FIRST QUARTER 2019 – 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 U.S. stock markets hit record highs near the end of September, the fourth quarter of 2018 saw a complete reversal in market sentiment, as pessimism set in regarding the U.S.-China trade war and slowing global economic growth amid heightened expectations for Federal Reserve rate hikes. Domestically, the aging economic expansion, by now the second longest on record, showed signs of downshifting even before the Federal Government's December shutdown. The combination of these headwinds proved too much to bear for risk markets, with stocks and credit instruments falling at an accelerating rate to a crescendo on Christmas Eve. The last week of the quarter saw the beginnings of a rebound form, but the damage was done to returns in 2018, with virtually all markets posting negative returns for the year as a whole.

In the fixed income markets, expectations for the Federal Reserve to hike rates in this cycle peaked in early October, before reversing course to price in a very low probability of any additional hikes going forward. The yield curve continued its compression throughout the quarter, with the difference between 10-year and 2-year treasury yields falling from 0.24% to 0.21%. And although this shrinking spread stayed positive during the fourth quarter, it continued to close in on a flat (or possibly inverted) yield curve, which in the past has been a good predictor of forthcoming recession.

Looking ahead, lower valuations on stocks due to reduced expectations for corporate earnings and economic growth appear to be setting the stage for a 2019 market rebound. In a historical context, stocks generally perform well in years following those with negative returns, and with only a glimmer of a possible recession on the horizon, global markets look attractively valued going forward. In the meantime, fixed income markets appear to be pricing in a coming recession

MARKET PERCENTAGE TOTAL RETURNS AS OF DECEMBER 31, 2018

Index	Q4-2018	One Year	Five Years (Annualized)	Ten Years (Annualized)
Barclays U.S. Aggregate Bond Index	1.64	0.01	2.52	3.48
S&P 500 Index	-13.52	-4.38	8.49	13.12
Russell 2000 Index	-20.20	-11.01	4.41	11.97
MSCI EAFE Index	-12.54	-13.79	0.53	6.32
MSCI Emerging Markets Index	-7.47	-14.58	1.65	8.02

as a near certainty. As such, once the shutdown ends, and economic reports start flowing normally again, we could see a significant rebound in risk markets. However, with all of the unknowns, Exchange Bank continues to recommend focusing on the long-term risk and return needs for each client in order to ensure our clients' goals are met regardless of the direction of markets in the short-term.

Recent Economic Highlights

By Argus Research Company

Economic Growth Expected to Slow

We are expecting the 4Q18 GDP growth rate will be below the average 3.8% rate of the previous two quarters. Looking forward, we continue to forecast growth, as we think the positives in the economy can outweigh the negatives. However, the growth rate will most likely slow from the recent highs, and we anticipate a below-long-term-trend quarter in the first quarter, due to the government shutdown and the recent dip in ISM new orders. On an annual basis, we believe growth increased in 2018 to around 3% from the 2.5% growth rate recorded in 2017. We now expect a slowdown in 2019 to the 2-2.5% range.

Fed Funds Still Below Fair Value

At its January meeting, the Federal Reserve Open Market Committee did not raise short-term interest rates. In a bit of a surprise, the central bank also indicated that it had no plans to raise short-term rates for the foreseeable future. With the federal funds rate now at 2.4%, within a range of 2.25% to 2.50%, it would require at least two hikes to reach Argus's 2.98% estimate of fair value on the fed funds rate. This fair value estimate is similar to, but not necessarily the same as, the FOMC's estimated "neutral" level of interest rates, which ranges from 2.25% to 3.5%, and now averages 2.9%. Historically, the Fed has tended to overshoot the fair value of the fed funds rate. In 2018, the Fed was on course to do it again, but this year the outlook may be different.

Equity Valuations Becoming More Attractive

Although most investors now see much slower growth in earnings in 2019 than in 2018, stocks are still attractive. Why? The P/E on forward earnings has fallen sharply in the past few months, improving valuations. At the start of the year, Argus lowered their 2019 EPS estimate from $185 to $177, reducing the growth rate from 12% to 8%. They think the S&P can easily climb back to fair value in 2019, implying a market rise of 11%. Moreover, normalized earnings could grow close to 10% this year—as flat 2015-2016 EPS fall out of the average—so returns could be 15% or higher on the upside.

Cap-Ex Investment Slows

ISM Manufacturing dropped sharply in December as New Orders tumbled 11%. Employment, Production and Price gains slowed. Supplier Deliveries fell as Inventories fell. Although most economists expect a slowdown in economic growth, a recession is not likely. In late 2008, the economy already was slowing and New Orders already were negative. At that time, all the components quoted above were under 50 (i.e., falling). Today, all are rising, albeit slowly. Investors are wondering if trade frictions contributed to the ISM Order collapse. Certainly, some companies may have double ordered before in advance of higher tariffs. But most importantly, ISM New Export Orders rose in December. This is another reason to expect a slowdown but not an outright recession.

Home Price Gains Fall Back to Earth

The S&P/Case-Shiller National Home Price Index for November showed that prices gained 5.2% year-over-year, down from the 6% range during the past year, and reflecting a slowdown in housing. Looking into 2019, expect price hikes to settle in the 3.0%-4.0% range. To make this forecast, Argus monitors several leading industry supply and demand indicators. Rising borrowing costs due to the Fed's rate-hike campaign are raising the cost of buying a home, cutting into the bullish case for housing. Indeed, residential investment has declined in seven of the past eight quarters. Note, though, that the consumer remains employed and confidence is high. And white-hot housing conditions aren't always conducive to sustainable long-term growth in the industry.

