



Montecito
Bank & Trust[®]
Wealth Management

LOOKING FOR A BOTTOM

March 2020

The COVID-19 outbreak (coronavirus) roiled markets over the past two weeks, putting the S&P 500 into correction territory with over a 20% bear market decline. Though new cases in China slowed during the month, data out of China pointed to economic contraction and economic forecasts in the United States began to fall as new cases emerged in the United States and globally as containment efforts intensified.

INVESTMENT TAKEAWAYS

- The ongoing market correction may present an attractive medium-to-long term opportunity and our year-end 2020 fair value S&P 500 Index target of 2900 may still be attainable. However, given the uncertainty, our economic, earnings, and market forecasts are currently under review.
- We favor large cap **stocks** over small and a balance of growth and value equity styles where suitable.
- Attractive valuations and solid economic growth may favor **emerging markets** over foreign developed markets. Slowing new cases in China has helped buoy emerging market stocks in recent weeks.
- The emergency 100 basis point rate cuts by the Federal Reserve (Fed) this month in response to the risks to U.S. growth from the outbreak did little to stop cascading **yields at all-time record lows**.
- We favor a blend of high-quality intermediate **bonds** with a modest underweight to U.S. Treasuries and still see value in **mortgage-backed securities (MBS)** relative to Treasuries, but we have downgraded our view to neutral due to the potential impact of refinancing as mortgage rates fall.
- U.S. stocks corrected sharply in recent weeks, leaving markets oversold on various metrics. Bottoming can be a slow process, but sentiment reveals signs of extreme fear often associated with market lows.
- **Sector weights:** Technology, Health Care and Staples are viewed as positives; downgraded industrial metals view to neutral from positive; MBS and Investment grade corporates remain positive.

OUR ASSET CLASS & SECTOR CHOICES

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
Emerging Markets Equities Large Cap Equities	Technology Health Care Staples	Investment Grade Corps U.S. Treasuries (with caveats) Mortgage-Backed Securities	Event Driven

Data as of February 29, 2020

ECONOMY: PRE-OUTBREAK MOMENTUM EVIDENT IN U.S. DATA

February data reflected some evidence of COVID-19 impact but generally held up well in the United States. That picture will likely change, however, when March data is reported. Globally, it was a different story, with first quarter data pointing to economic contraction in China, the epicenter of the outbreak.

- **Conference Board's Leading Economic Index (LEI)** rose 0.9% year over year in January. The strong bounce in the LEI after a string of lethargic readings signaled continued economic growth.
- **Payrolls and Labor.** Nonfarm payrolls increased 273,000 in February, well above expectations for a gain of 175,000. The gain, which is sufficient to maintain the current low unemployment rate, was above the 12-month average of 201,000. Wages rose 3% year over year in January, in line with recent trends.
- **Inflation.** The core Consumer Price Index (CPI), which excludes food and energy prices, increased 2.3% year over year, in line with the recent trend and not high enough to worry the Fed.

On the **wholesale** side, the core Producer Price Index (PPI), excluding food and energy increased 1.5% year over year in January.

Prices for core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, increased a softer-than-expected 1.6% year over year in January, well within the Fed's 2% target.

- **U.S. manufacturing** slowed in February as the Institute for Supply Management's (ISM) Purchasing Managers' Index (PMI) edged lower to a marginally expansionary 50.1. Supplier delivery times lengthened due to China's measures to contain the COVID-19 outbreak.
- **U.S. Consumer.** The Conference Board's Consumer Confidence Index rose slightly in February and remained elevated despite increasing fears of a U.S. COVID-19 outbreak. Recent sales data reflected a 0.3% increase in January, in line with expectations. The retail sales component within gross domestic product (GDP) was unchanged after a 0.5% increase in December.
- **U.S. Business Investment.** Bookings for all durable goods dipped 0.2% month over month in January and fell 2.3% year over year. However, excluding volatile transportation orders, capital goods orders rose a solid 0.9% month over month and were flat year over year, reflecting continued sluggish capital investment from corporate America.
- **Federal Reserve.** The Fed announced two emergency cuts in March - one for 50 basis points and one for 100 basis points March 3 and March 15, respectively. These are the first intra-meeting cuts since 2008, amid concerns about a widening COVID-19 outbreak.

2020 REAL GDP GROWTH FORECASTS

Our real U.S. gross domestic product (GDP) growth forecast for 2020 is 1.75%.

Our forecasts are all under review:	Developed International (ex. U.S.) now 1.5%	Emerging Markets now 4.6%	Global Growth now 3.5%
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U.S. and global GDP estimates are LPL forecasts. Other GDP estimates are International Monetary Fund projections.

