FOURTH 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 to build on the second quarter's gains, the third quarter of 2018 saw a slow and steady increase in the U.S. stock markets, culminating in multiple indices' record highs toward the end of September. The economic expansion, now the second longest on record, continued to advance at an accelerated rate, partly due to the continued effects of last year's tax reform and this year's increased fiscal spending plans. Meanwhile, the U.S. Dollar continued to strengthen, interest rates continued to rise across the yield curve, and commodities and emerging market currencies continued to face pressure.

Increasing U.S. stock market returns were broad based again during the third quarter. As corporate profits expanded in earnest, fears of trade wars took a back seat to domestic economic strength as the quarter wore on. Unlike the second quarter in which small cap stocks outperformed their large cap brethren due to less exposure to international markets and supply chains, the third quarter large caps outperformed as second quarter earnings numbers came in much better than expected. Much of that may have been due to the front-loading of international revenues prior to staggered tariff implementation dates here and abroad, however some portion may also have been due to the makeup of large cap indices, with heavier weights to large technology firms that have been less subject to trade war fears.

International equities generally underperformed domestic equities during the quarter as international growth rates could not keep up with the U.S. economic acceleration. This growth differential significantly contributed to the increasing value of the U.S. Dollar relative to other currencies, which only magnified the differences in returns for domestic vs. foreign stocks. Emerging Market equities

MARKET PERCENTAGE TOTAL RETURNS AS OF SEPTEMBER 30, 2018

Index	Q3 2018	One Year	Five Years (Annualized)	Ten Years (Annualized)
Barclays U.S. Aggregate Bond Index	0.02	-1.22	2.16	3.77
S&P 500 Index	7.71	17.91	13.95	11.97
Russell 2000 Index	3.58	15.24	11.07	11.11
MSCI EAFE Index	1.35	2.74	4.42	5.38
MSCI Emerging Markets Index	-1.09	-0.81	3.61	5.40

underperformed developed markets, mostly due to their increased exposure to U.S. imports and their need for hard currencies as they have increasingly tapped the global debt markets for loans in U.S. Dollars.

In the fixed income markets, interest rates continued to rise across the yield curve, with shorter-term rate increases again outpacing those at the long end. As the markets have now moved to fully price in four Federal Reserve rate hikes this year and multiple additional hikes in 2019, the difference between 10-year and two-year treasury yields fell from 0.33% to 0.24%. This rapidly shrinking spread is closing in on a flat (or possibly inverted) yield curve, which in the past has been a good predictor of forthcoming recession. At the current rate of compression, this inversion could happen sometime around mid-2019, possibly reflecting the bond market's expectations that the Fed is being too aggressive in its rate hikes and economic forecasts, and foretelling a possible recession in the 2020-21 time frame. In the meantime, the "bear flattener" that occurred throughout the third quarter left aggregate bond market total returns near zero, with principal losses wiping out nearly all of the income that was generated.

Looking ahead, the fixed income markets have continued their realignment relative to the equity markets and expectations for higher economic growth rates than were previously expected. This realignment is providing a better balance of risk and return available in the fixed income markets than we have seen for the past several years. Additionally, an extended economic expansion and record high stock markets may be signaling that now is a good time to review your risk and return needs, and possibly make changes to your asset allocation, if necessary. Although expansions don't die of old age, ensuring that your asset allocation matches your long-term risk and return needs is something Exchange Bank recommends doing in any market environment. As always, if you would like to set up an appointment with any of our Investment team, please reach out to us and we'll be happy to assist you in this process.

The S&P 500's New Communications Services Sector

By Austin Bryant, *Vice President &*
Matthew C. Kelman, *Vice President*

In November of 2017, the MSCI/S&P Dow Jones indices announced a plan to expand and modify its smallest sector – Telecommunication Services. Standard & Poor's Global Industry Classification Standard ("GICS") recently embarked on its biggest set of changes ever. After the markets closed on Friday, September 21, 2018, over $2.5 trillion in equities were reshuffled into the newly formed Communications Services sector. This new sector includes companies that facilitate communication operations, as well as those that offer content and information that is spread through today's various types of media outlets. The move is seen as a way to address how the primary business of different companies often spans multiple sector categories, and don't always reflect the industry they've traditionally been classified in.