Mixed Trends in Growth Abroad

Economic growth in the UK and Europe began to slow long before it did in the U.S., as Brexit has been an ongoing concern in the EU since mid-2016. The UK has done better recently, while the Eurozone continues to slow. The Purchasing Managers Index for UK manufacturing has risen from 51 to 54 (below 50 signals contraction) as the separation deadline has approached. But the Eurozone PMI fell to 51.4 in December, reflecting concerns about Brexit and the outlook for global trade, as well as country-specific factors. The French Services PMI tumbled 5.5% in December, likely driven in part by the negative impact of the "yellow vest" movement, and Italy's financial status remains uncertain, especially its ability to meet EU budget requirements.

Value Opportunities Overseas

Many investors seeking current value are looking beyond U.S. borders. That's because global stocks appear cheaper than domestic stocks on numerous valuation metrics. Consider yield. The yield on the S&P 500 is 2.0%, below the global average of 3.0% and well below the 4.3% average yield in Europe. A review of price/sales ratios tells a similar story. One reason investors pay a premium for North American securities is the transparency of the U.S. financial system. Moreover, global returns can be volatile given currency, security and political risks; indeed, U.S. stocks are already outperforming EAFE in 2019. Even so, we recommend that Growth investors have a significant portion of their equity allocations in international stocks, both developed and Emerging Markets.

Fiduciary Duty – What is it and Why is it Important?

By Emily Menjou, *Vice President & Personal Trust Fiduciary Manager*

A fiduciary is an individual or entity which maintains a relationship of trust and loyalty with another party, often managing money or assets on behalf of another person. Under the American legal system, a fiduciary duty is the highest duty owed to another person. The relationship between a trustee and a beneficiary is a clear example of a fiduciary relationship, however it isn't just trustees who carry this responsibility. For example, some investment managers have a fiduciary responsibility to their clients, while others do not—an important distinction when placing your wealth in the hands of another.

Bank trust departments and RIAs (registered investment advisers) are legally bound to a fiduciary standard which was established as part of the Investment Advisers Act of 1940. (*Note that 'adviser' is intentionally spelled with '-er' in the case of an RIA to correspond with the law.*) Regulated by either the SEC or state securities regulators, fiduciary investment managers must act in a manner which places their clients' interests above their own. A fiduciary is required to provide advice and recommendations that are viewed as being in the best interests of the client, not the manager. The fiduciary standard requires up-front disclosures of fees and avoidance (or clear disclosure) of potential conflicts of interest.

In contrast, advisors who are regulated by the Financial Industry Regulatory Authority (FINRA) operate under standards that require them to make *suitable* recommendations to their clients. Instead of having to place his or her interests below that of the client, as a fiduciary does, the suitability standard requires that an advisor reasonably believe the recommendations are suitable (but, perhaps not best) for his or her clients financial needs and objectives.

Unfortunately, the suitability standard has the potential to result in conflicts of interest between advisors and clients, most often in the form of fees. Under a suitability standard, an advisor is permitted to purchase a mutual fund in a client's account which provides him/her a higher fee or commission, which is often not disclosed to the client, so long as the investment is suitable for the client's portfolio. This potential can motivate advisors to use their own products or less desirable products in an effort to receive higher compensation. In comparison, commissions and hidden fees are strictly prohibited under the fiduciary standard.

Keep in mind, there certainly are FINRA regulated advisors who act in their clients' best interest, even if they are not required to do so. Given the differences between the suitability and fiduciary standards, it is important to remain aware of how your advisor's actions may be affecting your portfolio. As a state chartered trust institution, Exchange Bank is a fiduciary, both for trust and investment relationships. We have always provided full disclosure of fees, and we never accept commissions or hidden compensation of any kind.

New Face in the Trust and Investment Management Group

By Emily Menjou, *Vice President and Personal Trust Fiduciary Manager*

Alysia Corell
Vice President & Trust Officer

Dear clients and friends,

It is my pleasure to introduce you to Alysia Corell, vice president and trust officer. Alysia has taken a leading role over trust administration in our Roseville office, servicing the Sacramento area and beyond. Alysia has over 17 years of trust administration experience and previously served as vice president and senior trust officer for First Northern Bank.

Alysia earned her bachelor's degree in Communications from San Diego State University, and earned her designation as Certified Trust and Financial Advisor (CTFA) in 2008. Alysia is a past president and current member of the Sacramento Estate Planning Council. In her position, Alysia will administer complex trust accounts including revocable, irrevocable, charitable and terminating trusts.

Please join me in welcoming Alysia to the Exchange Bank family.

We have updated our Trust and Investment Management website. Visit **exchangebank.com/trust-investment** for information about our services, team and philosophy.

Upcoming Events

Exchange Bank's Trust and Investment Management Symposium Series Presents:

A CANDID DISCUSSION OF GOVERNMENT POLICY AND ITS IMPACT ON THE ECONOMY

Wednesday, May 1, 2019 | 2:00pm–5:00pm

Vintners Inn Event Center
4350 Barnes Road | Santa Rosa, CA 95403

GUEST SPEAKERS:

Robert Eyler, Ph.D.
Professor of Economics, Sonoma State University

David McCuan, Ph.D.
Professor of Political Science, Sonoma State University

RSVP by April 12, 2019 – 707.524.3151 or erin.dorado@exchangebank.com

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-investment**. 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 number 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**.