CROWELL WEEDON ASSET MANAGEMENT
MONTECITO INVESTMENT PORTFOLIOS

January 1, 2018

Dear Fellow Investors,

We've outlined the major topics & takeaways of our annual letter below – details follow!

MAIN MESSAGE HIGHLIGHTS:

- ***WALK DOWN MEMORY LANE –*** We've presented a lot of thoughts, facts, information, & opinions over the past several years. We thought now would be a good time to revisit some of our Main Messages for a big picture overview.
- ***ACCELERATION!! –*** The knock on this recovery dating back to 2009 has been its sloth-like pace of growth. After 8 years we are finally witnessing the US economy get a little pep back in its step. Companies are no longer buying earnings growth – we are seeing the fastest pace of top-line sales growth in well over 7 years!!
- ***RECOGNITION –*** This pick-up in growth hasn't gone unnoticed. Investors are now willing to pay up for businesses showing solid growth prospects & execution. For years we believed the market in general was undervalued, we now find ourselves believing we are fairly valued. So what's the plan in a market like this – we believe active portfolio management is more important than ever.
- ***STRENGTH OF ADVICE –*** The wealth advisory business has changed from a high information divide to a low information divide. Trading expenses & index investing cost next to nothing. We explore the value an asset manager & wealth manager can bring to you.

FORECASTS

- **Economy** grows at 3%+ during 2018
- **S&P 500** ends the year between 2,800 and 2,900
- **Short-term rates**: 2 to 3 Fed hikes with 2 to 2.5% on the Fed Funds rate by year-end
- **Long-term rates**: 10 year ending the year at a yield of around 3.00%
- **Oil prices**: see $50 to $65 price range for WTI
- **Inflation**: remains in check and 2.2% rate eclipsed in 2018 for at least one quarter.
- **Commercial real estate** – Cap rates will come under slight pressure. Still a preferred alternative to a buy and hold of long term bonds, but underweight in an all equity portfolio.
- **Residential real estate** –much the same as last year - smaller homes still the spot to be and in states that are tax-friendly or retiree friendly – the Millennials will start buying more houses.

Three more forecasts that are not entirely investment related:

- Online learning rates increase dramatically
- Climate change awareness leads to more countries adopting clean air legislation
- 3D printing becomes mainstream and may give rise to one of the things that keeps us up at night.

CONCLUSION

Walk Down Memory Lane

Over the years we've covered numerous topics. Sometimes these thoughts and opinions can become overlooked if they aren't refreshed in the memory banks every now and again. This year we thought it was important to look back at our main messages from previous letters over the past several years:

- ***January 2012***: Great Recession has bottomed out but still a lot of work to do to get the economy starting down the long road to recovery. 2011 was like an E-ride ticket at Disneyland, full of ups and downs but finishing the year essentially unchanged.

- ***January 2013***: The more things change the more they stay the same – we found many similarities in news stories during 2012 that were not uncommon looking back over the decades. Earnings growth is being driven by buybacks & we're concerned with the lack of real revenue growth.

- ***January 2014***: Stocks have now outperformed "safe" investments going back to the previous market peak in 2007. Price should be the primary factor when determining the "safety" of an investment. Market volatility is nothing new and should be tolerated for the benefit of your financial well-being.

- ***January 2015***: Lifecycle of an investment – Deep Value, Value, Growth at a Reasonable Price, Growth, & Momentum. Although the market has moved higher we see it moving out of the Deep Value & Value stage into the Growth at a Reasonable Price phase.

- ***January 2016***: A below average year from the stock market as we believe companies will come to realize they can't continue to buy Earnings Per Share growth but must instead invest for the future. Tracking Sales Growth may be of utmost importance in today's slower growth "new normal" economy.

- ***January 2017***: A Lost Generation – the past 16 years was pretty dreadful for the stock market. Major market crashes sandwiched around fear of the financial system collapsing have turned off many to investing. We believe the 2000 – 2016 time frame is amazingly similar to the 1966 – 1982 time frame. If this rhyme holds true we could be at the beginning of the next major move in growth & productivity that will lead to higher prices for the stock market over the next long-term time periods.

Certainly a plethora of facts, information, & opinions throughout the years!! As we consistently emphasize, we sincerely value the trust placed in us to provide sound, well-reasoned advice & counsel. It is with a bit of pride we highlight that for the most part, our Main Message calls have been spot-on! Keep in mind, these messages were conveyed to our investors at a time when it wasn't easy to look beyond the constant fears & pessimism plaguing the market & economy for years now. Hopefully, these letters have added to the trust placed in us & strengthened credibility in our process & investment philosophy. With that said & our Main Message recaps done, let's tie it all together and take a look at what we see happening today.

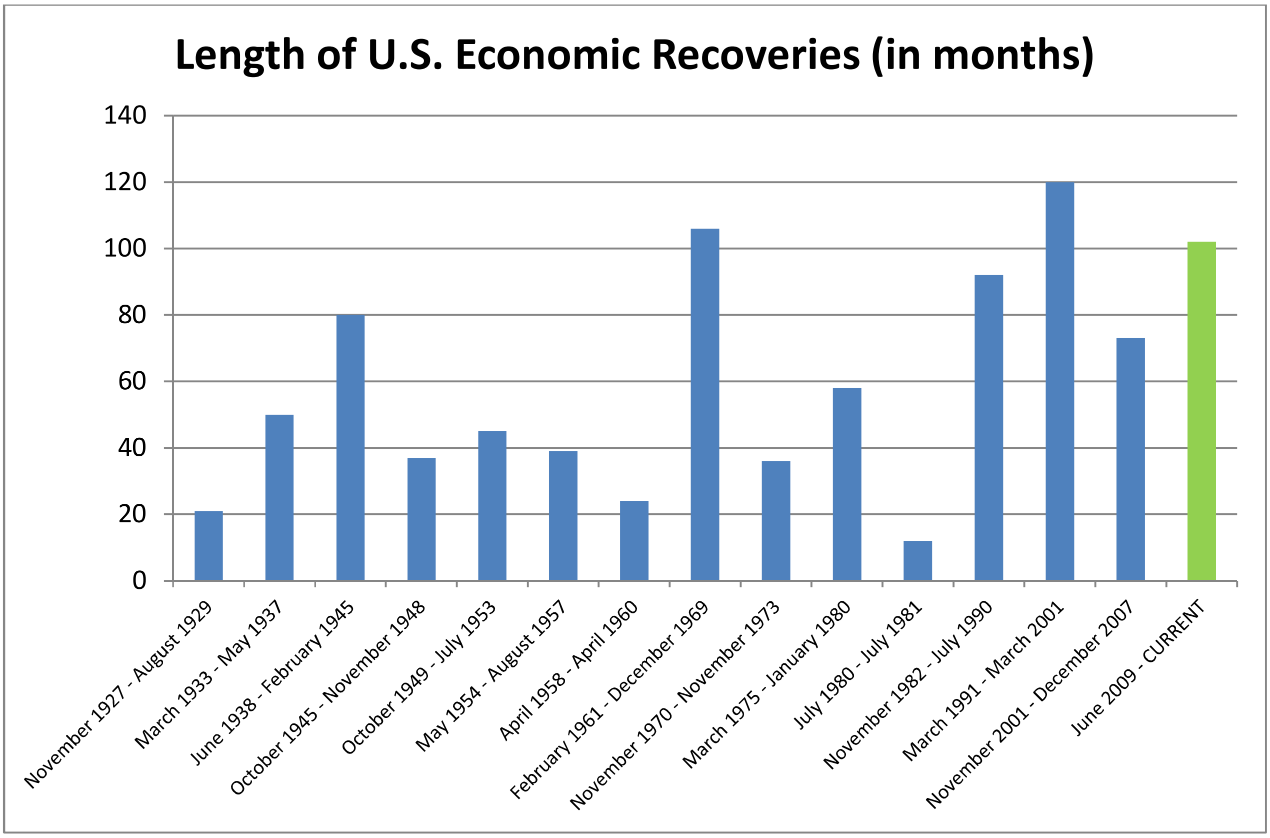
ACCELERATION (FINALLY)

