THIRD 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*

Following the first quarter's dramatic return of volatility to the global financial markets, the second quarter of 2018 saw slightly more orderly stock and bond market action, while geo-political uncertainty increased. Terms like "tariff" and "trade war" came front and center for the first time in decades as increasingly protectionist policies and threats stole most of the financial news headlines. At the same time, economic growth looked set to accelerate as the full impact of last year's tax reform, as well as increased fiscal stimulus from congressional spending bills, exerted their influence on the economy and financial markets.

Increasing U.S. stock market returns were broad based during the second quarter. With expected acceleration in 2018 corporate profits due to the effects of tax reform in conjunction with the strengthening domestic economy, most domestic market sectors posted positive returns. As has been the case for the past few years, Growth continued its outperformance over Value, with a limited number of well-known Tech names generating most of the market's positive returns, while Small Caps continued their recent run of outpacing their Large Cap counterparts. Some of the recent outperformance in the Small Cap space has been due to investors' assumptions that smaller firms tend to have a more domestic focus, which could make for meaningful differences in growth rates when accounting for protectionist trade policies and a strengthening dollar. These same issues also impacted both Developed and Emerging Markets during the quarter, causing broad losses across most markets when translated into U.S. Dollars.

In the fixed income markets, interest rates continued rising across the yield curve, with shorter-term rates rising more significantly

MARKET PERCENTAGE TOTAL RETURNS AS OF JUNE 30, 3018

Index	Q2 2018	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	-0.16	-0.40	2.27	3.72
S&P 500 Index	3.43	14.37	13.42	10.17
Russell 2000 Index	7.75	17.57	12.46	10.60
MSCI EAFE Index	-1.24	6.84	6.44	2.84
MSCI Emerging Markets Index	-7.96	8.20	5.01	2.26

than at the long end. Amid growing expectations for four Federal Reserve rate hikes this year, the second of which was announced at their June meeting, yield curve compression continued with the difference between 10-year and 2-year rates falling from 0.47% to 0.33% during the quarter. The falling spread between these rates is beginning to cause some consternation amongst economists, as a so called "inverted" yield curve (where short-term rates exceed long-term rates) has been a fairly accurate predictor of recessions over the past half-century. Questions remain though regarding whether the Fed's unconventional policy responses during and following last decade's financial crisis (such as the unprecedented bond purchases during the so-called Quantitative Easing programs and extended Zero Interest Rate Policy) may have altered this particular indicator's forecasting ability. All told, fixed income total returns were generally flat during the quarter with interest income being mostly offset by principal losses from the rate increases.

Looking forward, rate markets are now much more closely aligned with the expected path of future Federal Reserve interest rate hikes, and with a correction in both price and time making stock valuations look much more reasonable, the risks to a well-diversified portfolio appear much more balanced than we've seen in recent years. Exchange Bank's philosophy continues to focus on each individual client's long-term risk and return needs when designing our investment portfolios, and with the risks now more balanced to both the upside and downside, finding the right mix of assets is more crucial than ever to meeting these long-term goals.

Why Invest Internationally?

By Joe Williams, *Investment Officer*

Diversifying a portfolio with international stocks and bonds can help decrease risk and increase expected returns. While international investing comes with its own unique set of risks, the benefits more than make up for it.

So, what are the risks?

The Securities Exchange Commission (SEC) lists the additional risks of international investing relative to investing in domestic corporations. Some of the additional risks to consider are exchange rate risk, political risk, liquidity risk and information risk. Exchange rate risk is the fluctuation of the currencies between the U.S. dollar and the foreign currency that you are investing in internationally. If your investment does well, but the U.S. dollar appreciates against the international currency you're investing in, your overall return suffers. Of course, the exchange rate risk could play out in your favor as well, but it is an additional risk that domestic investors do not face. Political risks include a foreign government changing regulation on its businesses, imposing additional taxes or tariffs, or currency manipulation. Liquidity is also a risk (although this is not exclusive to *international* investing) that needs to be considered. Some foreign markets have very low trading volumes, which mean that it could be tough to sell your international investments when you want. Information risk should also be considered as some foreign markets do not require the same amount of disclosure or reporting that the U.S. requires publicly traded companies to share.

What about the benefits?

Even with the previously mentioned risks that international investors face, the benefits may still outweigh the risks. Over the years there have been several notable studies on the effects of a portfolio that is diversified internationally versus a domestic-only portfolio. Since more than half of the world's stock market capitalization is outside the United States, it makes sense to invest in international markets. Other countries excel in certain industries where the U.S. may fall short. To further diversify your investments, international investing allows you to invest in economies that are largely independent of the United States economy. Studies have shown that your risk falls dramatically with diversification. According to a MSCI study, a fully-diversified domestic portfolio only has about 27% of the risk that an average individual stock has. This risk can be reduced to less than 12% if you include a proper mix of international diversification. Diversification gives you options: you can assume a higher level of expected return, you can lower your risk for the same expected return, or you can do a combination of lowering your risk and increasing your expected return. Who says you can't have your cake and eat it too?

How does EB's Trust and Investment take advantage of international diversification?

Our investment management team understands the value of international diversification. Our managed portfolios typically allocate approximately a third of the equity portfolio to international funds. We carefully select funds that fulfill our international investment diversification needs so we can simultaneously reduce risk and increase expected return over time.

Recent Economic Highlights

By Argus Research Company

Strong GDP Forecast for 2018

Since the current economic expansion began at the end of 2009, the economy has grown for 34 quarters in a row. The six expansions since 1960 have averaged 27 months. Based on the historical record, the current expansion could continue for a few more quarters. Looking into the remainder of 2018 and 2019, we are forecasting continued growth. Drilling down to the second half of 2018, we expect a pick-up in demand from the Consumer sector, which is benefiting from robust employment. We also look for growth in capital investment and from the export sector. At our forecast 2.9% pace of growth for the full year, we anticipate two more Fed rate hikes this year. We look for a modest slowdown in 2019 to 2.3%.