EQUITY ASSET CLASSES: VIRUS FEARS DROVE STOCKS SHARPLY LOWER

The **S&P 500 Index** tumbled 8.2% in February, as the COVID-19 outbreak in China spread to dozens of countries around the world and increased fears of a global pandemic. The 12% drop in the S&P 500 during the last week of February was its largest since 2008 and registered the fastest ever 10% correction from a record high. Market volatility in early March left the S&P 500 near the technical definition of a bear market—a 20% or more decline based on closing prices.

Style/Capitalization

Large cap and small cap stocks suffered similar losses during February, based on the Russell 1000 and Russell 2000 indexes, while large caps held up better during the first week of March. Growth stocks held up better than their value counterparts during the selloff as the top growth sectors—consumer discretionary and technology—outperformed the biggest value sectors—energy and financials.

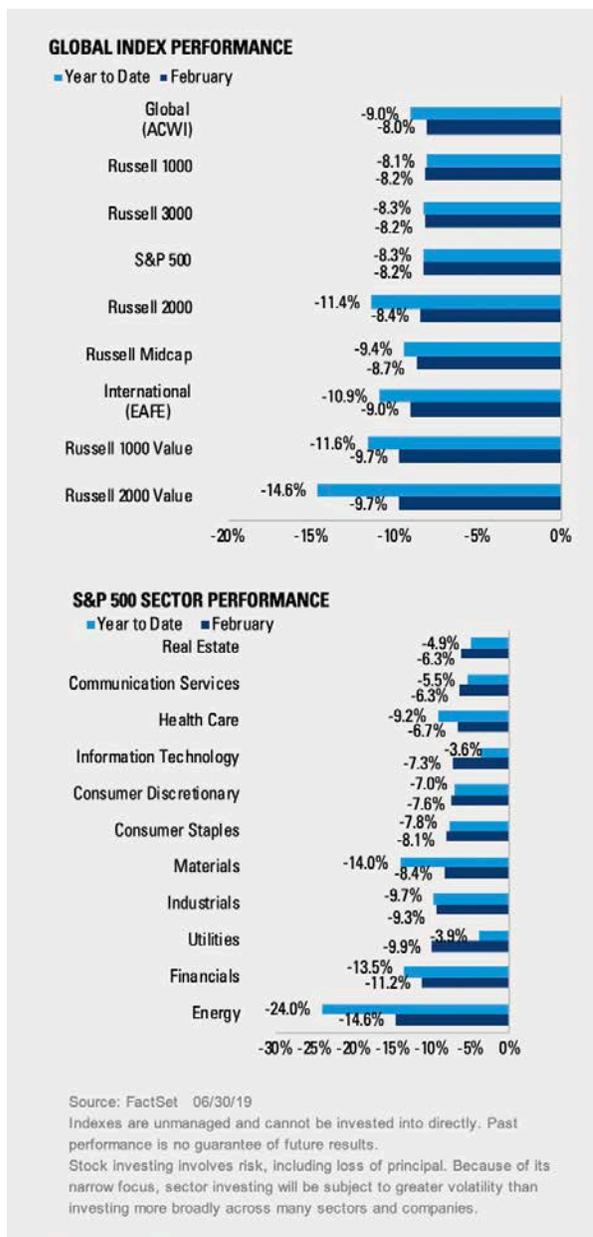
Global Equities

Emerging equities stood out among regions in February with a more modest loss than U.S. and international developed market stocks. Modest gains for the U.S. dollar weighed on dollar-based international returns.

Emerging markets equities lost 5.3% in February, based on the MSCI Emerging Markets Index. **China** produced a modest gain for the month, based on the MSCI China Index, as cases of the COVID-19 there slowed. Stocks in **Taiwan** also outperformed, while stocks in **Brazil** lagged.

International developed equities lost 9% for the month, based on the MSCI EAFE Index. The **United Kingdom** market underperformed, based on the MSCI country indexes, while stocks in **Hong Kong** held up relatively well.

Over the first week of March, returns for the various global indexes were similar, though China's stock market continued to exhibit some resilience on a relative basis.



