



Montecito
Bank & Trust®
Wealth Management

December 2018 IN REVIEW

January Update | As of December 31, 2018

ECONOMY:

SIGNS OF STRONG U.S. ECONOMY CLOUDED BY MARKET VOLATILITY

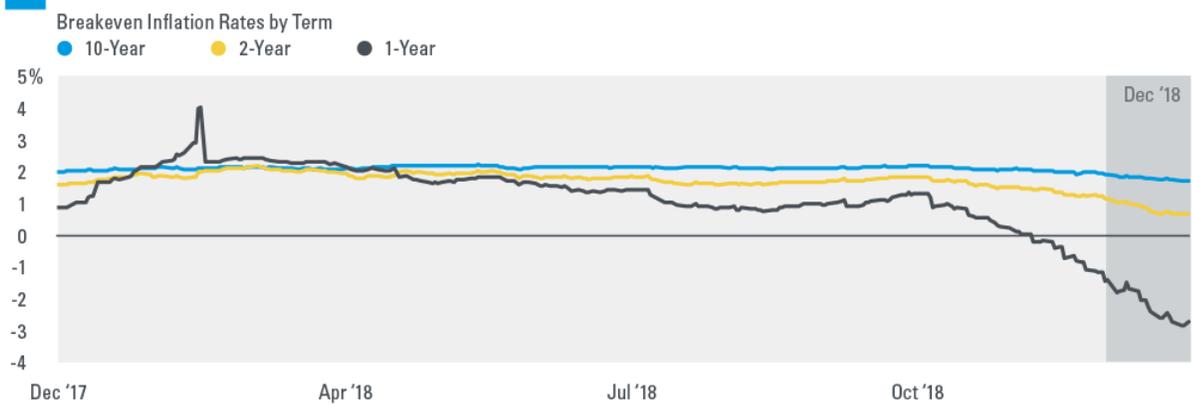
Economic trends generally improved in December, even amid some of the most significant financial market volatility of the bull market. The Conference Board’s Leading Economic Index (LEI), an aggregate of ten leading indicators, increased 0.2% in November and 5.2% year over year. While LEI growth slowed for a second month, positive momentum signaled low odds of recession in the coming year.

Still, signs of economic strength last month were clouded by U.S. stocks’ worst monthly performance since February 2009. In the month, investors became more anxious about the economic landscape given an ongoing U.S.-China trade dispute, signs of slowing global demand, and the Federal Reserve’s (Fed) monetary policy tightening. Both short-term and long-term inflation breakeven rates, or the difference between the yields of nominal Treasuries and those of Treasury Inflation-

Protected Securities, dropped significantly in December as investors positioned for the possibility of slowing price and wage growth amid growing uncertainty [Figure 1]. In December, the one-year breakeven rate slid the most since October 2008, while the 10-year breakeven rate fell the most since September 2011.

Still, we saw no indications in economic data that inflationary pressures are slipping significantly. Average hourly earnings grew 3.1% year over year for a second straight month, tying the fastest pace of wage growth since April 2009. The core Consumer Price Index, which excludes food and energy components, rose 2.2% year over year in November, marginally above the 12-month year-over-year growth of 2.1% for the measure. The core Producer Price Index increased 2.4% year over year in November, higher than the 12-month average growth of 2.2%. Core personal consumption expenditures, the Fed’s preferred inflation measure, climbed 1.9% in November, just below the Fed’s 2% target for the gauge. We think current inflation is sustainable and healthy for the U.S. economy, especially given manageable wage growth.

1 INFLATION EXPECTATIONS DROP IN DECEMBER



Source: LPL Research, Bloomberg 12/31/18

We also remained encouraged by solid data on U.S. consumers and businesses. While the Conference Board’s gauge of consumer confidence fell for a second straight month, it is still just below an 18-year high reached in October, signaling strong consumer demand will likely help boost future output. A continually strong job market aided consumer health towards the end of the year, as nonfarm payrolls grew solidly in November and the unemployment rate stayed at a 48-year low. Personal incomes grew year over year in November near its fastest pace in three years, while personal spending rose near the fastest such pace in four years. In 2019, we expect modestly accelerating wages, continued steady job gains, and fiscal stimulus to lift consumer spending, which should be the primary driver of gross domestic product growth.