The knock on this recovery since the depths of 2009 has been the lackluster growth. Certainly, the pace of growth has been below expectations with many even accepting the supposed truth that the United States now finds itself in a "new normal" period of slower growth. ***U.S. Annual GDP*** growth rates since the depths of 2009 are as follows:

AVERAGE	2016	2015	2014	2013	2012	2011	2010
2.14%	1.5%	2.9%	2.6%	1.7%	2.2%	1.6%	2.5%

Source: FactSet

The only saving grace optimists could point to was the length of this recovery being one of the longest on record. Although growth rates have been rather lackluster, the steadiness of the recovery has been impressive making this the 3rd longest recovery in U.S. history.

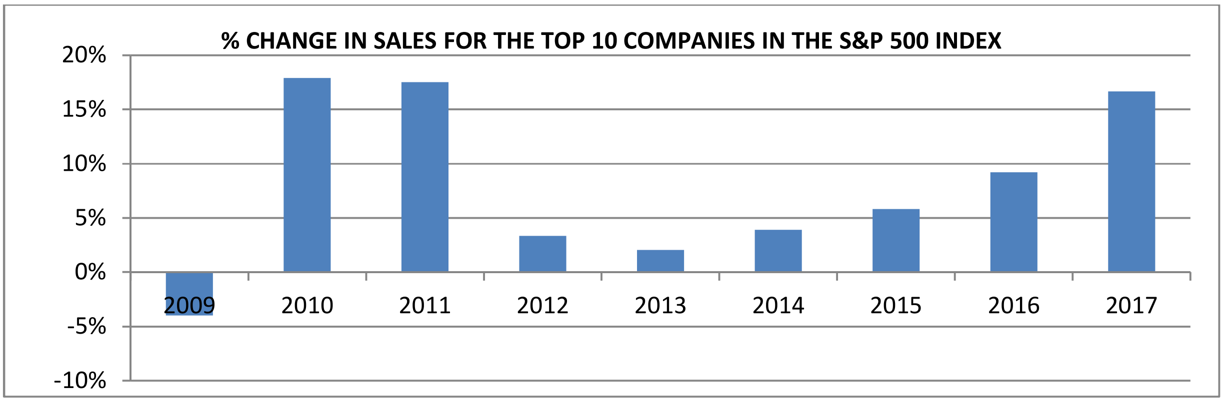


Source: National Bureau of Economic Research

Now however, an interesting occurrence is taking place. Second quarter GDP grew at 3.1% & the third quarter growth was even faster at 3.3% - a substantial pick-up from the average 2.14% seen over the past 7 years. The plow-horse like economy (as coined by Brian Westbury at First Trust) appears to be showing signs of running and possibly turning into a race horse once again. So how does the third longest recovery in U.S. history start to gain momentum instead of running out of it? We've held the belief for years now that technological advancement drives economic growth & we've seen so much innovation over the past few years that eventually, this was going to translate into higher growth. We do indeed feel this has played a major part in the recent acceleration. Yet, the most important component causing much of this acceleration may not be tied to tangible statistics we can measure, instead it may come from a basic human emotion that has improved greatly from where we stood in the depths of 2009 & that is **CONFIDENCE**.

As we listen to numerous conference calls from corporate boardrooms & read quarterly & annual filings, we noticed a change in tone & language about 12 – 18 months ago. Many companies were communicating a message of real strength & acceleration that had been lacking for quite some time. This got us thinking – if some of the best & largest corporations in the world were seeing an acceleration in growth, how does that stack-up to other times in history? From this question, a historical study was born. ***We decided to track the 10 largest companies in the S&P 500 throughout the years & see what the average sales growth rate for these leaders has been.*** The study proved fascinating & led to several takeaways:

1. The leaders of the index change more often than many realize
2. Sales growth does certainly seem to reflect the current business environment quite nicely.
3. This recovery has indeed been slow.
4. 2009 was an exceptionally rare time as it was the only year in our 36 year study with a negative growth rate. This shows just how severe the downturn of the Great Recession was.
5. The acceleration is evident & meaningful as we are well beyond the easy percentage gain years seen in 2010 – 2011 as we exited the depths of 2009.



Source: FactSet

In our opinion, a major cause of the recent acceleration has been confidence. Confidence from consumers, confidence from corporate boardrooms, confidence in international markets – you name it and it has most likely improved. You don't even have to take our word for it. First paragraph in the World Bank's Global Economic Prospects report reads:

"Global growth is firming, contributing to an improvement in confidence. A recovery in industrial activity has coincided with a pickup in global trade, after two years of marked weakness (Figure 1.1). In emerging market and developing economies (EMDEs), obstacles to growth among commodity exporters are gradually diminishing, while activity in commodity importers remains generally robust. As a result, and despite substantial policy uncertainty, global growth is projected to accelerate to 2.7 percent in 2017, up from a post-crisis low of 2.4 percent in 2016, before strengthening further to 2.9 percent in 2018-19, broadly in line with January projections."

Political leanings aside, we believe the pro-business agenda of less regulation and lower taxes has also contributed to this confidence. Confidence is good. A shift from worry to confidence was needed. However, it can also come with some concern. The worry that keeps us up at night is ***overconfidence.*** That's the type of thinking that typically occurs near economic & market tops. Fortunately, we believe we're a long ways from overconfidence. The question now is: In a world anticipating positivity, how do we position portfolios to capitalize on this? We believe the first step is to recognize where we stand before crafting our strategy.

RECOGNITION

It's no secret that global stock markets have been strong this year. Investors now show a willingness to pay up for businesses displaying solid growth prospects and execution. This has pushed some closely followed market valuation metrics above long-term averages and caused many to warrant caution or even outright fear by telling their investors to get out. We believe it is foolish to only tout one or two metrics that might happen to agree with our own personal biases. Instead, we like to use a broad set of tools to get an idea of where we've been, where we stand, & where we may be going to position investor's portfolios. Let's review some of the facts we are seeing today & discuss our thoughts in regards to each of them.