EQUITIES ASSET CLASSES: FAVOR U.S. LARGE CAPS AND EMERGING MARKETS

Asset Class	Comments
Market Cap	We favor U.S. large caps over their small cap counterparts as the business cycle ages and financial conditions potentially tighten further. The U.S.-China trade deal signed in January should be beneficial for more global large cap companies, while larger companies offer a superior corporate profit outlook, in our view.
Style	We continue to favor growth over value. However, relative valuations and the duration and magnitude of the growth rally suggest value stocks deserve consideration. The aggressive rate cuts by the Fed and slowing economic growth due to the COVID-19 outbreak fuel our tilt toward growth. The interest rate environment and credit concerns in the energy sector increase near-term pressure for the value-heavy financials sector.
Region	<p>United States. Among developed markets, we remain U.S. focused, supported by relatively stronger but slowing economic growth, low inflation, and a supportive Federal Reserve. Although the earnings growth outlook for the next couple of quarters has been impaired by virus containment efforts, supply chain disruptions, and changes in consumer behavior, at this point we still think the S&P 500 could potentially deliver flat earnings in 2020, which may still be enough to outpace Europe and Japan.</p> <p>Europe. Fiscal deficits, populism, and exhausted monetary policies could weigh on sentiment, spending, and investment in Europe, though improving economic data before the outbreak caught our attention.</p> <p>Japan. Structural reforms have had limited success, and the recent consumer tax (VAT) hike contributed to a sharp economic contraction in the fourth quarter that may lead to a technical recession by the end of March. Corporate earnings contracted sharply in 2019.</p> <p>Emerging Markets. Attractive valuations and solid economic growth favor emerging markets over developed foreign markets. Although the benefits to the Chinese economy from the phase-one trade deal with the United States were derailed by the COVID-19 outbreak, the outbreak's cycle is further along in Asia than in the United States or Europe. This suggests the market had already started to price in an economic recovery there as March began. That said, we acknowledge the risk of a worsening health crisis in China and other emerging economies.</p>

EQUITIES SECTORS: FAVOR CYCLICALS FOR THE REBOUND

Sector	View	S&P 500 Weight (%)	Comments
Materials	Neutral	2.6	Global growth and China trade were improving pre-outbreak, but virus risk is high.
Energy	Negative	3.4	Prior supply shocks had little sustained impact, and the virus outbreak and OPEC inaction add downside risk.
Industrials	Negative	8.6	Transports have been hit twice by slower passenger and slower freight transportation. Capital Goods should be hit hard as capex projects are delayed and Energy companies cut back.

Sector	View	S&P 500 Weight (%)	Comments
Communication Services	Neutral	10.4	High valuations, regulatory risk for internet companies, and telecom exposure keep us neutral. Home entertainment getting a boost from the outbreak.
Consumer Discretionary	Neutral	9.8	Though valuations are rich, consumer spending has been resilient. Outbreak clouds near-term outlook for travel and leisure industries.
Technology	Positive	24.5	Productivity enhancements in areas such as mobile, cloud, automation, and artificial intelligence (AI) are driving demand. We still see earnings growth in 2020.
Financials	Negative	11.7	It is not just Energy industry loans that banks need to worry about, but every industry impacted by social distancing from the coronavirus.
Utilities	Negative	3.7	We continue to favor cyclical sectors; valuations are high; and we expect interest rates to move higher.
Healthcare	Positive	14.5	Our upgraded view is driven by a solid healthcare spending outlook, favorable demographics, attractive valuations, steady earnings, and improved prospects for a moderate policy environment.
Consumer Staples	Positive	7.6	Ultra-low rates make Consumer Staples 2.6% dividend yield extremely attractive. With many expecting flat to down earnings growth for the S&P t00, Staples mid-single-digit earning growth should look superior
Real Estate	Neutral	3.2	High dividend yields of 3.5% remain attractive even if the 10-year yield rebounds to over 1.00%.

FIXED INCOME, CURRENCIES, AND COMMODITIES

U.S. Treasury yields fell sharply in February as the spread of COVID-19 drove a safe-haven rally. The 10-year Treasury yield slid another 38 basis points (0.38%) during the month to end February at a record low of 1.14% and continued to decline in early March.

Performance was mixed across bond sectors, as shown in the **Fixed Income Performance Table**. There was a flight to quality during the month, as Treasuries paced gains. The Bloomberg Barclays U.S. Aggregate Bond Index (Agg) returned a solid 1.8%. Lower-quality bond sectors struggled, as emerging markets debt, high-yield corporates, and leveraged loans all posted negative monthly returns.

Credit Quality: Medium

We maintain a more cautious approach as the cycle ages, but we still prefer corporate bonds to government bonds.

Duration: Short to Intermediate

We prefer below-benchmark interest-rate sensitivity due to the historically low longer-maturity U.S. Treasury yields and prospects of a second half economic rebound.