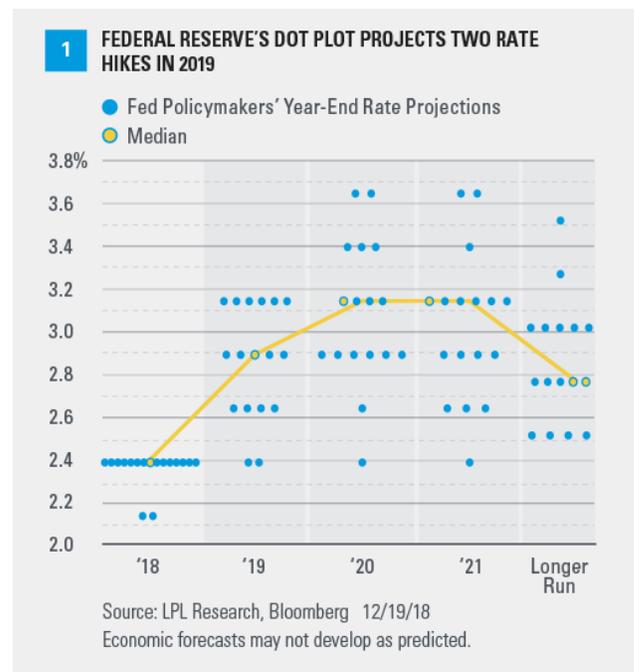
Business spending growth rebounded in November, as new orders for nondefense capital goods (excluding aircraft) increased 6.6% year over year. Small business optimism indicators remained solid, and the Institute for Supply Management’s (ISM) gauge of new business orders rebounded sharply from an 18-month low. Overall, Markit and ISM data showed manufacturing activity stalled in November, but both Purchasing Managers Index gauges are still well into expansion territory. Still, we are encouraged by U.S. manufacturing strength relative to global manufacturing, and we expect fiscal tailwinds and economic momentum to fuel further growth in the sector. We see the ongoing trade dispute as the primary obstacle to corporate health. Trade tensions have been difficult to navigate for U.S. corporations, and some 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.

Data released last month showed the U.S. housing market continued to cool in November. While existing home sales grew 1.9% month over month, they fell 7% year over year, the biggest decline since November 2010. Year-over-year growth in housing prices, represented by the S&P CoreLogic Case-Shiller 20-City Composite, slowed for a seventh straight month.

Stocks Slide as Fed Hikes Rates

Fed policymakers reconvened in December and on December 19 announced the central bank’s fourth rate hike of 2018, boosting the fed funds rate to a target

range of 2.25–2.5%. More importantly, policymakers lowered their expectations for future interest rate hikes in the new “dot plot” [Figure 2]. However, the dovish context wasn’t enough for markets. That day, the S&P 500 slid 1.5%, closing down for a seventh straight Fed day, after being up as much as 1% before the announcement. Markets were especially jittery around Fed commentary last month, but domestically economic fundamentals generally remained favorable.



GLOBAL EQUITIES

WORST DECEMBER FOR STOCKS SINCE 1931

The S&P 500 Index suffered its worst December performance since 1931, as major U.S. stock averages each fell about 9% for the month. Performance was particularly disappointing given some progress on U.S.-China trade talks, a generally positive economic backdrop in the United States, and the fact that December has historically been one of the best-performing months of the year. December's losses resulted in the first down year for the S&P 500 since 2008. The S&P 500 lost 4.4% on a total return basis in 2018, while the Dow Jones Industrial Average and Nasdaq Composite both held up slightly better with 3.5% and 2.8% declines, respectively.

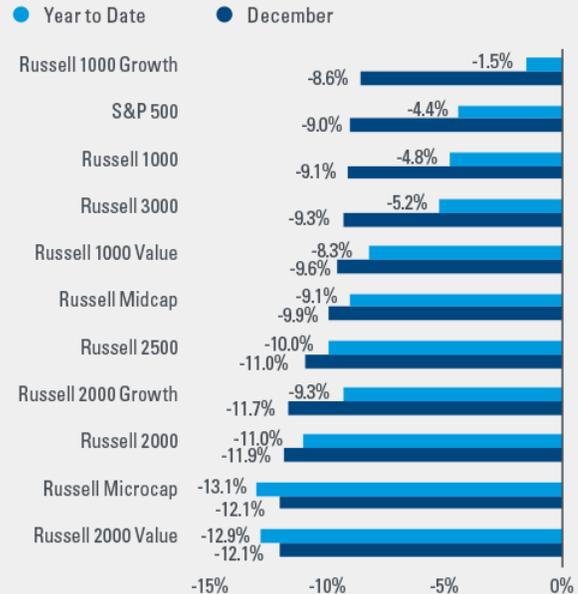
The stock market's sharp decline in December was driven primarily by the market's fears of a full-blown U.S.-China trade war and a possible Fed policy mistake, combined with an already tenuous economic environment overseas. Trade grabbed headlines at the start of the month after President Trump and Chinese President Xi met at the G20 summit and agreed to a 90-day "trade truce." Initial accounts were quite positive, but stocks sold off after additional details left market participants disappointed.

