FIRST QUARTER 2018 – TRUST & INVESTMENT MANAGEMENT'S

WEALTH MANAGEMENT UPDATE

Exchange Bank

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TRUST & INVESTMENT MANAGEMENT GROUP

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Investment Review and Outlook

By Matthew C. Kelman, *Vice President*

Continuing with the theme from the first three quarters of the year, the fourth quarter of 2017 saw a continuation of broad-based economic growth across the globe that resulted in rising interest rates and global equity prices. Unemployment rates continued to fall, with the headline US Unemployment (U3) Rate touching new post-financial crisis lows during the quarter at 4.1%. Historically, at this point in the economic cycle, and with an unemployment rate below what the Federal Reserve considers "full employment," there is an expectation of increasing wage growth and rising inflation metrics, however neither of these have fully manifested themselves to the degree many would expect. Part of the reason for this may actually be the Federal Reserve, who is intent on raising short-term interest rates to slow the economy and then questioning why inflation is not accelerating toward their own goal of 2%.

Additionally, comprehensive tax reform legislation (or more precisely, corporate tax cuts and a personal tax re-distribution) worked its way through Congress and was signed into law near the end of the quarter. Included in the legislation were some of the biggest changes to tax laws in a generation, with permanent major reductions to corporate and pass-through entity tax rates, as well as significant, temporary changes to individuals' rates, deductions and exemptions. The end result of the legislation should amount to over $1 Trillion in reduced tax revenue over the next decade, the bulk of which will be enjoyed by large multi-national corporations and wealthy individuals residing in low-tax states. At this point, the big question is whether these tax cuts for the wealthy will trickle down to the greater economy as hoped, or whether they will only serve to increase the income and wealth inequalities that have been receiving increasing amounts of press over the past few years?

MARKET PERCENTAGE TOTAL RETURNS AS OF DECEMBER 31, 2017

Index	Q4-2017	One Year	Five Years (Annualized)	Ten Years (Annualized)
Barclays U.S. Aggregate Bond Index	0.39	3.54	2.10	4.01
S&P 500 Index	6.64	21.83	15.79	8.50
Russell 2000 Index	3.34	14.65	14.12	8.71
MSCI EAFE Index	4.23	25.03	7.90	1.94
MSCI Emerging Markets Index	7.44	37.28	4.35	1.68

Regardless, the combination of a more synchronized global growth landscape in conjunction with major corporate tax reductions in the US meant that stocks, both in the US and globally, saw major gains during the fourth quarter as well as for 2017 as a whole. Risk was rewarded as emerging market stocks outperformed their developed market counterparts over both time frames—with US stocks having a better fourth quarter while slightly underperforming for the year relative to the developed world ex-US markets. All in all, the majority of developed and emerging stock markets saw 20+% gains for the year.

In 2017 fixed income markets, the Federal Reserve's accelerated pace of tightening (albeit slow by historical standards) pushed up the short end of the yield curve with three ¼ point rate hikes during the year, while the longer end actually saw yields fall by a modest amount due mainly to a lack of inflation pressures showing up on the horizon. All this is also occurring as the Fed began the process of shrinking its balance sheet for the first time since the financial crisis in the fourth quarter. Overall, the bond market as a whole (as measured by the Bloomberg Barclays Aggregate Bond Index) had a moderately successful year, with total returns exceeding its yield for the second consecutive year.

Looking ahead to 2018 and beyond, it appears that the global economy is poised to strengthen and solidify its expansion, which should allow for additional gains in US and global stocks. Meanwhile, bond markets look slightly less attractive due to increasing US treasury rates and the slowing, stopping and unwinding of major central bank balance sheets globally. That said, we at Exchange Bank continue to believe that the best method to achieve investment success is to determine each individual investor's long-term risk and return needs, and to build a portfolio to meet those goals.

Taxes, the Economy and Investing

By John E. Mackey, *Senior Vice President*

By now, most of us have completed some analysis of how the 2017 Tax Cuts and Job Act (TCJA) will impact the amount we will pay in taxes for tax year 2017. However, the impact of tax rate changes and deductions on behavioral economics, and investment decision making on the economy are difficult to anticipate with existing models. There might be some significant surprises.

