SECOND 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*

After a great start to the year, the first quarter of 2018 saw the significant return of volatility to global financial markets that many economists and market participants have been anticipating over recent months. Rising interest rates and high stock market valuations, including multiple records for the Dow Jones Industrial Average, Standard & Poor's 500 and Nasdaq Composite Indices, paved the way for the first 10% equity market correction in two years and included a significant shift in market sentiment to a more risk-averse setting.

Coming into January, stock and bond markets were still digesting tax reform legislation that passed through Congress and the White House in late December, anticipating a boost in economic growth and corporate earnings from reduced tax rates. Adding to the fiscal stimulus were government spending bills that increased federal spending as well. With expectations of above-trend growth for 2018, stocks and long-term interest rates continued their ascent reaching a near-term peak by the middle of the quarter.

Rising long-term interest rates typically occur due to increasing or accelerating economic growth leading to higher inflation expectations, which in turn lead fixed-income investors to demand higher yields as compensation for that increased inflation risk as well as in anticipation of Federal Reserve rate hikes to keep inflation to a reasonable pace. These rates are important not just for fixed income investors but also for equity investors due to various valuation methodologies that require some sort of discounting. By the end of January, long-term rates, as measured by the 10-year Treasury Note, had moved up over 30 basis points, from 2.4% to 2.72%, and eventually moving up to 2.94% by late February. This significant

MARKET PERCENTAGE TOTAL RETURNS AS OF MARCH 31, 2018

Index	Q1 2018	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	-1.46	1.20	1.82	3.63
S&P 500 Index	-0.76	13.99	13.31	9.49
Russell 2000 Index	-0.08	11.79	11.47	9.84
MSCI EAFE Index	-1.53	14.80	6.50	2.74
MSCI Emerging Markets Index	1.42	24.93	4.99	3.02

increase in long-term rates, even without any actual Federal Reserve rate hikes during this period, caused a significant re-pricing in both the stock and bond markets that lasted through quarter end.

In summary, the first quarter produced losses for most investors across virtually all asset classes, with stocks and bonds broadly seeing losses across both the US and developed markets, while expectations for increased global growth allowed Emerging Market equities to hold positive returns even in light of rising global rates. As US markets saw their first 10% correction since 2016, valuations are looking much more reasonable for positive returns going forward, and continue to look attractive in particular relative to expected returns for fixed income investment in the current rising rate environment. That said, Exchange Bank continues to believe that focusing on each individual client's long-term risk and return needs, instead of short-term market movements, is the best approach for ensuring all of our clients meet their financial goals.

"Sorry Son, the Fed thought you'd like higher interest rates more than a trip to Disneyland this summer."

Who Pays the Tax for My Trust?

By Emily Menjou, *Vice President*

Having just finished another tax season, I'm reminded that many clients and beneficiaries are unclear on the income tax implications associated with income earned in their trusts, and more specifically, who pays the tax? The question is straightforward, but the answer depends on a variety of factors. For example, is the trust a grantor trust or a non-grantor trust? Is income required to be distributed, or is it discretionary? Is income currently being distributed?

Grantor Trusts

The IRS generally defines a grantor trust as any trust "over which the grantor or other owner retains the power to control or direct the trust's income or assets." The grantor is the person who created and funded the trust, and often serves as trustee during his or her own lifetime with the ability to control the trust's income and assets. Revocable or living trusts are common forms of a grantor trust.

The powers retained by the grantor to control or direct the trust assets result in ownership for income tax purposes. Therefore, any income or deduction earned by the trust will be taxed on the grantor's individual income tax return, subject to applicable individual income tax rates. If the grantor is acting as his or her own trustee, the trust need not file a separate return as the trust's income can be reported under the grantor's social security number. In cases where there is an independent trustee, the trustee will typically provide the grantor with a Grantor Letter—a tax reporting document which passes income and deductions through to the grantor's individual returns.

Non-Grantor Trusts

Any trust that is not a grantor trust is classified as a "non-grantor" trust. A trust established as a non-grantor trust is itself a taxable entity, requiring a separate income tax return to report income from assets which are owned by the trust. Most irrevocable trusts are non-grantor trusts.

In a typical scenario, the trust is required to pay income tax at the trust level for income which is retained within the trust. If the trust requires that net income be distributed to beneficiaries, the income is generally passed through to the beneficiary for tax purposes, regardless of whether it is actually distributed. For a discretionary trust where income is not required to be distributed, income flows to the beneficiary's tax level to the extent it is actually distributed to the beneficiary, with undistributed income to be taxed at the trust level. In either case, capital gains taxes are generally paid at the trust level.

For non-grantor trusts, the trustee must file a fiduciary income tax return and issue a Schedule K-1 to the beneficiary, showing the amount and classification of trust income to be included on the beneficiary's individual tax return.

Tax Considerations

It is important to note that trusts and individuals are subject to significantly different tax rates, which increases the importance of understanding tax treatment of grantor and non-grantor trusts. Tax brackets for trusts are compressed with trusts hitting the top tax rate (37% for 2018) for taxable income over $12,501, as compared to individual taxpayers who can report up to $500,000 of income before hitting the highest tax rate. As always, we recommend that you consult with a licensed tax professional for advice and guidance around your unique circumstances and how these rules may apply to you.