According to Sebastien Lieblich, Managing Director and Global Head of Equity Solutions Research at MSCI, "The GICS structure is evolving to stay abreast with the ever-changing business environment. Convergence between telecom and media companies is not just a trend, but a fact. Companies in these two industries are clearly finding synergies between creation of content and its delivery. The proposed Communication Services Sector reflects this evolution. Also, the universal nature of internet has led to it being integrated in almost all aspects of communication and business transactions."

Additionally, per David Blitzer, Chairman of the Index Committee at S&P Dow Jones Indices, "The internet began as a technological approach to sharing information; it has become the way many businesses operate. Cable companies are combining with telecom companies, creating their own media content and delivering it to consumers. The lines among media, communications, and content are blurred. It is time to acknowledge this convergence and the overlapping services these companies provide. The Communication Services sector addresses this progression."

Over the last three decades, telecommunication services companies have declined to a mere 2% of the S&P 500 on a market capitalization basis. During that same time frame, the Information Technologysector has grown substantially to now hold the largest market cap weighting. The darlings of the investment world's landscape, namely Apple (AAPL), Microsoft (MSFT), Facebook (FB) and Alphabet (GOOGL, GOOG), have displayed parabolic moves higher and now represent five of the S&P 500's largest companies. This is noteworthy as the majority of the weighting to the new Communications Services sector will come from the Information Technology and Consumer Discretionary sectors, where these companies have inhabited in the past.

The new Communications Services sector will also hold the remnants of the old Telecommunication Services sector like AT&T and Verizon, but will also now include media companies like CBS, Walt Disney and News Corp., and social media names like Twitter and Facebook. With the exception of Amazon and Apple, the majority of the FAANG stocks—Facebook, Netflix and Alphabet (Google)—will be included in the new sector. Facebook and Alphabet are coming over from the Information Technology sector and Netflix is departing Consumer Discretionary. With these changes, the weighting of the Information Technology sector will drop from about 26% of the overall market to 21%, though it will continue to have the biggest influence. The Consumer Discretionary sector will drop to 10% from roughly 13%. As such, the newly formed Communication Services sector will represent roughly 10% of the market capitalization of the S&P 500 with a mere 26 holdings.

Based on the size of several of the stocks included in this new sector, the Communication Services sector will be very top heavy. In fact, the three of the aforementioned FAANG stocks, which include Facebook, Alphabet (both classes) and Netflix, will make up over 40% of the sector. Other notable inclusions will be Walt Disney, Verizon, Comcast and Twitter. See the following chart for a list of the top holdings included in the newly formed Communications Services sector along with their approximate weights:

Company Name	Ticker	Prior Sector	New Sector Weighting
Facebook Inc. Class A	FB	Information Technology	17%
Alphabet Inc. Class C	GOOG	Information Technology	11%
Alphabet Inc. Class A	GOOGL	Information Technology	11%
Walt Disney Company	DIS	Consumer Discretionary	5%
Verizon Communications Inc.	VZ	Telecommunication Services	5%
Comcast Corporation Class A	CMCSA	Consumer Discretionary	5%
Charter Communications Inc. Class A	CHTR	Consumer Discretionary	5%
AT&T Inc.	T	Telecommunication Services	4%
Activision Blizzard Inc.	ATVI	Information Technology	4%
Netflix Inc.	NFLX	Consumer Discretionary	4%
Electronic Arts Inc.	EA	Information Technology	4%
Twitter Inc.	TWTR	Information Technology	3%
Twenty-First Century Fox Inc. Class A	FOXA	Consumer Discretionary	3%
CenturyLink Inc.	CTL	Telecommunication Services	3%
CBS Corporation Class B	CBS	Consumer Discretionary	3%
Omnicom Group Inc	OMC	Consumer Discretionary	2%
Take-Two Interactive Software Inc.	TTWO	Information Technology	2%
Viacom Inc. Class B	VIAB	Consumer Discretionary	2%
Twenty-First Century Fox Inc. Class B	FOX	Consumer Discretionary	2%
Discovery Inc. Class C	DISCK	Consumer Discretionary	1%
Interpublic Group of Companies Inc.	IPG	Consumer Discretionary	1%
DISH Network Corporation Class A	DISH	Consumer Discretionary	1%
TripAdvisor Inc.	TRIP	Consumer Discretionary	1%
Discovery Inc. Class A	DISCA	Consumer Discretionary	1%
News Corporation Class A	NWSA	Consumer Discretionary	1%

