Montecito Bank & Trust®
Wealth Management

Wealth Office:
JEFF PITTMAN
EVP, DIRECTOR OF WEALTH MANAGEMENT
1106-E COAST VILLAGE ROAD
MONTECITO, CA 93108

THE ECONOMY AT A GLANCE

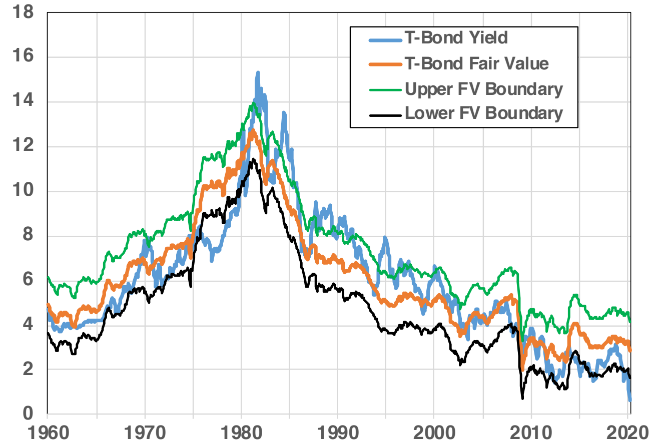
ECONOMIC HIGHLIGHTS

August 3, 2020
Vol. 87, No. 109

BONDS EXTREMELY OVERVALUED

Our Treasury Note Yield Model is signaling that bond yields are too low based on the fundamentals, though not necessarily on sentiment. Our current 10-year T-bond fair value yield is 2.85%. The normal valuation range has a floor of 1.6% and a ceiling of 4.1%. The current 10-year bond yield is around 0.66%. On asset allocation, we think that bonds remain fully valued compared to stocks and recommend that long-term investors under-weight fixed-income. We break the fixed-income portfolio component into four areas: Core, such as the industry benchmark ETF AGG or Treasuries; Inflation-Indexed; Opportunistic, such as securitized debt, corporate debt, high-yield or floating-rate bonds; and Cash. We favor the Core and Opportunistic categories with medium-term maturities.

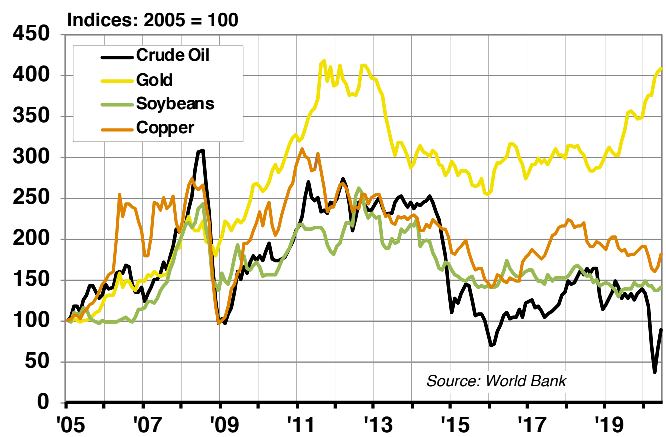
TREASURY NOTE YIELD MODEL (%)



COMMODITY PRICES START TO RECOVER

Commodities investors are accustomed to volatility. Since the lows reached in April, oil has more than doubled and copper is up almost 15%. We think underlying long-term economic fundamentals are favorable for most commodities (except oil), but expect ongoing volatility due to the coronavirus. A stable or falling dollar would help. With the virus still spreading, risk remains high and our sector recommendation for Basic Materials is Under-Weight. The current market weighting of the sector is 2.5%, and we think investors should consider exposure of just 2% in diversified portfolios. We recommend well-managed, financially strong industry leaders that are able to take market share during challenging periods for the Chemical, Metals, Ag and Paper industries.