The last significant reform of the tax code was the Tax Simplification Act of 1986. That act reduced tax rates and compressed the tax brackets, leading economists to predict very positive outcomes for the economy for many years. Those predictions were proven to be true, but it was a very bumpy ride. Restrictions on accelerated cost recovery for equipment, removal of many levered tax deductions and lengthening the depreciation schedule for income producing real estate, led to changes in the way investors made decisions. Those changes left a painful mark on many of us in the form of Black Monday (Oct. 1987) and the severe recession of the early 1990s.

Most of the models economists are using predict marginal increases in GDP ranging from 1.7% to 2.8% over the next 10 years (Parker Sheppard/David Burton of the Heritage Foundation). Those predictions might not seem significant, but they can have significant impacts on many aspects of our economy that in turn impact the markets and us. Small increases in economic activity can have large impacts on an already scarce labor supply, construction materials and energy costs. Increases in the net income associated with business decisions made due to the lower tax rates will increase the number of investments that have positive net present value, which leads to more capital spending such as equipment purchases and new hiring. Greater growth in the US will likely lead to more growth in both developed and emerging markets, which benefit from sales to the US and increases demand and prices for natural resources. Foreign growth also creates demand for US products and services along with increased earnings for many US companies.

With the US economy in 2018 emerging from the "Shadow of the Great Recession" (Robert Dye, PHD) and likely to produce more consistent positive earnings growth both here and abroad, how do we expect markets to respond? We have reason to believe that equity markets will continue to perform well even with the outstanding performance of 2017. Fixed income markets performed well due to improved income opportunities at the short end of the yield curve (thanks to the Federal Reserve's three Fed Funds increases in 2017). There is not much change at the long end of the curve and strong price appreciation for riskier assets. We will likely see more of the same activity in 2018 leading to higher short term interest rates, nudged along by three more Fed Funds increases, a relatively flat yield curve and narrow risk premiums for high yield debt.

While the current view of 2018 is very rosy, I remain concerned about the factors that we are not yet seeing and are not in the economist's models. Diversification remains the key to obtaining the best outcomes in our interesting and changing world.

Estate Tax Changes with New Tax Plan

By Emily Menjou, *Vice President*

In our third quarter newsletter of last year, we included an article detailing Trump's proposal to eliminate the estate tax. In December, the House and Senate passed the final plan, effective 1/1/2018, which includes changes to the then-proposed plan. Most notably, the estate tax has not been eliminated, however the new tax bill doubles the exemption amount for estate, gift and generation-skipping taxes from the $5 million base set in 2011 to a new $10 million base (indexed for inflation). The increased exemption amount will remain in effect from tax years 2018 through 2025, at which point it is expected to sunset back to pre-2018 levels.

Under the new plan, an individual can now shelter $11.2 million in assets from estate tax. Portability remains intact, allowing a surviving spouse to utilize a deceased spouse's unused exemption amount. The result is that a married couple can now exclude $22.4 million from estate tax. These amounts will continue to increase for inflation through 2025. Although the vast majority of estates will not be subject to estate tax—now even fewer than before—the new tax bill offers a significant planning opportunity for wealthy families who may benefit from the increased exemption amounts while they remain in effect.

The new tax plan has not made any changes to rules allowing a cost basis adjustment at death, which were subject to elimination under earlier versions of the tax plan. The ability to adjust basis to date of death values provides the tax advantage of eliminating or shrinking capital gains on appreciated assets passing to heirs, which will continue to benefit a much larger number of American families than changes to the estate tax.

After indexing for inflation, the annual gift tax exclusion amount increases from $14,000 in 2017 to $15,000 in 2018. Each individual can gift $15,000 per year to any number of individuals without dipping into the lifetime estate, gift and generation-skipping transfer tax exemption. This increase is not a result of the new tax plan, but a notable figure for 2018.

