFRX Equity Hedge Index, long/short equity managers delivered disappointing returns even as most global developed equity markets rallied. A sell-off in momentum-related securities weighed on the long books of many strategies, while price increases in short holdings also detracted from overall performance. Year to date, the HFRX has now declined 0.9%, with a majority of the relative weakness originating during the past two months.

HFRX INDEX PERFORMANCE (Sorted by Monthly Return)



MORNINGSTAR INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 09/30/18

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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:

WEAKNESS IN REAL ESTATE, INFRASTRUCTURE HIGHLIGHT CHALLENGING MONTH

Most liquid real asset categories fell during September, with U.S. real estate investment trusts (REITs) suffering the largest decline. Commodities were the lone bright spot, with a solid gain for the month.

Master Limited Partnerships

Master limited partnerships (MLP) broke a two-month winning streak, as the Alerian MLP Index lost 1.6% in September. The month's losses brought the year-to-date return to 5.9%. Higher oil and natural gas prices and solid energy production trends were not enough for the group to offset the rise in interest rates that has historically weighed on MLPs. The group was also likely negatively impacted by policy risk related to a proposition on the November 6 ballot in Colorado that would tighten industry regulations, along with some—though manageable—disruption from hurricane Florence.

REITs & Global Listed Infrastructure

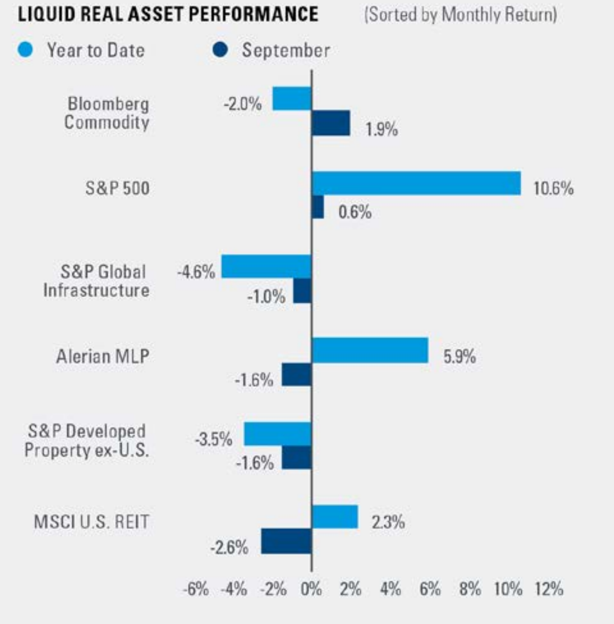
Domestic REITs lagged all other major real asset categories, including international REITs, during September as the MSCI U.S. REIT index lost 2.6%. Year to date, domestic REITs have lagged the S&P 500 Index by about eight percentage points but have outpaced international REITs, global infrastructure, and commodities. Rising interest rates and the market's preference for more cyclical sectors are the primary reasons for U.S. REIT underperformance. Within the REIT sector, industrial and office REITs outperformed while healthcare and data center REITs lagged.

The S&P Global Infrastructure Index fell 1.0% during September, bringing its year-to-date decline to 4.6%, including dividends. Performance within the utility sector was the most noteworthy detractor, as the rise in interest rates weighed on returns. Year to date, the S&P Global Infrastructure Index now trails the global equity benchmark MSCI ACWI Index by more than eight percentage points.

Commodities

Commodities broke a three-month losing streak in September. The Bloomberg Commodity Index rose 1.9%, with gains in energy and industrial metals prices offsetting losses in precious metals. Crude oil prices surged higher amid the anticipation of tightening global supply, primarily from impending Iran sanctions. Copper edged higher during the month, likely aided by reports of new Chinese economic support measures, while precious metals fell, hurt by sustained U.S. dollar strength. U.S. trade negotiations fueled intra-month volatility in agriculture prices. Corn and soybeans rose slightly during the month, while wheat prices dropped. The Bloomberg Commodity Index was down 2.0% year to date through the end of September.

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.



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