FACT #1: THE MARKET IS INDEED MORE EXPENSIVE THAN ITS BEEN IN RECENT MEMORY

Looking at where we've been, we absolutely recognize the market is indeed above its recent averages. The ***Forward P/E Ratio*** of the S&P 500 in recent times looks like this:

Current	18.3 X
Start of Q4 2017	17.8 X
5 Year Average	15.8 X
10 Year Average	14.2 X

Source: FactSet

We would be greatly concerned if we were only seeing expanding multiples without a corresponding pick-up in growth. Otherwise, investors aren't getting any more for what they pay for. We are pleased to report that the pick-up witnessed in top-line revenue growth is also translating into a pick-up in EPS growth:

2017 Projected EPS Growth (Q4 2017 pending)	10.3%
2016	1.4%
2015	-0.3%
2014	6.7%
2013	5.2%
2012	6.2%

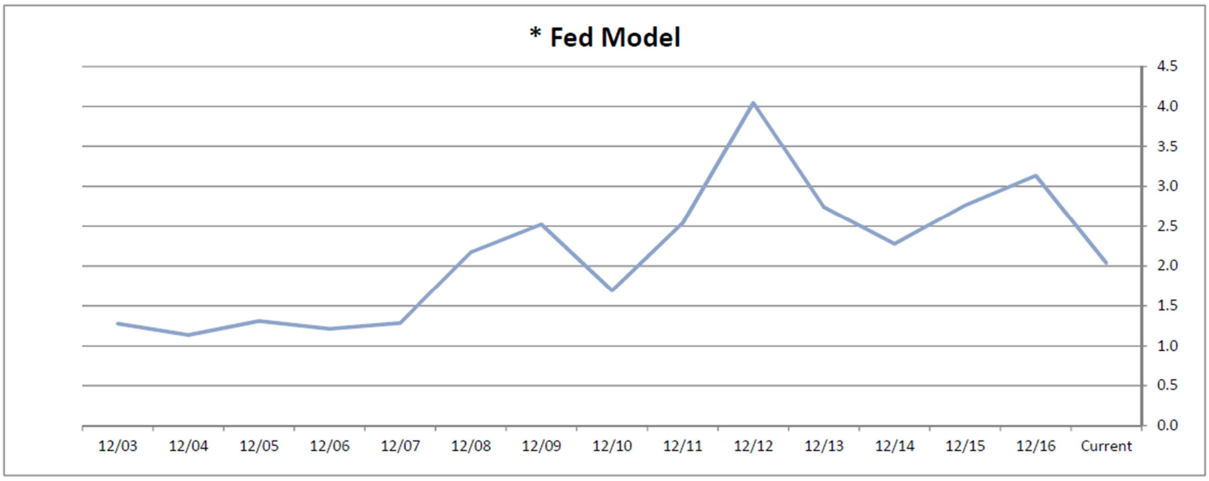
Source: FactSet

Forward estimates (always taken with a grain of salt but useful to monitor nonetheless) are positive as well with EPS growing by 11% in 2018 & 10% in 2019. It appears our main message from last year is coming to fruition – ***we saw this period as starting to embark on a pick-up in growth & productivity driven by all the amazing technological innovation.*** Throw in the possible benefits of a lower corporate tax rate & less regulation & we believe the market is correct in being optimistic.

OUR TAKEAWAY: YES THE MARKET IS MORE EXPENSIVE BUT IT IS BEING DRIVEN BY A PICK-UP IN GROWTH.

FACT #2: EVEN WITH RECENT GAINS IN THE STOCK MARKET – STOCKS STILL LOOK ATTRACTIVE WHEN COMPARED TO BONDS

It is going to take a substantial move in interest rates before the potential return from bonds becomes more attractive when compared to stocks and real estate / asset based investments. As our disciplines require, we invest in companies that not only pay a dividend but give our shareholders a raise on a consistent basis. With yields we're finding today, plus the potential of these companies to produce a growing income stream, it will be quite some time or take a significant move in prices before we view a fixed income investment being as attractive. Recall, we track the earnings yield of the stock market compared to the yield on the 10 year U.S. Treasury in a metric called the ***Fed Model***. This model has shown stocks being substantially more attractive than bonds for years now. We still believe this holds true.



* FED MODEL = EARNINGS YIELD OF S&P 500 / 10 YEAR US TREASURY YIELD. READING ABOVE 1 SIGNALS EQUITIES ATTRACTIVE VERSUS BONDS.

Source: FactSet

OUR TAKEAWAY: WE'VE STILL GOT A WAYS TO GO BEFORE BONDS LOOK ATTRACTIVE WHEN COMPARED TO STOCKS, REAL ESTATE, AND ASSET BASED SECURITIES.

FACT #3 – WE ARE EXPERIENCING A PROLONGED PERIOD OF LOWER VOLATILITY

In our January 2017 Annual Letter we discussed the period of time from 2000 – 2016 in great depth. One of our key points based on our historical studies was ***this period of time saw the highest volatility of earnings in market history!*** Based on this and numerous other factors, ***we forecast the next 10 – 15 year time period will see a much less volatile earnings environment.*** So far this has proven accurate. However, we do remind investors volatility is part of investing and nothing new. A study by American Funds helps add perspective when discussing market declines & shows just how regular of an occurrence they are:

A History of Declines (1900-December 2016)