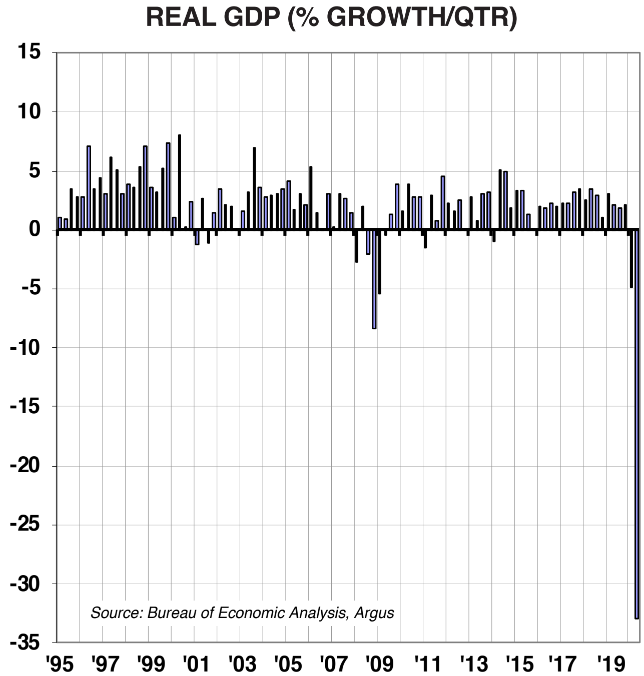
COMMODITY PRICE TRENDS



Peter Madlem, SVP / Chief Investment Officer .... (805) 560-3428 • pmadlem@montecito.bank
Drew Brahos, SVP / Sr. Portfolio Manager .... (805) 979-4473 • dbrahos@montecito.bank
Kathleen Kalp, SVP / Sr. Portfolio Manager .... (805) 564-7327 • kkalp@montecito.bank
Rick Weber, VP / Portfolio Manager .... (805) 686-8620 • rweber@montecito.bank
Scott Estby, SVP / Sr. Portfolio Manager .... (805) 564-7303 • sestby@montecito.bank
Thomas Fisher, SVP / Sr. Portfolio Manager .... (805) 560-3429 • tfisher@montecito.bank
Luca Romani, Investment Operations Manager .... (805) 560-3497 • lromani@montecito.bank

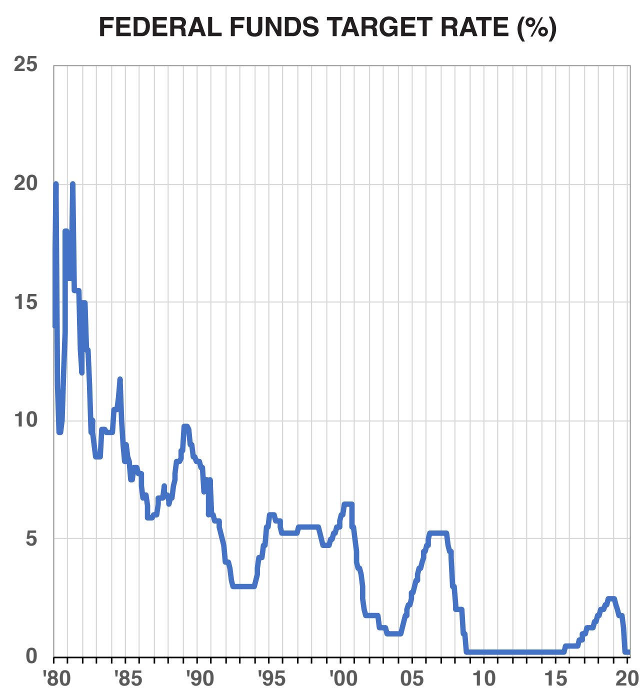
GDP PLUNGES 32.9% IN 2Q

The U.S. economy contracted at an astonishing 32.9% rate in 2Q20, as the nation shut down to combat the coronavirus. Here are some of the stark numbers. Personal Consumption Expenditures plummeted 35%, led by a 44% drop in spending on Services, as the country sheltered in place. Private Domestic Investment fell 49%, including a 38% plunge in Equipment, as the oil and gas industry suffered. Exports were down 64%. The positives? Very few. Consumer Spending on Durable Goods declined "only" 1.4% and Investment into Intellectual Property Products fell "only" 7.2%. Federal Government Spending surged 17%, including a 40% increase in Nondefense Spending, reflecting Congress' $2.3 trillion spending program. A 53% decline in Imports also supported GDP. This is likely (hopefully) the worst quarter, as most of the country was shut down for at least several weeks. That said, some states that had reopened parts of their economies are closing down again as coronavirus cases surge. There will be an economic comeback, and it might start as early as next quarter – but we expect GDP to be impacted by the pandemic well into 2021.



RATES VERY LOW FOR VERY LONG

The Fed has announced that it expects to keep interest rates at the current level of 0-0.25% until it is "confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." So the policy is now open-ended. But that doesn't mean the central bank won't be busy. The Fed will leave intact all of its funding programs through the end of the year, and extend repo operations and dollar liquidity swaps through March 2021. The central bank will also continue to purchase large amounts of U.S. Treasuries and agency mortgage-backed securities, effectively "controlling" longer-term rates as well. These moves will keep mortgage rates at or near the current 3% level. The Fed has no plans to purchase equities, as it feels that buying corporate bonds is its way of supporting the equity markets. One thing we don't expect the Fed to do is to lower interest rates below zero. Although that strategy has been implemented in some countries, it is not clear to Chairman Powell that the tool works. Further, he does not think it is appropriate in the U.S. given the country's dependence on money-market mutual funds.