Later in the month, anxiety around tightening Fed policy threw markets for a loop. Fed Chair Jerome Powell had given markets hope in late November that the central bank might announce a pause in rate hikes in its December policy announcement. After the (expected) rate hike on December 19, the Fed disappointed markets by lowering its projection for 2019 by just one hike (from three to two). Markets also didn't like hearing that the Fed's balance sheet reduction program, which tightens financial conditions as bonds mature and are not reinvested, would remain on "autopilot."

As tends to be the case during down markets, large cap stocks held up best during December. The large cap Russell 1000 Index lost 9.1% during the month, slightly better than the 9.9% and 11.9% declines for the Russell Midcap and Russell 2000 small cap indexes. Smaller capitalization companies tend to exhibit more sensitivity to big market moves, especially when accompanied by widening credit spreads. Large caps led the way in 2018

DOMESTIC INDEX PERFORMANCE

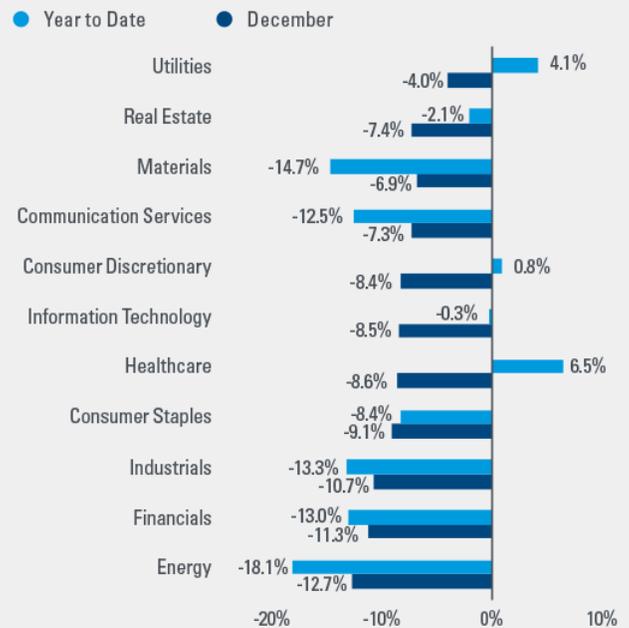
(Sorted by Monthly Return)



Source: LPL Research, FactSet 12/31/18

S&P 500 SECTOR PERFORMANCE

(Sorted by Monthly Return)



Source: LPL Research, FactSet 12/31/18

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.

despite relatively more exposure to global trade. The Russell 1000 lost 4.8% for the year, ahead of the 9.1% and 11% declines for the mid and small cap benchmarks.

Growth stocks held up slightly better than their value counterparts during December, halting value’s two-month win streak. The Russell 1000 Growth Index lost 8.6% for the month, compared with the 9.6% decline for the Russell 1000 Value Index. Weakness in energy and financials, both value-focused sectors, and strength in the growth-oriented communication services sector drove growth’s outperformance. The biggest growth sectors, consumer discretionary and technology, finished in the middle of the pack. Growth far outpaced value for the year on strength in consumer discretionary and technology, and weakness in financials. The Russell 1000 Growth Index fell just 1.5% in 2018, compared to the 8.3% loss for the Russell 1000 Value Index.