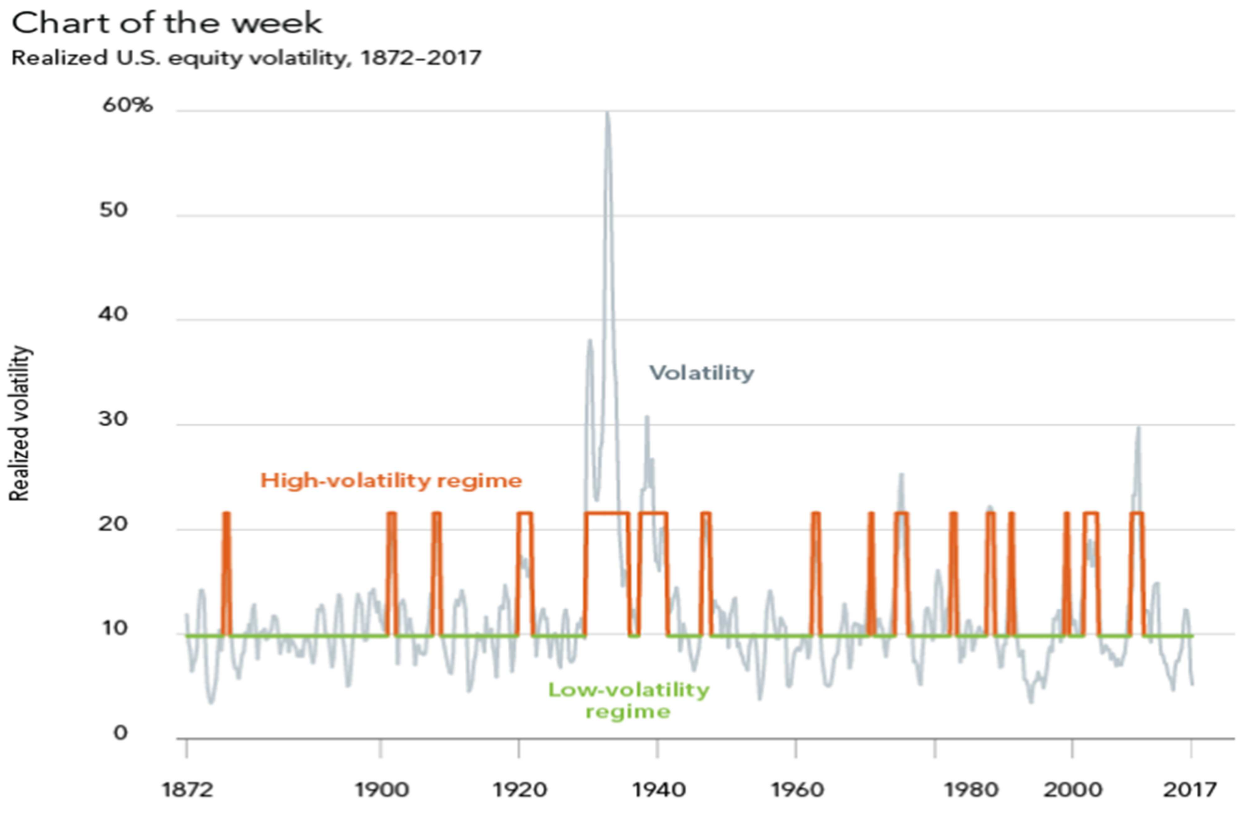
Type of Decline	Average Frequency[1]	Average Length[2]	Last Occurrence
-5% or more	About 3 times a year	47 days	August 2015
-10% or more	About once a year	115 days	August 2015
-15% or more	About once every 2 years	215 days	October 2011
-20% or more	About once every 3½ years	341 days	March 2009

Source: Capital Research and Management Company

[1]Assumes 50% recovery rate of lost value.

[2]Measures market high to market low.

We are not alone in our view of a less volatile earnings outlook for the stock market. Recently, BlackRock did a study on volatility & found a strong correlation with the underlying economic volatility. Their point was lower volatility is a result of a strong underlying economy. Waiting for periods of high volatility may take a lot longer than you think without a corresponding decline in the economy.



Sources: BlackRock Investment Institute, with data from Robert Shiller, June 2017.
Notes: Realized volatility is calculated as the annualized standard deviation of monthly changes in U.S. equities over a rolling 12-month period. Using a Markov-Switching regression model, we calculate two volatility regimes: a high-volatility regime (orange) and a low-volatility regime (green). The orange and green lines plot the average level of volatility during each regime based on data from 1872 to 2017.

OUR TAKEAWAY: WE KNOW THE LAST 5% OR 10% PLUS PULLBACK IN THE STOCK MARKET OCCURRED IN AUGUST 2015. IF WE SEE A DECENT PULLBACK ANYTIME SOON WE REMIND INVESTORS THIS IS NORMAL ACTIVITY FOR THE MARKET. WE WOULD ALSO BE INCLINED TO VIEW THIS DROP AS A BUYING OPPORTUNITY AS OPPOSED TO THE START OF ANOTHER MAJOR DOWNTURN.

STRENGTH OF ADVICE

The wealth management industry has changed dramatically over the decades. No longer is your wealth manager the only option to turn to for market information & trade execution. There are now numerous solutions available charging next to nothing for passive investment strategies & trade execution. If you want to be a DIY investor, there has never been a better time. ***So what then is the value wealth managers bring to the table?*** It has certainly been redefined throughout generations. We could list the numerous services quality wealth managers provide although it would be quite lengthy. Also, the focus of our practice and this letter is asset management and not so much on wealth management services. However, typically asset management and wealth management go hand-in-hand which is why we want to address the value question. In our opinion, the best response to illustrate the value we bring to the table is also in the form of a question: ***What would you have done on your own?***

The answer to this question is beautifully illustrated by Vanguard (the inventors of passive investing) in a report they created called Advisor's Alpha. In this report they break down the numerous services wealth managers provide and assign an actual percentage value to each of them. The results may surprise some, but Vanguard believes the value added from a solid wealth manager is approximately ***3% per year***. Part of the value is attributed to rebalancing portfolios to control risk, recommending investments take place in certain account structures for added tax benefits, and helping create withdrawal strategies to optimize cash flows. However, the one area that made up half of this 3% per year value was attributed to something much less tangible - ***Behavioral Coaching***.

Behavioral Coaching is many things in our business. It is keeping people invested in the stock market when it goes through a correction. It is reminding people politicians don't run the economy, entrepreneurs do. It is pointing out that cash and CDs aren't necessarily safe when you think of them in a long-term context and factor in inflation. It is a wealth of knowledge gathered over decades from helping people reach their financial goals. As Vanguard found, wealth managers today are more Financial Fathers and Financial Counselors than stockbrokers. ***We are here to listen, help identify your goals, craft a plan, bring our own and additional expertise to your plan, and most importantly - keep you on track.*** We believe just because you can do something yourself, doesn't mean you necessarily should.

FORECASTS

This is the section of the annual letter where we discuss forecasts made in the past and discuss the bullets on the opening page of this annual letter. We remind ourselves it's a foolish section where we think we can actually make forecasts for the future! While we went 9 and 2 last year (yes we score favorably for ourselves) – the score isn't what this is about. We enjoy using "What If" in our thought process as it allows for outside-the-box thinking and challenges our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the then current market environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we have been dealt.

We changed the format a bit this year. We will discuss each major area as a continuum of thought, the past and the future. And yes, we will have a few forecasts outside of conventional thinking – just to keep us all on our toes! We reiterate our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2017's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2018.

THOUGHTS ON 2017 AND FORECASTS FOR 2018

2017 forecast on the Economy:

Psychology impacts the markets considerably as it is the marginal trade (that last trade as a small percentage of an entity) that is so influenced by the fear and greed of the traders. And that in turn sets the valuation of all the shares of a company. But psychology is as important in the corporate boardroom as anywhere else. The corporate boardrooms have had to deal with a political system that was regulation and tax friendly for the past 8 years. Now there is a new mood, one of hope and expectations of a more business friendly environment. Less regulation and lower taxes combined with additional infrastructure stimulus initiatives by the government create a perfect storm for the C suites to be positive and invest in the future. Rather than buying back stock, perhaps they will invest in Research and Development and capital equipment. ***While there will be a lag effect of the change in corporate mentality, the growth rate of the economy should be better in 2017, and much better in 2018. We see GDP for 2017 at the 3% level, and the momentum being higher as the year progresses.***

Full Point – Not only were the last 2 quarters of GDP growth above 3%, but this growth was achieved in spite of two hurricanes disrupting the economy in Florida and Texas for a significant period of time. Further, the economy grew only with the prospect of tax reform in the future, not the benefit of the actual tax reform.