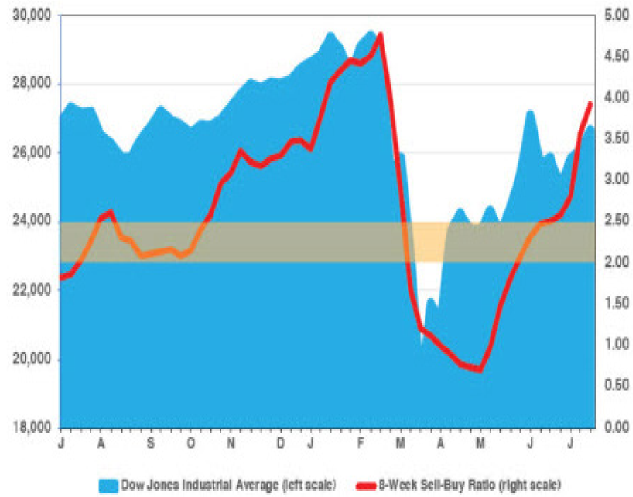


FINANCIAL MARKET HIGHLIGHTS

INSIDER SENTIMENT BENIGN

With earnings season in full swing, corporate insiders are largely prohibited from trading shares in the companies at which they work (remotely, no doubt). That said, Vickers Stock Research continues to monitor the insider transactions that do occur, and to provide barometers of insider sentiment. Vickers' longest-term indicator is the overall Insider Index, which has been in a tight and clearly neutral range for the past seven weeks. Next up are the eight-week readings, which are expressed via Sell/Buy ratios. Vickers' Total Eight-Week Sell/Buy Ratio is 3.92. That's technically bearish, but not overwhelmingly so and very much to be expected after insiders were exceptionally bullish when stocks first crashed on pandemic fears. Overall, there are no major red flags here -- but also no signal to "sell everything you own" in order to purchase equities.

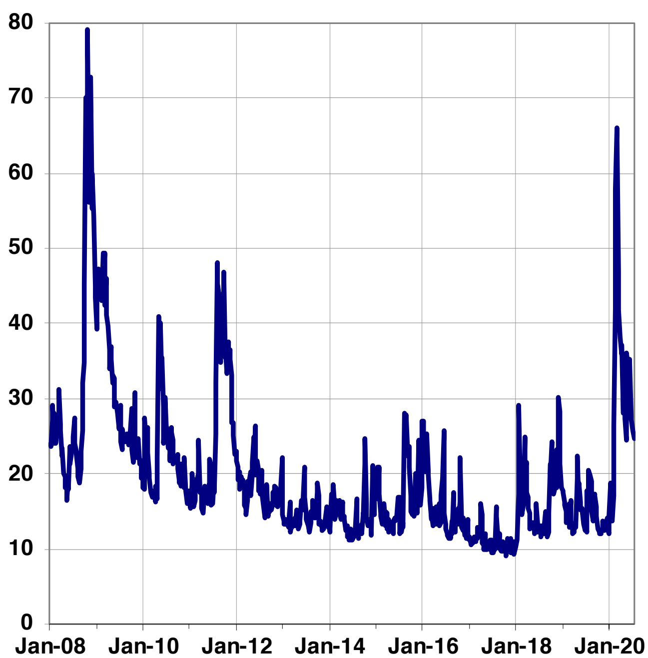
VICKERS TOTAL 8-WEEK SELL/BUY RATIO VS DJIA



VOLATILITY REMAINS, DESPITE STRONG JULY

The VIX Volatility Index lifted off in February, soared in March, and remains elevated. Investors should expect volatile market conditions through at least the balance of 2020. This forecast fits in with our "Three Levels of Recovery" theory. We look for public health to recover first, with widespread COVID-19 testing; treatment options by the fall; and a vaccine in late 2020/early 2021. The second level of recovery will be the economy, helped by the government, which we think is almost certain to approve another rescue package. We look for historically weak economic numbers in 2Q20 and 3Q20 before the economy moves back to flat-line in 4Q and grows again 2021 (recovering to precoronavirus levels by the end of 2021). The third level of recovery will be earnings and the stock market. Second-quarter results are thus far pointing to a 35%-40% year-over-year decline. But investors are less focused on the latest numbers and more on the outlook. Stock investors have anticipated a turnaround in earnings and have bid shares higher even before the economy grows again. But the path has not been straight higher, and investors should brace for volatility in the months ahead.

VOLATILITY INDEX (WEEKLY CLOSE)



ECONOMIC CALENDAR

Previous Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
3-Aug	ISM Manufacturing	July	52.6	52.6	53.6	**54.2**
	Construction Spending	June	**-1.7%**	1.0%	1.0%	**-0.7%**
4-Aug	Factory Orders	June	**7.7%**	5.0%	5.0%	**6.2%**
5-Aug	International Trade	June	-54.6b	-54.0b	**-50.2**	NA
	ISM Non Manufacturing	July	57.1	55.0	**55.0**	NA
7-Aug	Non Farm Payrolls	July	4800k	3000k	**1500k**	NA
	Manufacturing Payrolls	July	356k	375k	**280k**	NA
	Average Work Week	July	34.5	34.4	34.4	NA
	Average Hourly Earnings	July	-1.2%	-0.5%	-0.5%	NA
	Unemployment Rate	July	18.0%	11.0%	11.0%	NA
	Consumer Credit	June	18.28b	**10.00b**	**10.00b**	NA

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
17-Aug	Empire Manufacturing	August	17.2	NA	NA	NA
18-Aug	Housing Starts	July	1,186 K	NA	1,230 K	NA
20-Aug	Leading Economic Indicators	July	2.0%	NA	NA	NA
	Philadelphia Fed BOS	August	24.1	NA	NA	NA
21-Aug	Existing Home Sales	July	4.72 mln.	NA	5.35 mln.	NA