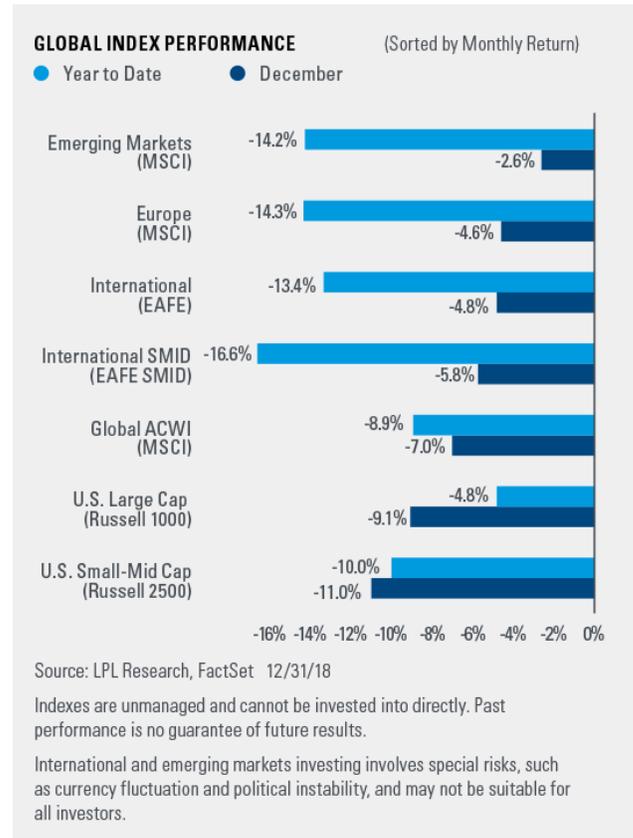
No sector produced a positive return for the month, with utilities coming closest with a 4% loss, while three sectors suffered double-digit percentage declines. For the year, only consumer discretionary, healthcare, and utilities finished with positive total returns, while materials and energy suffered the largest declines as commodity prices fell.

International

International equities suffered more modest losses than U.S. stocks during December, as the MSCI EAFE (developed international markets) and MSCI Emerging Markets (EM) indexes lost 4.8% and 2.6%, respectively. In EM, lower valuations, a pause in the U.S. dollar rally, and prospects for stimulus provided support. The best country performers included Mexico, Malaysia, Indonesia, and India, while equity markets in China and Russia lagged. EM suffered double-digit losses in 2018 amid slowing growth, trade tensions, and tightening financial conditions. Markets in China, South Korea, and Mexico detracted most from benchmark performance, while Russia, Brazil, and India were the biggest positive contributors to EM benchmark returns. The MSCI EM Index lost 14.2% for the year.

Lower valuations provided some relative support for developed international equities in December, along with a modest benefit from currency translation due to a slightly weaker U.S. dollar. Markets in Australia, Hong

Kong, and the United Kingdom performed relatively well, while Japan, Germany, and Switzerland lagged. Though developed equities fell amid more evidence of lackluster growth in Europe and Japan and ongoing Brexit uncertainty, the outperformance relative to the United States could be viewed favorably. For the year, the MSCI EAFE Index lost 13.4%.



FIXED INCOME

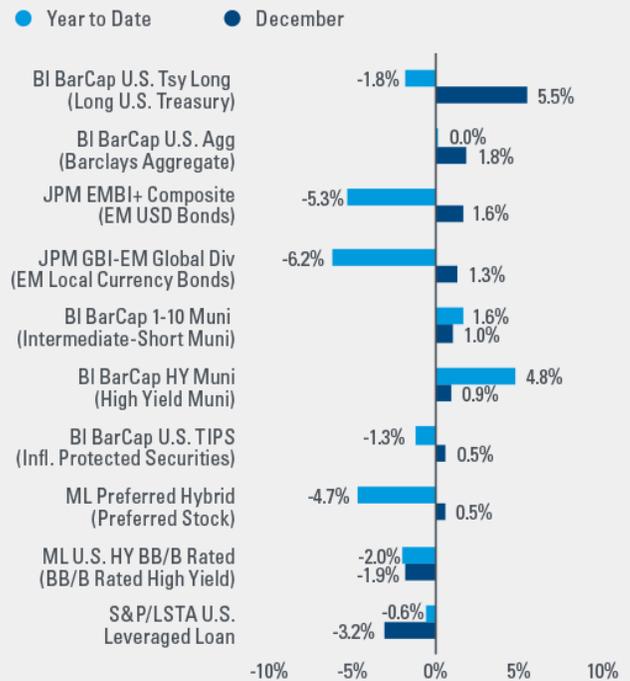
TREASURY YIELDS FALL MOST SINCE 2016 IN RISK-OFF RUSH

In December, U.S. Treasury prices jumped and yields dropped the most in two and a half years as investors' anxiety around global economic conditions and tightening monetary policy boosted appetite for safe assets. The 10-year Treasury yield dropped 30 basis points (bps) (.30%) in December, its biggest monthly slide since June 2016. The yield curve resumed flattening, as the spread between the 2-year and 10-year Treasury yields fell as low as 11 bps (.11%) on December 19, the lowest point of the current economic cycle. The 10-year yield ended the year at 2.68%, its lowest point since January 2018.