Bonds: Taxable

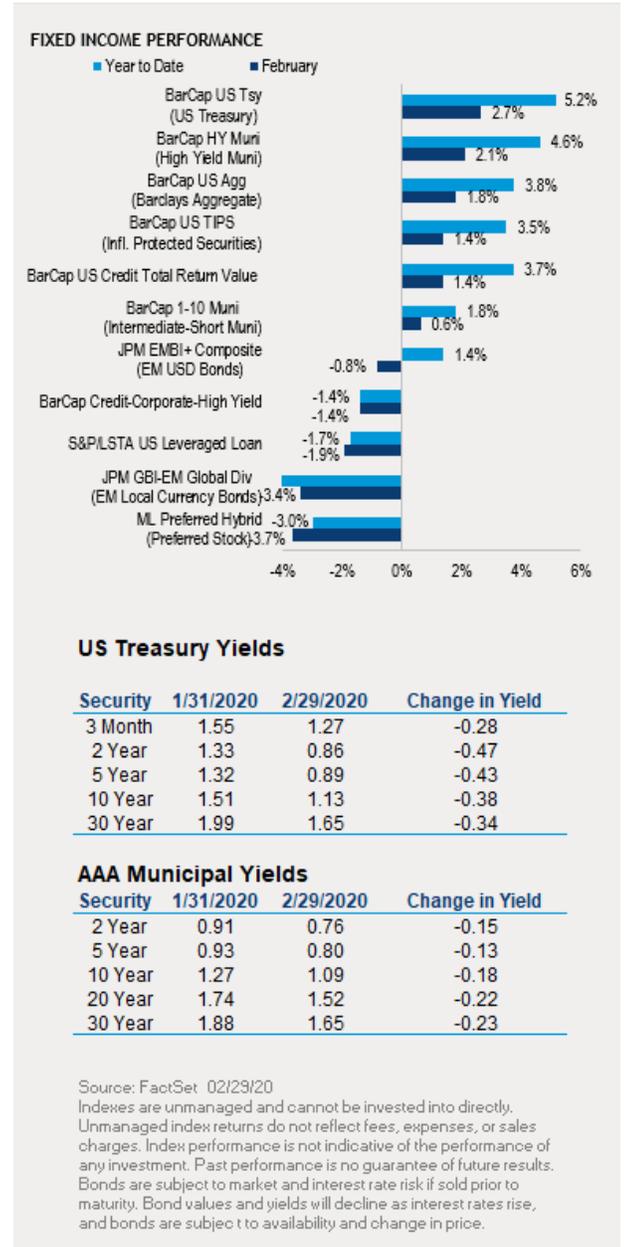
We suggest a blend of high-quality intermediate bonds in tactical portfolios. We expect modestly higher long-term rates in 2020 if we see a rebound in the second half of the year, and compensation for longer-maturity bonds remains unattractive in our view. We still see incremental value in corporate bonds and MBS over Treasuries, but risks specific to the individual bond sectors temper our views.

Bonds: Tax Free

We favor municipals bonds as a high-quality option for taxable accounts. Supply dynamics still look attractive, and valuations relative to Treasuries improved in February.

Commodities and Currencies

Safe-haven buying from COVID-19 outbreak fears and **potential U.S. dollar** weakness are possible catalysts for precious metals, where our view is positive. Our neutral industrial metals view reflects near-term COVID-19 risk. Our crude **oil** outlook remains negative on supply concerns and lack of sustained impacts from prior supply shocks.



FIXED INCOME AND ALTERNATIVE INVESTMENTS: LIMIT RATE SENSITIVITY

Sector Views	View	Comments
U.S. Treasuries	Neutral to Positive	Yield spreads to international sovereigns remain elevated, but have narrowed. Valuations have become very expensive on COVID-19-related demand.
Mortgage-Backed Securities (MBS)	Positive	Diversifying source of yield among high-quality options. Refinancing activity due to lower mortgage rates may weigh on returns.
Investment-Grade Corporates	Positive	We still find incremental value in corporate bonds due to the prospective economic backdrop. Overall credit quality compared to history remains a concern but valuations have improved.
Preferred Stocks	Neutral	Fundamentals for U.S. banks are still good. Higher interest-rate sensitivity and valuations may be concerns post-COVID-19 impact.
High-Yield Corporates	Neutral	Yields are attractive, and the economy is supportive, but high-quality options may be better diversifiers. High-yield bond sector exposure to energy is of concern following the collapse in oil prices.
Bank Loans	Negative	Weaker investor protections and falling rates reduce attractiveness.
Foreign Bonds	Negative	Rich valuations, interest rate risk, and potential currency volatility are among negatives.
Emerging Markets Debt	Neutral	Dovish central banks improve the valuation picture but may be vulnerable to COVID-19-related risk. Positive bias for second half.

Alternative Investments

Event Driven strategies have remained resilient during the recent bout of market volatility, with some managers seeking to prioritize deals with a shorter time to close. Healthy deal flow, private equity capital, and low interest rates continue to support the strategies' investment backdrop.

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