If you are concerned that the new tax bill may have an impact on your estate plan, or to take advantage of the increased estate tax exemption amount, we recommend that you consult with your estate planning attorney and CPA. As always, we continue to recommend periodic reviews of your estate planning documents to ensure they accurately reflect your wishes and financial position.

Why Invest in Foreign Markets?

By John E. Mackey, *Senior Vice President*

While most investors are comfortable owning US stocks, many clients express an aversion to international markets. The propensity to avoid foreign investments is referred to as "Home Bias" and is completely normal, maybe even rational. However, in portfolio construction it is key to be aware of and overcome this bias in order to take advantage of the benefits offered by international markets.

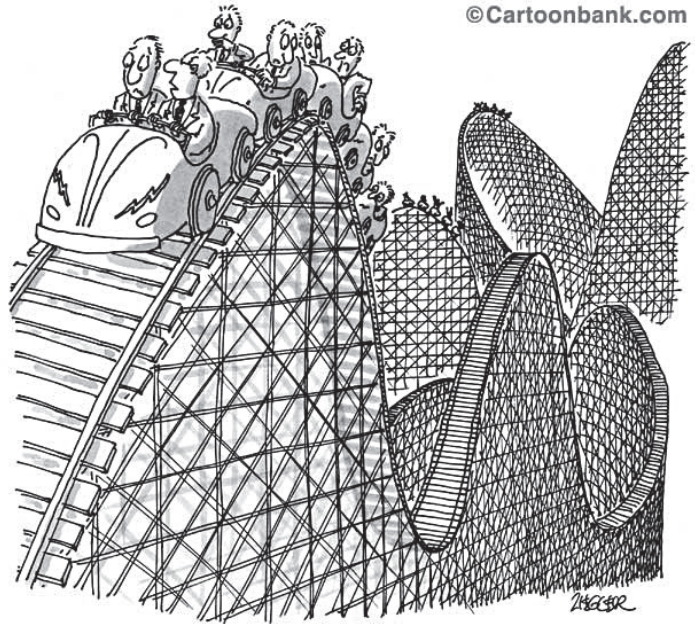
Bias against international stocks has been studied by behavioral scientists, market theorists, and it has even been addressed by the creators of Modern Portfolio Theory. Simply stated, most investors choose to invest in businesses that they understand or that are familiar to them. Investments from across the globe do not provide the same comfort level that US investments provide. Fortunately, many companies in the US are taking advantage of foreign trade, benefitting from the growth of developed markets around the world including increased liquidity, labor and natural resource price anomalies and currency fluctuations.

Other factors contributing to the "Home Bias" include the added risk of investing using foreign currencies, unfamiliar accounting practices, loosely or unregulated markets and unpredictable governments. Many of these factors have been mitigated by international treaty, accounting conventions and international courts. The world has become a smaller place, and as these risk factors have been mitigated, the benefits of international diversification have increased.

So why is exposure to international markets so important in portfolio construction? The answer is two-fold. First, international markets move independently from US markets, thereby providing true diversification benefits to reduce the risk and volatility, which is necessary to achieve optimal returns. Secondly, assets in developed markets tend to be priced more favorably than counterparts in the US and many economies around the word are strengthening, supported by strong growth in the US and China.

We enter 2018 enjoying a Bull Market that is reaching record levels in not only price, but length of time since the last significant correction. The outlook for US markets remains strong due to our economy's improved growth, and recent changes in corporate tax rates. Earnings from Large Cap US companies are setting records in 2018 supporting current high valuations. Also, much of the returns of the past few years have been dependent on a few stocks in the technology sector, which has grown to represent 20% of the S&P 500. Momentum in a handful of companies (Facebook, Amazon, Netflix and Alphabet) has increased the concentration in these stocks for most of us.

We continue to support diversification—through both domestic and international investments—as the most effective tool in managing risk and delivering returns within our portfolios. 2018 is likely to see a return to more normal levels of volatility therefore we expect prudent risk management to be rewarded.



"This reminds me of when you told me Bitcoin would help me retire."

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We hope you enjoy our quarterly update and musings, and we look forward to continuing our coverage of an array of wealth management topics that can assist you in meeting your investment, retirement, and estate planning goals.

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