For 2018 we see corporate board rooms able to make long term capital allocation decisions with a tax code that's been amended and more favorable towards them. The effects of lower corporate tax rates will positively impact earnings quickly. More importantly, the lower corporate rates should level the playing field in today's global economy and allow US corporations to be more competitive. The adoption of disruptive technologies in various industries will only continue to grow. As a result, this tortoise style recovery since 2009 should continue to see the acceleration many had hoped for. As mentioned in our Main Message - yes this recovery has lasted for a significant amount of time. However, it's been such a slow recovery it still has not grown as much as many recovery's that lasted far shorter periods of time. We feel there is more growth ahead before the economy becomes overheated marking the end of this upswing. ***As a result, we expect US GDP to continue its growth rate above 3% in 2018 and reaching closer to 4% near year end.***

2017 forecast on the Stock Market:

Earnings drive markets over the long-term. Expectation of future earnings drive markets in the short-term, along with some event driven emotional volatility. We forecast earnings will be up for 2017 over 2016. While the consensus earnings estimate for the S&P 500 is around $130, we think it does not factor in a potential relief on corporate taxes and the number could come in a bit higher. The headwinds of potential interest rate increases, the offset of potential fiscal stimulus, along with the competiveness in the world economy based on our currency, are all wild cards to the perception of those earnings and how the markets will value them. Additionally, the potential for isolationism to disrupt global trade is a "Grey Swan" type of event that could derail the pro-business climate. We have a much longer viewpoint that the growth of earnings year after year will drive the Dow Jones average over the years to 30,000, 40,000, 50,000 and higher. The question is when. As these forecasts are for next year we are assuming the market will be anticipate 2018 earnings by the end of 2017. ***Applying a reasonable multiple on those future earnings we would expect the S&P 500 to end the year at 2,500 which is approximately 10% higher than today's levels.***

Full Point – We had the direction right, just not the magnitude. However, if you remained invested based on a double digit rate of return expectation, you most likely stayed invested for the excess returns above that number. Especially when the reason for the increases appeared to be what we said – higher earnings and anticipation of tax relief boosts EPS going out into 2018 and beyond.

For 2018 we forecast the earnings of the Standard and Poor's 500 companies should increase because of tax relief, revenue increases, continuing share shrinkage via buybacks, and continuing productivity (margin) increases from disruptive technology. Given the significant spread of equity valuations to bonds as measured by the Fed model, we feel the gradualism of rate increases in the bond markets will not disrupt asset allocations significantly in 2018. Equities will still be the asset class of choice for both cash flow returns and total return. As a result we will go out on a limb and say earnings could be $150 or greater next year for the S&P 500 and that animal spirits (although maybe challenged a bit in the middle of the year going into mid-term elections – could this be the year the "Go away in May" trade works?) should be enough to have the market trading at a multiple still above the mean. ***We forecast 2,800 to 2,900 for the S&P 500 based on continued earnings and economic growth.*** If we are wrong, we believe once again the market may be above rather than below our forecast. However, with a Price to Earnings ratio of 20, the market remains within one standard deviation above the mean. Further, if we do see mean regression a bit this year, we feel it will come from earnings growth rather than price declines. Historically, true market peaks that result in substantial (greater than 30%) declines in market valuations have generally happened from much higher valuation levels. With market momentum on the side of an upward bias and the emotional pendulum having not yet swung to euphoria, there is a solid case to be made that the Price to Earnings ratio could expand a bit more before an adjustment happens. Are the markets "due" for a correction? Based on historical evidence presented earlier, one is indeed overdue. However, looking past the quarters to the years, we see fundamentals continuing to improve and feel a noticeable correction may be a great buying opportunity.

2017 forecast on Short-term rates:

> The Federal Reserve has released its "Dot Plot" that anticipates 3 rate hikes in 2017. They anticipated 4 last year and we believed them. This coming year we will have potential economic stimulus coming from Washington at a time in the economic cycle when normally you would expect none. This coupled with potential adjustments to the tax code could lead to monetary policy and fiscal policy being in direct conflict with one another. We believe it will take the better part of the year to get any meaningful fiscal changes done, so the impact of those changes would not be felt in the economy until 2018. However, the anticipation of those policies very well could be reflected in the markets well before they impact the economic numbers. As a result we feel ***2 to 3 rate hikes will be the actual number for the year but language and rhetoric will be talking rates higher rather than lower.***

Full Point – Three raises and the language is talking higher next year. In addition, tightening was further emphasized with the talk of balance sheet reduction through run-off. We also were correct that the time to accomplish any meaningful tax program would not be quick and have no material impact on 2017.

For 2018 we forecast two Fed Rate hikes – maybe three – but believe the Fed understands market players all closely monitor the yield curve. The Fed will not want to artificially cause an inverted yield curve that potentially erodes confidence recently built up in financial markets. The carry trade of foreign money that has a zero (or even negative) yield still has the impact of keeping ten year rates lower than they otherwise would be. Until foreign central banks also start on a discount rate increase program, this carry trade will continue to exist. The ECB's recent announcement indicating they will continue their asset purchases well into 2018 along with a corresponding 0% discount rate illustrates that controlling the carry trade remains outside the Fed's control. However, the Fed balance sheet is in their control. Because of this, perhaps we'll see more than just a run-off of securities to lower the balance sheet size, but also potential asset sales to reduce the balance sheet to a more appropriate size in the future – which we view as 2 to 2.5 Trillion dollars. If the Fed is successful at driving up long term yields by shrinking their balance sheet, then we may see more than two rate hikes in 2018. Watching M2 will be very telling to see what impact the shrinking of the balance sheet will have on the potential for inflation targets to be realized. Without growth of the money supply, inflation will be tough to manufacture. But let us say with a slight chuckle, never fear, congress will find a way to spend more than they should and the shrinking Fed balance sheet may take a lot longer to happen than we think!

2017 forecast on Long term-rates:

> One of the main indicators of the health of the economy has been the shape of the yield curve over time. When it goes inverted it traditionally signals a recession. When it has a normal slope with long term rates being higher than short term rates, it signals the proper relationship of the cost of capital to the length of the use of that capital. In the past few years we have seen a fairly flat yield curve. Since the election it has steepened considerably. We see this as another indicator of a positive outlook for the economy. We feel that as the Fed raises the discount rate we should see a like increase in the yield curve – all the way along the yield curve. Therefore with our forecast of 3 rate hikes for a 75 basis point increase in the Federal Funds rate, ***we anticipate the 10 year bond yield to rise to 3.25% by year end 2017.***

No Point - 2017 did see the short end of the yield curve rise with the discount rate being increased. However, we were wrong in thinking the long end of the curve would rise in lock-step and keep the same spread we entered the year with. The 10 year yield will end 2017 close to where it began the year causing the yield curve to flatten and us to waive a yellow flag of caution. Jan 1, 2017 2.446% ----- December 29, 2017 2.405 %. If we look back to just after the election, spreads between the discount rate and 10 year bond widened as the 10 year bond yield increased by more than 60 basis points. We assumed this new spread would hold and the yield curve would keep its shape through 2017. However, we were wrong as 10 year yields remained relatively flat and thus the yield curve flattened.