The rise in Treasury prices lifted higher-quality fixed income sectors (as shown in the Fixed Income Performance Table). Treasuries posted the best performance of all fixed income segments we track, climbing 5.5% while the Bloomberg Barclays U.S. Aggregate Bond Index increased 1.8%. Mortgage-backed securities climbed 1.8%. Investment-grade bonds, represented by the Bloomberg Barclays U.S. Aggregate Credit Index, rose 1.5% in its best monthly performance since June 2016. Lower-quality sectors fared worse amid investors' risk-off sentiment. Bank loans dropped 3.2%, while high-yield debt decreased 1.9% for a third straight month of losses. Emerging market (EM) debt climbed 1.3%.

FIXED INCOME PERFORMANCE

(Sorted by Monthly Return)



U.S. TREASURY YIELDS

| Security | 11/30/18 | 12/31/18 | Change in Yield |
|----------|----------|----------|-----------------|
| 3 Month | 2.37 | 2.45 | 0.08 |
| 2 Year | 2.80 | 2.48 | -0.32 |
| 5 Year | 2.84 | 2.51 | -0.33 |
| 10 Year | 3.01 | 2.69 | -0.32 |
| 30 Year | 3.30 | 3.02 | -0.28 |

AAA MUNICIPAL YIELDS

| Security | 11/30/18 | 12/31/18 | Change in Yield |
|----------|----------|----------|-----------------|
| 2 Year | 1.90 | 1.82 | -0.08 |
| 5 Year | 2.19 | 2.05 | -0.14 |
| 10 Year | 2.64 | 2.51 | -0.13 |
| 20 Year | 3.14 | 3.03 | -0.11 |
| 30 Year | 3.28 | 3.17 | -0.11 |

Source: LPL Research, Bloomberg, FactSet 12/31/18

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

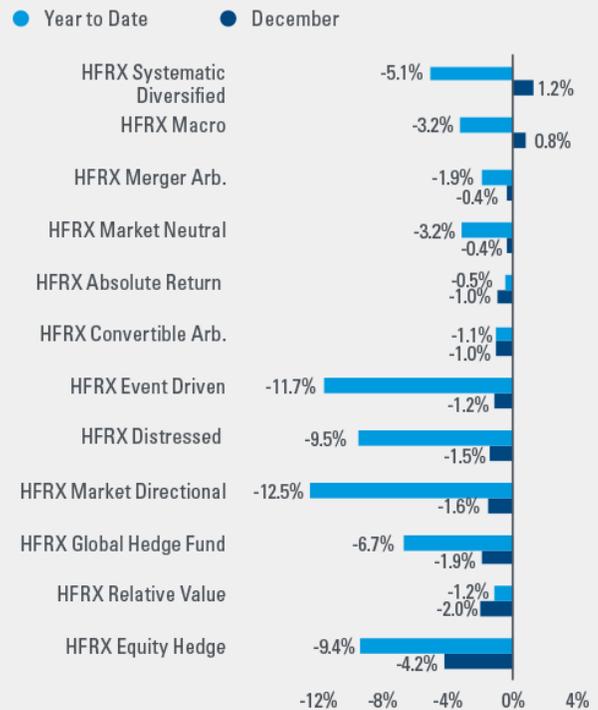
STRONG DOWNSIDE PROTECTION

The HFRX Systematic Diversified CTA Index led subcategory returns with a gain of 1.2% during an extremely volatile end to 2018. While performance of the index should not be compared to that of the S&P 500 Index because of the many differences, it's worth noting that the CTA Index outperformed the S&P 500 (down 9.0% in December) by 10.2%, which was its best month of relative performance since February 2009. Short equity and long fixed income exposure drove monthly returns, while currency trading detracted, as short exposure to the Mexican peso and Swiss franc led to losses. For the year, the CTA Index declined 5.1%, with many strategies struggling to fully recover from losses experienced in the first quarter.

The HFRX Equity Hedge Index declined 4.2% during December and 9.4% on the year. Long/short equity performance held up reasonably well through the end of May, as an overweight to the information technology and consumer discretionary sectors supported performance. However, the remainder of the year was disappointing, with the index declining 10.2%, as compared to the 6.3% decline in the S&P 500. Crowding in common securities (both long and short) and momentum-related exposure weighed on performance as the year progressed, with price deterioration in securities that previously exhibited positive momentum leading to further selling pressure.