The bottom line for investors is that these changes may impact various sectors of the market as large money managers rebalance their portfolios to align more closely with the new sector weightings and constituencies. Over time, these changes may also alter the perception of these sectors for smaller investors as well. One example is that the old Telecommunications sector was traditionally viewed as a "defensive" area of the market, with high dividend payouts and qualities that outperform in a down market. Now, with the addition of more cyclical growth stocks included, those characterizations may no longer be accurate, and defensive oriented investors may look toward other sectors to meet their goals.

For broad, diversified market investors (like our clients who work with Exchange Bank's Trust & Investment Management Department), these changes may not mean large differences to the risk and return characteristics of their portfolios. However, they are a sign of the times that individual companies and the structure of the market are changing.

Dear Clients and Friends,

We are proud to announce that our footprint is growing, and so is our team. As you may have read in Exchange Bank's press release dated October 9, 2018 and subsequent news articles, we are in the process of acquiring First Northern Bank's Trust Department, which is currently serving clients out of Sacramento.

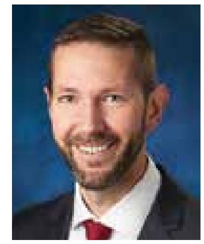
Regulatory approval is expected before year end, at which point our team will grow with the addition of three experienced and well-respected professionals. Trust Officers Chris Ann Bachtel and Alysia Corell, and Trust Securities Specialist Kelly Lind will begin serving their (soon to be our) clients out of Exchange Bank's Roseville office. We look forward to continuing to serve all of our valued clients—both new and longstanding—throughout Sonoma County, Sacramento and beyond.

Sincerely,
John Mackey | *Senior Vice President*

We are updating our Trust and Investment Management website, with completion anticipated by the end of November. Visit **exchangebank.com/trust-investments** for information about our services, team and philosophy.

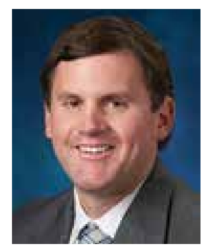
New Faces in the Trust and Investment Management Group

We are pleased to announce the addition of two experienced investment officers to our team: Joseph Williams and Austin Bryant.



Joseph Williams
Investment Officer

Joe joined our team earlier this year—you may have already read one of his articles in a prior newsletter. Joe brings a strong understanding of investing and the economy, paired with an efficient yet caring nature. Joe obtained his Associate's Degree from Santa Rosa Junior College and is currently pursuing his Bachelor's Degree in Finance from Sonoma State University. In his spare time, you might find Joe spending time with family and chasing around his two kids, ages five and two.



Austin Bryant
Vice President &
Investment Officer

Austin joins our team with 12 years of financial services experience, and brings a strong background in investments and client relations. Originally from Macon, Georgia, Austin earned his Bachelor's Degree with a major in Finance and a minor in Economics from the University of Alabama. Since joining our team, Austin has already achieved the Accredited Investment Fiduciary designation. Austin enjoys spending time with family, and he has a two year old son and another son on the way.

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: **exchangebank.com/trust-investments**. 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**.