There is a potential concern we see with the Fed not being a buyer of longer-term maturities as they allow their balance sheet to shrink. At some point in the future we are in danger of a tipping point where the Federal Budget deficit's tapping the bond market for capital will impact the long term capital available for corporations. More supply of debt and fewer buyers could very well lead to higher yields as the competition for those investment dollars increases. Absent in this consideration is the ability of central governments to "print money" as needed to cover their own deficits. However, this is not without its own consequences as it opens the door for potential devaluation of the currency and possibly letting the inflation genie out of the bottle thus leading to the vicious cycle of the 1970s stagflation all over again. Certainly a scenario we would not want to see. Maybe this is the attraction of "finite" quantity crypto currencies.

Fortunately, for 2018 we do not see the tipping point occurring and once again will forecast that the spread between short and long rates will stay close to the same level we enter the year with. With our forecast of 50 to 75 basis points of increase in short-term rates, we forecast the 10 year rate to end the year between 2.9 to 3.15%.

2017 Forecast on Oil:

During the attempt by Saudi Arabia to try to capture or protect their market share by forcing the price of oil lower, the oil industry had to adapt once again to lower prices. That meant delaying development, capping wells, reducing expenses wherever possible, and paying attention to their balance sheets. In doing so, the production cost for a barrel of oil has declined significantly. Bad news for anyone who wants to see a rapid return to triple digit oil prices. The United States has become the de facto swing producer in the world oil supply market. As the price increases, so will our production. Maybe not as quickly as an OPEC meeting in Vienna, but the free market will regulate the price of oil more going forward. If congress gives the oil industry the ability to ship oil overseas in addition to LNG, then we may see the United States build up production and finally become a net exporter of oil. Given our outlook that the price of oil will be based on profitable economics going forward, our forecast is for the ***price of oil to be range bound between $50 and $65 a barrel in 2017.*** Because of the lag in putting on production as the price rises, there is a chance the upper end of the range may be pierced for short periods of time. On a longer term basis, we feel the adoption of alternative fuels will slow the growth of consumption of oil and may cause this range to actually slide lower in the ensuing years.

Full Point – Much of 2017 saw oil range bound between $50 and $65 – except for the short term piercing of the bottom end of the range during the summer months. Technology is finding its way into every industry and the oil industry is no exception. Going into the year the estimate for recovery breakeven from Shale wells was somewhere in the $45 to $50 a barrel range – hence the lower end of our range was $50. As the year progressed many oil companies were guiding closer to $40 a barrel costs! Therefore, drilling continued and inventory excesses found it harder to be worked off than many had anticipated. The Saudi controlled OPEC realized flooding the markets to try and maintain market share was a strategy that would over time bankrupt many oil producing countries. Acknowledging this, they organized a return to production cuts in attempt to raise the price back to a level that would prevent the political instability of budget cuts in their countries. Unheralded in the financial press was the victory for America's oil industry as producers not only retained, but grew their market share thereby capturing more of the world's production revenue. What OPEC recognized was that the entire pie was increasing. Therefore, a smaller share of a larger pie at the right prices was better than how much of the pie you had. We are still waiting for the US to be an oil-exporting nation, but that can't be too far off with the current administration in Washington. After all, we have gone from not exporting LNG to being the largest exporter of LNG in the world in just a very few short years because of our shale technology. Mid-term elections could be very important on this issue.

While we are believers that alternative forms of energy continue to become more economic, it is still a number of years before there is any material impact on the demand side of the oil equation. ***We believe the $50 to $65 range will hold again for 2018.***

2017 Forecast on Inflation:

Inflation remains in check for most of the year until energy prices begin to rebound. Otherwise, we see continued strength in the dollar which should keep inflation low as imports remain down in price in dollar terms. We see moderate economic growth along with moderate wage increases. ***In our opinion, another year of benign, sub 3% inflation.***

Full Point - This has been a constant refrain for a number of years. The tough call is to time when, and if, inflation will become a major part of the economic narrative. In our predominantly service oriented economy, inflation has historically been driven by wage increases. Declining unemployment levels should eventually lead to higher wages and not just from legislatively driven minimum wage increases that are happening in various communities. However, headline unemployment numbers do not tell the story of those that have run out of unemployment benefits or merely fallen off employment rolls and no longer looking for jobs. We must also factor in more is being done with less as the industrial economy continues to be impacted by disruptive technology causing reduced prices, improved efficiencies, and elimination of wages as jobs are replaced by automation.

Today, we believe inflation may be driven more by interest rates. It has for years been a real "chicken and the egg" question. Which comes first - inflation or higher interest rates? With rates held low for an extended period of time, inflation has also remained low. So the corollary could be true. As rates rise, the inflation rate will rise. Wouldn't it be great if it was that easy? But in economics, there will always be yet another influence that impacts a statistic. In the case of inflation we can think of Money Supply (M2), Federal Deficit and Trade balances just to name a few.

All that said, ***we believe inflation will start to rise a bit in 2018 – still below 3%, but nudging above the 2.2% rate we have seen for the past few years.*** Toward the end of the year we may see the surprise that it is above 2.5% for at least one quarter.

2017 Forecast on Commercial Real Estate:

> Rising interest rates can have a dampening effect on commercial Real Estate. The value of these properties is based on the income they generate and then applying a rate of return that is acceptable to the purchaser of the property – or the Capitalization Rate. While rents can rise with inflation clauses in many rental contracts, if the rate of the increase in the Cap Rate outpaces the income increases, the value of the properties will decline. The only way that you can overcome that is by adding value in other ways on the property, either through development or revenue enhancements. ***The REIT sector will probably be challenged next year as rate rise. Defensive sectors with solid fundamentals, REITs with unique growth propositions, & REITs that can expand their portfolios and increase Funds from Operations on an accretive basis should be the best performers. If mortgage rates increase and affordability becomes an issue, Manufactured Homes could also do well.***

Full Point – one of the great things about Real Estate is that it tends to move slowly and in long-term trends for years, not quarters. According to NAREIT statistics, during 2017 the 4 best performing sectors through November 30th were Infrastructure (up 36.49%), Data Centers (up 30.86%), Manufactured Homes (up 25.34%) and Industrial (up 24.01%). These leaders were largely right in line with our idea of owning defensive sectors with solid fundamentals. These areas clearly were stand-outs as the average of all equity REITs was up 5.45% last year. This implies there had to be some areas that got hurt. Not surprisingly, it was Shopping Centers (down 13.47%), Regional Malls (down 7.13%) and Diversified (up 1.0%). The internet is impacting Retail. We see this trend continuing but possibly slowing as bricks-and-mortar locations appear to be morphing into delivery points/warehouses for online purchases.