Recent Economic Highlights

By Argus Research Company

1st Quarter GDP Growth Better than Expected

The first estimate of Gross Domestic Product (GDP) growth showed the U.S. economy advanced at a 2.3% rate during the 1st quarter of the year. Personal Consumption Expenditure growth during the quarter was 1.1%, down from 4.0% in the prior quarter. Drilling deeper, spending on Durable Goods declined 3.3%, as expected, as Durable Goods spending had soared on average 9% in the previous three quarters. Spending on Consumer Services rose a solid 2.1%. Capital Spending strengthened, with investments into Equipment increasing 4.7% and investments into Intellectual Property increasing 3.6%. Exports, benefiting from a lower dollar, advanced at a 4.8% pace. Elsewhere, Housing was flat, Government Spending climbed 1.2% and Inventories rose. Offsetting growth, imports were higher. Pricing pressures picked up a bit; Ex Food and Energy, the price index for Gross Domestic Product rose 2.5%, up from 1.9% in 2017's 4th quarter.

Tax Reform Lifts Corporate Earnings Growth Rate

Last year's tax reform raised our upside target for the market by permanently lifting the expected level of S&P 500 earnings. Argus Research estimates the lower tax rate will raise S&P EPS from 10% to 20% growth in 2018. In 2019-2020, earnings should grow a few points faster than previously estimated as accelerated depreciation and other changes boost capital spending and economic growth. Domestic industries will benefit most from lower corporate tax rates. Accelerated depreciations and the 20% deduction on income from certain pass-through businesses will have broader benefits for companies and investors. The decline of the U.S. dollar will help all exporters, but increase costs for retailers and other importers.

Taxes and Currencies Lifting Earnings

Expected earnings growth for virtually all of the S&P 500 sectors has moved up, in many cases substantially. Tax reform typically is seen as the driving factor, yet other factors may be at play that benefit multinationals, in particular the ongoing weakness of the U.S. dollar. The U.S. effective corporate rate has fallen under 20% in the last two years, as many multinationals already have moved to lower taxes by operating abroad. All U.S. sectors have at least 40% exposure to U.S. revenues, but Technology, Materials & Energy have the most foreign exposure. These global groups have seen 2018 EPS estimates rise over 8% in the past three months. Much, but not all, of the relatively large upward revision in global earnings per share is likely due to the weakness of the dollar.

Business Investment Picking Up

Non-Defense orders for durable and capital goods have made a strong recovery. Business decisions to invest may have been stimulated by factors including the election of President Trump, who promised to stimulate growth and reduce regulations, and the decline of the U.S. dollar, which helped promote a recovery in manufacturing; and the reduction in the corporate tax rate. Drilling down, Private Durable Goods Orders, Ex Transportation, picked up 7.8% in the four quarters ending in February, up from 2.9% in the prior year. Meanwhile, Non-Defense Capital Goods Orders, Ex Aircraft, grew 7.4% in the past four quarters, compared with just a 1.3% rise in the prior year. These positive trends could be at risk if trade wars break out.

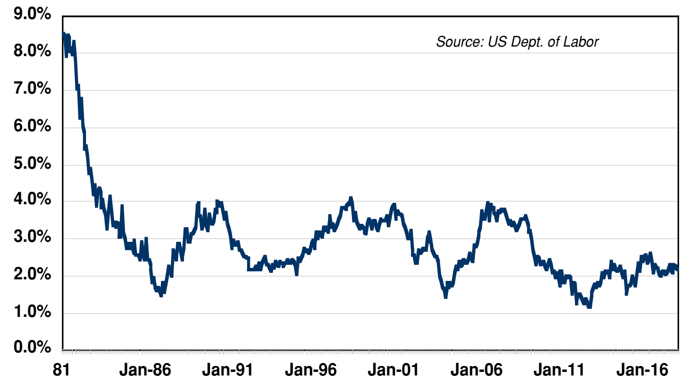
Workers Slow to Return

The current labor force participation rate is 62.9%. That's below the historical average of 65.4% and the more recent 10-year average of 63.8%. The labor force participation rate most recently peaked at 66% in 2007-2008 (at the peak of the previous economic and market cycle) and then declined to 63.2% in September 2015 (as discouraged workers left and remained out of the workforce). The rate has been slowly recovering over the past three years. We have seen this before. In the early 1980s, the labor force participation rate was below 64% due to the lingering impact of stagflation on the workforce. It took five years for the rate to recover to the historical average.

Wages Slowly Recovering

The current wage growth rates are a bit below the historical average growth rate of 3.0%, dating to 1980. The current rate is, of course, far below the highs of 8.0% recorded during the period of high inflation in the early 1980s. But the current rate is also well above the recent lows of 1.2%, recorded as the economy was just beginning to emerge from the 2007-2009 recession in 2011. We've seen this pattern in the past. In 1985, the average growth rate slowed to 2.3%, before taking another five years to reach the historical growth average of 3.0%. Investors will be watching the wage growth trends closely.

AVERAGE HOURLY EARNINGS (Y/Y CHANGE)



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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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