While all alternative subcategories were negative for the year, the HFRX Convertible Arbitrage Index and HFRX Merger Arbitrage Index were the best relative performers, declining 1.1% and 1.9%, respectively. Merger arbitrage strategies continue to perform well even as numerous geopolitical risks overshadow global transactions. Going forward, we expect the merger and acquisitions (M&A) environment to remain healthy, however, we're aware of the potential weakening impact of U.S. tax reform.

HFRX INDEX PERFORMANCE (Sorted by Monthly Return)



MORNINGSTAR INDEX PERFORMANCE (Sorted by Monthly Return)



Source: LPL Research, FactSet 12/31/18

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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:

CAUGHT IN THE BROAD MARKET DOWNDRAFT

The liquid real asset categories we track were all negative in December, with master limited partnerships (MLP) and U.S. real estate investment trusts (REIT) suffering the largest declines, while international real estate and global infrastructure held up best.

Master Limited Partnerships

MLPs fell for the fourth straight month, losing 9.4% during December to roughly match the S&P 500 Index. The sharp decline in oil prices was the predominant headwind and overwhelmed any potential benefit from lower interest rates. Natural gas prices also suffered a large decline and weighed on the group. MLPs lost 12.4% in 2018 even as the industry continued to improve balance sheets and reduce reliance on external capital as West Texas Intermediate (WTI) crude oil tumbled 25%.

REITs and Global Infrastructure

U.S. REITs lost more than 8% for the month but slightly outperformed the broad U.S. equity markets. The modest outperformance brought the asset class's decline for 2018 to 4.6%, in line with the S&P 500. International real estate fared better than U.S. REITs in December with a 1.9% monthly loss. All domestic REIT sectors suffered declines in December, with self-storage and mortgage REITs holding up best. The cyclical real estate sectors were not immune to the market sell-off as industrial, office, and hotels/lodging all underperformed the domestic REIT asset class.

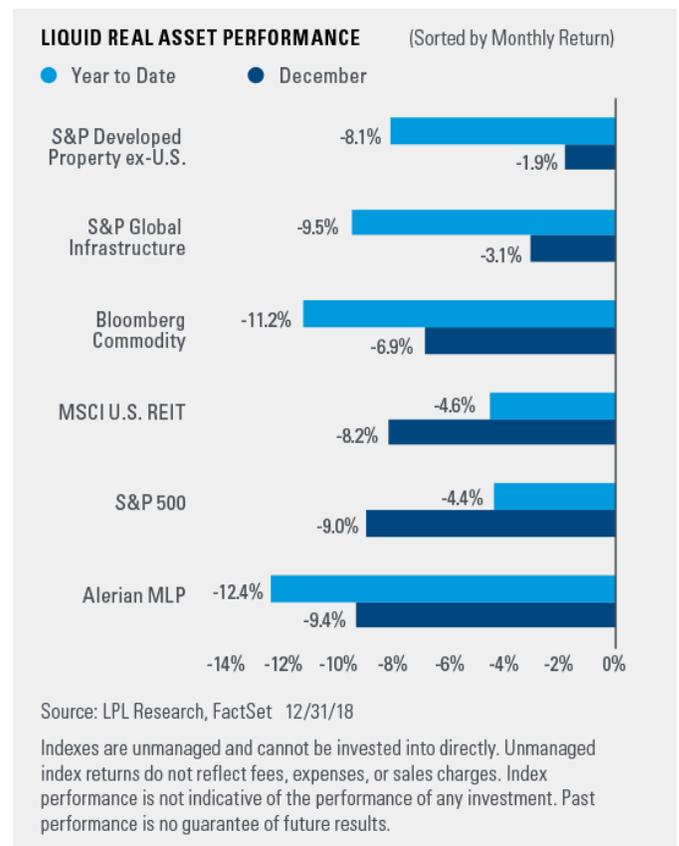
The S&P Global Infrastructure Index fell 3.1% in December, outperforming the S&P 500 and REITs for the month, due in part to its defensive characteristics and better international equity performance. The 8.1% decline for global infrastructure in 2018 still trailed the S&P 500 and MSCI REIT indexes.

Commodities

The Bloomberg Commodity Index fell 6.9% in December primarily due to the drop in energy prices. Trade tensions between the United States and China continued to take a toll on commodities' performance, as deteriorating Chinese economic data reduced expected future demand for oil and copper, weighing on prices. Oversupply

globally also contributed to oil's decline, while weather shifts drove natural gas prices down significantly, unwinding November's surge. These moves more than offset gains in gold and silver prices, which benefited from a flight-to-safety environment. Agriculture prices were relatively stable during the month. The Bloomberg Commodity Index lost 11.3% in 2018.

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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