What we wrote last year certainly applies for 2018. We would just add that distribution centers supporting the online retail market and data centers for "The Cloud" are areas that could very well have solid long term runs in the Real Estate Sector. While they may appear "rich" based on historical valuations, we feel every portfolio with a Real Estate allocation will benefit by having representation in these sectors.

For 2018 we forecast much of the same. Active portfolio management will be needed to add value to overcome the downward pressure a gradual rise in interest rates will place on the sector. Finding these unique opportunities will be how value is created over and above the increasing dividend (rent) stream of commercial real estate. We will maintain a neutral asset allocation in our models, but note that our neutral allocation is significantly larger than most on Wall Street who continues to view REITs as an "Alternative" asset class. We believe most firms are missing the reality that Real Estate is the largest asset class by value in all of the United States. Therefore, we feel if an investor cannot own investment real estate directly, they need a higher representation in their investment portfolio to be truly diversified.

2017 Forecast on Residential Real Estate:

Jobs drive real estate prices more than any other factor. Scarcity of land and housing supply is a second driver. Third, is the cost of mortgage financing. We then have the demand side of the equation. For a number of years Millennials have not been following the tradition of launching households as soon as they have their first jobs. They have either lived at home, or chosen to rent as they have a mobile outlook for jobs. With remote job capabilities becoming more accepted and thoughts of having children start to enter the equation, we feel Millennials will begin to seek that "nest" they will call home. They will be entry level purchasers shopping for condos and town houses in urban areas and houses in more remote locations. The trend toward larger and larger homes since the 1950's we see as reversing in the years to come as more of life will be experienced outside the walls of the house. So once again, we forecast ***entry level homes will do well in 2017 and the larger "mega" homes will continue to be under pressure. With more demand and sales driving the starter home end of the market the net result will be for an increase nationwide in the price of a home.*** Yes, as the 10 year treasury increases in yield, mortgage rates will rise. The affordability of a $200 - $250 thousand dollar home will be marginally affected, but not enough to counteract the demographics. If there is tax reform and the mortgage interest deduction is impacted, then again, the larger priced homes will suffer more in price.

Full point – Prices trended up with the Case Shiller index rising from 184.71 to 195.51 through September. Put in dollar terms, the US existing single family home median sales price increased from $236,000 on January 1st to $248,300 on October 31st. While additional data is not out, there is no indication that prices have dropped in the last quarter of the year. Limiting the deductibility of interest and real estate taxes may have a negative impact on real estate markets in some higher priced communities in the country. The gradual creep up of interest rates may also begin to have an impact on the affordability of higher priced homes. The next generation of homeowners are starting to buy, but not large home. They are content owning smaller homes with more of a minimalist feel than their parents and grandparents (maybe because they haven't accumulated enough 'stuff' yet – never fear, they will inherit a lot of 'stuff'!). ***They are still focused on houses at the lower end of the price continuum. We see this area exhibiting continued strength in 2018 and the Case Shiller index continuing to rise. In 2018, we see the trend continuing.*** Much like in commercial real estate, these trends tend to be long lived.

SPECIAL FUN FORECASTS

US Government issues 50 or 100 Year bonds:

Most borrowers will match off borrowings with the life of the project they are funding – or the expected length of time borrowed funds will have an economic usefulness to the entity. The US Government has a time horizon measured in centuries, not decades. As such, we feel they should be borrowing money long term to fund long term infrastructure and other investments. With business people in the Executive branch we feel they will realize the cost of infrastructure projects being financed at lower rates available now should be done over the very long term. And common sense will be part of the economics of the country for this administration – you borrow long when rates are low and expected to rise; you borrow short when rates are high and expected to come down. To accomplish this, ***we think the US treasury will issue 50 or 100 year bonds.***

No Point - but honorable mention for the concept having been explored by the Treasury. On February 23rd Treasury Secretary Steve Mnuchin said he asked his staff to explore issuing 50 and 100 year bonds. The idea of locking in today's ultra-low interest rates for long periods of time, and simultaneously pairing off liabilities with funding of the same duration, makes economic sense. Presently, approximately $1 trillion of debt matures after 2027 and the issuance of ultra-long term debt could save a substantial amount of interest in the future should rates rise as expected. However, on October 30th Mr. Mnuchin said that for the moment, there is not enough demand to warrant going forward with the issuance of 50 and 100 year bonds. Our hope is that before interest rates increase the Treasury changes their mind and issues some of these bonds possibly with call features allowing them to be redeemed in 10 or 20 years.

Shifting International Balance of Power:

International tensions will become more of the front page news as the world deals with two things simultaneously. ***Issue #1: the apparent retrenchment of America from the role of world policeman will create a perceived vacuum that China and Russia will try to fill.*** This will be accomplished either with China continuing to assert dominance and control over the South China Sea, or with Russia expanding its influence in the Middle East and coming to a mutual friendship agreement with Ukraine. ***Issue #2: the solidarity of the three major superpowers to combat the destabilizing influences of terrorism worldwide.*** Yes, the three will be US, China, and Russia. Germany will see their place in the influence of the geopolitical world wane as continued pressures to maintain the Eurozone prove increasingly more expensive – both in money and prestige.

The Chinese party conference is done and Xi Jinping has as strong a hold on power as any leader since Mao Tse Tung. Xi Jinping has demonstrated already that China will exert its new found world power role in its own best interests. With 3.3 trillion dollars of goods shipped through the South China Sea annually and potential vast energy resources to be developed, China continued to build and occupy islands to expand their claims to sovereignty over the waters (their "Nine Dashes" claims from 1948). Although the Philippines won a lawsuit in the International Court in Hague regarding the sovereignty of the Spratley Islands, they backed away from confrontation to enforce the rulings due to dependence on trade with China. The South China Sea may be more of a potential spot of military confrontation than even North Korea. However, China is using diplomacy and economics to exert its influence and power over many of the Asian countries.

In Syria, Russia withdrew some of its forces in early December and then announced they would have two military bases along the Syrian coast with 50 year leases – creating a permanent influence in Syria and an ability to extend their military influence in the Mediterranean Sea. While expanding their sphere of influence on the world stage, they are cooperating with the United States to battle terrorism. In the middle of December Vladimir Putin picked up the phone and called Trump to thank him for sharing intel that thwarted a terrorist plot in St. Petersburg and also offering to reciprocate in the future should they uncover anything of note for the United States.

As far as keeping score, we will take ***a point*** – although in truth this point was obvious before the year even started. We put it in the letter to bring awareness more than be a forecast.

Disruptive technology:

> Technology is the advancement of any field, not just computer science. The assembly line was once advanced technology. Today, the advances are happening at ever increasing rates across all industries. ***If an industry thinks it is immune then it is going to get disrupted.*** The most recent example is the concept of a "driverless car". The car for hire business will be disrupted. The need for multiple vehicles in a family will be reduced. Delivery drones may not fly through the air, but be driverless cars with delivery robots that place the package on your front doorstep. Machine Learning and Artificial Intelligence will be the buzzwords of 2017 as the ethics and disruptions impact many industries.