Strong Payrolls Report for June

The U.S. economy generated 213,000 jobs in June, topping the Argus Economics forecast of 200,000 and the consensus outlook of 195,000. The unemployment rate ticked higher, to 4.0%, as more workers re-entered the workforce given promising jobs prospects. Wage growth was steady, at a 2.7% annual rate. Revisions to the prior two months added another 37,000 jobs. The report is indicative of a healthy economy. Jobs growth was best in manufacturing, healthcare, construction and professional and technical services. The monthly gain was in line with the 6-month average of 215,000 new jobs per month and ahead of the 12-month trend of 192,000. There remains slack in the labor force, though. The labor participation rate was 62.9%, still below the 10-year average near 65%. The jobs report and its generally strong data continue to signal a solid economic environment.

Staying ahead of Inflation?

In his statement after the June FOMC meeting, Federal Reserve Chair Powell implied four interest rate hikes this year are now likely, saying that "the U.S. economy is in great shape." Curiously, rising inflation was virtually ignored — saying only that "core Personal Consumption Expenditures (PCE) inflation remains under 2%." That is true, but various measures of core consumer prices and headline PCE all have risen to 2% or higher and all stand at or near cyclical highs. The implied inflation rate of 10-year TIPS remains over 2%. Median and Core stand at or near cyclical highs; and the Core PCE Deflator nears a six-year high. Wages of Production workers and total Employment Costs both rose to nine-year highs. These trends also suggest the Fed may be raising rates every quarter for the next few quarters.

Rising Orders Will Boost CAP-EX

A strong expansion in Capital Goods orders began approximately two years ago. The Capital Goods proxy (orders for Non-Defense Capital Goods Ex-Aircraft) has been flat for most of this cycle. But that ignores the fact that Capital Goods orders were very strong in the first three years of the expansion and were depressed by the U.S. dollar-driven manufacturing slump in 2014-2016. Non-Defense Durable and Capital Goods orders surged at 25% and 35% compound annual growth rates in the past two years. The exclusion of aircraft from the Capital Goods proxy makes sense when aircraft orders are occasional, but not when they occur repeatedly. In the past two years, for example, aircraft orders have grown at a stunning 137% annual rate. Excluding them shrinks growth in Non-Defense Capital Goods orders.

Slower Growth Abroad

The ISM U.S. Manufacturing Purchasing Managers' Index (PMI) hit a cyclical high in February, while the slower-moving U.S. PMI of Markit Economics has reached a three-year high. In conjunction with lower corporate tax rates, the higher demand indicated by the PMIs should lift capital spending and employment. Meanwhile, based on the Markit Economics PMIs, growth in Europe is down from cyclical highs, but remains strong.

The Euro Zone Manufacturing PMI hit an all-time high around year-end. Irregular weather, supply constraints and political factors dampened the index. But at 55.5 in May, it remains very strong (PMI readings above 50 generally indicate improvements in business conditions from the prior month, with readings below 50 indicating deteriorating conditions). The U.S. Markit PMI hit 56.4 in May, its highest level since Sept. 2014. The UK slipped to 54.4 in May, yet that's still good growth.

For Value, Look Foreign

Many investors seeking current value are looking overseas. That's because global stocks appear cheaper than domestic stocks on numerous valuation metrics (yield, price/sales, P/E ratios). Yet one reason investors pay a higher price for North American securities is the transparency of the U.S. financial system. What's more, global returns can be volatile across individual countries, given currency, security and political risks; indeed, U.S. stocks are generally outperforming Developed and Emerging Market stocks thus far in 2018.

Email Delivery of Wealth Management Update

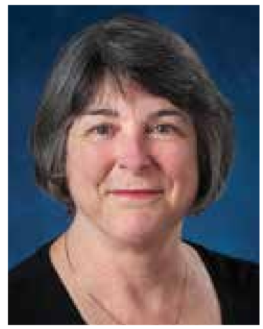
We are transitioning our Wealth Management Update newsletter to email delivery. The economic and market data we present is time sensitive and we can save considerable time in getting the information to you while it is fresh, accurate, and useful. We will continue to post a copy on Trust and Investment Management's website: **invest.exchangebank.com**. If you are a client or an estate planning professional and you have changed your email recently, please give us a call so that we can update our records. Print copies will continue to be mailed by request. If you would like to continue to receive this through the mail, please contact our office at the numbers listed on the front cover.

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.

If you would like to be removed from our mailing list, please contact: **ebmarketing@exchangebank.com**.

A New Face in Trust and Investment Management

Dear Clients, Friends and Advisors:



We are pleased to announce the addition of Mary Chapot, Personal Trust Officer and Assistant Vice President, to our Trust and Investment Management team. Mary brings a strong fiduciary background with a sincere interest in relationship management. She will manage a diverse portfolio of personal trust and estate settlement accounts, in addition to deepening relationships with trusted members of our professional community. She is a great addition to our already strong team of dedicated trust and investment professionals.

Mary joins Exchange Bank with more than 6 years of trust administration experience. Before joining Exchange Bank, Mary worked as licensed private fiduciary and managerial accountant. Mary has a love of learning and has studied in several different fields. In addition to being a licensed private fiduciary, Mary holds Master's Degrees in Accountancy, American History and Music History.

In her spare time, Mary loves to sing with her church choir, read, garden, and travel with her son. Please join me in welcoming Mary to Exchange Bank.

Emily Menjou
VP/Personal Trust Fiduciary Manager,
Trust & Investment Management