This too was more about awareness than a forecast. To us it's obvious we're experiencing a fundamental change in this techno-industrial revolution. The speed of change is surprising many and impacting virtually all industries in some way. As a perfect example, who would have thought Amazon would buy Whole Foods Markets. The internet sales leader buying bricks-and-mortar locations. The company known for low prices buying the company known as "Whole Paycheck". While at first blush surprising, the technology driven distribution efficiencies and economies of advertising and scale make the transaction look like it will work. The grocery store business is being impacted by advanced technology.

During the year the buzz words were not limited to Machine Learning and Artificial Intelligence – there were other words as well – block chain, distributive ledgers, crypto currencies, and yes – Bitcoin. Many will argue about the potential bubble aspects of Bitcoin, but no one is arguing that the underlying block-chain technology making it possible is ground breaking and adaptable to multiple businesses. However, we are of the opinion that the need for governments to control and regulate the flow of funds for the protection of the societies they govern (let alone their own survival) will lead to changes in crypto currencies in the next few years. The overwhelming apparent demand for a secure, digital currency will spark basic supply and demand, and additional crypto currencies will be created to absorb that demand. Will this lead to a popping of the current apparent Bitcoin bubble? At some point fairly soon we think at least the meteoric rise will abate, if not reverse.

Remember the signs of a bubble – it is on everyone's mind, people throw money at it not even knowing what it is, unwise leverage it utilized such as people taking out Home Equity to buy in near the top, or max out credit cards. The price action becomes almost parabolic to the upside as the last people buy in. Then, suddenly there are no more buyers, or the public says "The emperor has no clothes". One seller takes a profit, then another, and then sellers can't find a buyer to sell to and the price collapses. Same number of Bitcoins, just no buyers and all sellers. Or supply increases through alternative forms of ownership (derivative contracts example) or additional coins of other origin being created to absorb demand (Ethereum and Litecoin as two new examples that are already trading on the CoinBase App). If I was going to be a futurist and take a look out ten years or longer, I might forecast the Government would issue their own CryptoDollar currency and make it legal tender for the United States. We could be truly off the wall and say that because every movement of money could then be tracked that a new taxation system could be put in place and every transaction would have a tax on it. Let us get truly crazy and say that the government calls in all currency and it is replaced by CryptoDollars – and all debt of the United States is converted into CryptoDollars. Well even if those very long term thoughts don't come true, we have a good plot line for a book or movie!

2018 "Fun Forecasts"

This year's "Fun Forecasts" are designed to give us something to talk about. They challenge us to be aware of things that may lead to future investment opportunities or raise warning signs for existing investments we currently embrace.

1st Fun Forecast - Not to beat a theme to death, but disruptive technology in all its forms will continue to impact one industry after another. One of those industries we see it becoming more prevalent in is Higher Education. The information that can be learned in the classroom is now available online. The instruction in the classroom is also available on line as well. Classes given by Harvard and MIT professors are available at no cost. EdX is a website that provides advanced education as well – again at no cost. The adoption rate of these forms of education will continue to rise, and rise dramatically. The other advantages of a college education will be challenged as well. The network of alumni and connections that are created during those years are being replaced by digital communication and networking. With FaceTime and other methods of connection by students engaged in online classes, the modern friends from hither and yon will connect and stay connected. With the degrees of separation becoming smaller via apps like Linkedin, the concept of alumni is being replaced as well. One thing that is still (currently) important is the social learning and transitionary evolvement of a youth with very little responsibility in the home environment to that of an independent person out on their own. But how much can they afford for that social education when the cost of the classes will be under so much pressure.

2nd Fun Forecast - We have talked about it in different ways before, but awareness of the changing of the climate will continue to be a theme. Al Gore created a sequel to his "Inconvenient Truth" documentary that is an update. While we think there is very little new information and it is more a documentary on the passing of the Paris global accord, and the success of the network that he has established, it will be making the rounds and causing the conversation to stay in the forefront of a lot of people's minds. The ten hottest years on record are the last ten years. The Greenland Ice is melting, measurably, as is the mass of the ice in Antarctica. In the theme of this year's letter of looking back, those are both things we have talked about before. They are also facts. Are they a short-term trend in the very long-term cycles of the Earth? Are they exacerbated by industrial pollution? Has the tipping point of global warming been passed where no amount of cleanup will stop it? These are questions still open for debate, but the vast majority of scientists agree there is something happening and its impact on the earth's ability to support the human race is something that is of concern over the next 50, 100 to 200 years. While Earth survives, mankind may not. What we do today has a compounding impact on the future. We see countries around the world living to the spirit of the Paris Climate accord and adopting more alternative energy sources, legislating the use of electric vehicles in the future, and doing other actions on other areas of pollution as well (the sea cleanup project as an example). While the United States government may have pulled out of the Paris Agreement, we see the major corporations of our country embracing much of its terms – if for no other reason than we are in a global economy and to compete globally, they need to be in harmony with what the rest of the world is doing.

3rd Fun Forecast – 3D printing has made great strides in the past few years and we forecast it could well be one of the hottest technology gifts for 2018's holiday season. It appears Moore's law is applying here as the technology improves and costs shrink. As the technology has advanced from a powder bed process to metal sintering and melting and then to liquid molecules, the term has changed to "additive manufacturing" or AM for short. Ray Kurzweil asserts that "*By 2020 there will be a whole host of products available immediately to buy for pennies on the dollar and print straight away. It will become the norm for people to have printers in the home*''. While he believes that very soon you will be able to "print" your clothes (putting sweat-shops in 3rd world countries out of business) it is the exciting possibilities of being able to print human organs using modified stem cells with a patient's own DNA that truly excites us. At the same time, it opens up one of the things we worry about a lot to an ever increasing possibility – pandemics. With the entire genome sequence of the 1918 Spanish Influenza virus available as open source on the internet, the computing capabilities of today's laptops, and the potential of biologic 3D printing, the specter of a single terrorist starting a pandemic with a modified pathogen is becoming more feasible. Hopefully the nanoparticulate drug carriers are perfected before this happens. It is a truly astounding future of possibilities that the techno-industrial revolution has in store for us!

CONCLUSION

We've heard a lot of talk lately about this market being in the late innings. We challenge this metaphor. Markets & economies do not end. The US economy has never ended and neither have successful businesses. Being in late-innings implies the end is near. As a reminder to our investors, we don't invest in late-inning businesses. We diligently research the businesses we own and demand they continue to deliver on their plans thereby delivering increasing value to the true owners of the business – the shareholders.

This letter is perhaps longer than we would like. It is a soapbox we can get on and be uninterrupted. Believe it or not, we could continue to write more on things we see as important such as the 18 ½ year business cycle, our study of family offices and how you can create one virtually with the help of your wealth advisor, debt as a percentage of GDP, or looking at some of our investment successes and failures in the recent past. Stay tuned as we send out our short quarterly updates!

As always, we welcome your feedback and would love to talk about these and other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. ***Montecito Investment Portfolio's Mission: To provide diversified, disciplined long term investment solutions, service and guidance to help our clients achieve, and maintain, their "Financial Independence".***

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.

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