SECOND QUARTER 2019 – TRUST & INVESTMENT MANAGEMENT'S

WEALTH MANAGEMENT UPDATE

Exchange Bank

INSIDE THIS ISSUE

TRUST & INVESTMENT MANAGEMENT GROUP

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Investment Review and Outlook

By Matthew C. Kelman, *Vice President*

"It was the best of times, it was the worst of times…" With a nod to famed poet/author Charles Dickens, the first quarter of 2019 along with the final quarter of 2018 exemplified the oft-quoted opening of his classic novel *A Tale of Two Cities*. While the end of last year saw a rapid drop in investor confidence and severe wealth destruction culminating on Christmas Eve, with a peak to trough drop of around 20% in the domestic (and global) equity markets, the post-New Year's quarter saw a steady improvement in both, to round out the period as the best first quarter for equity returns since the turn of the millennium. The credit for much of the fourth quarter's fall, and first quarter's rebound can be laid at the feet of the Federal Reserve's Open Market Committee (FOMC) which had been indicating their intent to continue their short-term interest rate hike campaign well into 2019, if not 2020. The Committee's swift about face from December to January changed the trajectory of interest rate movements, as well as equity market and economic growth expectations for the better. The effect was a reduction in the risk of a policy error that might push the domestic (and global economies) into premature recession.

From a global equity markets perspective, the first quarter saw a continuation of the rebound from the lows in the late fourth quarter. Domestic equities generally posted double digit returns, while their international counterparts followed close behind. Small company stocks outperformed large caps as part of the "risk-on" trade, while growth stocks continued to outpace their value peers.

In fixed income markets, the downward trajectory of interest rates that began in early October continued through the first quarter as comments from Federal Reserve officials indicated that the FOMC would be "patient" in deciding about any further changes to monetary policy. By quarter-end, the FOMC's Summary of Economic Projections pointed to no additional rate hikes this year (with one potentially in 2020), while market forces began to price in the possibility of rate cuts due to slowing global growth. It was this slowing that caused portions of the yield curve to

MARKET PERCENTAGE TOTAL RETURNS AS OF MARCH 31, 2019

Index	Q1 2019	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	2.94	4.48	2.74	3.77
S&P 500 Index	13.65	9.50	10.91	15.92
Russell 2000 Index	14.58	2.05	7.05	15.36
MSCI EAFE Index	9.98	-3.71	2.33	8.96
MSCI Emerging Markets Index	9.91	-7.41	3.68	8.94

invert during the quarter, while the spread between the 10-year and two-year treasury yields continued to compress from 0.21% to 0.14%. This combination of falling yields, with compressing term premiums and partial curve inversions, has brought the possibility of a near-term recession to the forefront of the financial press, as they have all been possible signals in past market cycles.

Thinking back, it is hard to remember a time over the past decade when valuations of both the equity and fixed income markets were both within a range considered fairly valued relative to economic growth, interest rates, inflation and corporate earnings. Over time, financial markets tend to act like a pendulum, swinging from under-valuation to over-valuation and back again, always attempting to find balance, but never staying there for too long. Attempting to time these swings is difficult even when valuations are far from fair value, but is even more difficult when upside and downside risks are more evenly balanced. As always, Exchange Bank recommends finding the right mix of assets to meet each of our clients' long-term risk and return needs. This philosophy takes on extra importance in a market environment like the one we are currently seeing, as betting on markets moving one way or another in the short term is just as likely to lose as it is to win.

"The Fed decided today not to raise or lower rates, but instead just moved them sideways a little."

Recent Economic Highlights

By Argus Research Company

U.S. At A Premium

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. The yield on the S&P 500 is 1.8%, below the global average of 3.0% and well below the 3.5% average yield in Europe. A review of price/sales ratios tells a similar story. The U.S. ratio is 2.0x, well above the global average of 1.3x, while Japan and Europe appear to be valued at 1.2x or below. PE ratios? More of the same. The current trailing P/E ratio for the S&P 500 is 18, versus the global average of 15. 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 outperforming EAFE in 2019.

Gobal Growth Outlook Softens A Bit

Global GDP growth continues to decelerate. For 2019, the IMF is now calling for overall global growth of 3.3%, down from 3.6% in 2018 and 3.7% in 2017. These rates are a pick-up from the 3.1%-3.2% growth rates in 2015 and 2016. But the IMF had been looking for 3.9% growth in 2018-19 before its downward revisions. Why the softer outlook? We suspect issues such as trade and tariffs, tighter monetary policy in the U.S. and Europe, sliding commodity prices and geopolitical developments are main factors. Emerging markets are expected to drive growth over the next two years; forecasts for this segment of the global economy call for expansion at a rate of 4.4%, led by India and China. The industrialized country growth rate is expected to decline this year to 1.8% from 2.1% in 2018. There are risks to this outlook, of course. The UK still does not know how to exit the EU. China and the U.S. are talking trade, which adds volatility. The weak global outlook has resulted in strength in the U.S. dollar, which could be a further headwind to companies reliant on export sales.

Solid 3.2% Growth In 1Q

The U.S. economy advanced at a 3.2% rate in 1Q19—up from the 2.2% rate of 4Q18 and well ahead of expectations. Drilling deeper, the quarter featured below-trend personal consumption expenditure spending (more on that in a moment) but solid growth in cap-ex, exports, government spending and inventory building. Residential investment declined once again. Taking a closer look at the all-important personal consumption expenditure category, growth in 1Q19 fell to 1.2%, from 2.5% in 4Q18. The slowdown reflected a modest decline in durable goods spending, which is typically seen in 1Q, and a sharper pull-back in spending on nondurable goods, perhaps reflecting the impact of the lengthy government shutdown. Consumer spending on services was in line with recent trends. Pricing pressures eased a bit; ex food and energy, the price index for personal consumer expenditures rose 1.3%, down from 1.8% in 4Q. The final word? Growth continues at a solid pace, but inflation remains tame. We suspect the Fed remains on the sideline after reading this report.

Payrolls Rebound

The U.S. economy generated 196,000 jobs in March, bouncing back, as expected, from a weak reading in February and signaling that the U.S. economic expansion is set to continue. In March, after government workers returned to the workforce, employment in food services and drinking establishments resumed its upward trend. Other industries with good jobs growth included professional and technical services, and healthcare. Construction reversed course and turned positive as well, though growth in manufacturing jobs was subdued for a second month. The stock market has moved higher on the news. Bond yields are higher as well. We don't think there is enough in the jobs report to force the Fed to change its mind about interest rates: the economy continues to chug along.

Deficit Improving But Debt Is Long-term Risk

The estimated 2019 annual federal budget deficit is 4.2% of GDP. That's an improvement of almost 60% from the 10.1% of GDP deficit recorded during the depth of the Great Recession, but lower than the 3.8% deficit in 2018. According to the Congressional Budget Office, annual federal deficit spending will peak at 4.8% of GDP in 2028 and average 4.4% through 2029. But the spike in the gross federal debt as a percentage of GDP has yet to subside. The spending required to pull the economy out of its tailspin in 2007-2009 lifted the total debt level to 90% of GDP. Today, the ratio is 104%. Another spike higher for the deficit could ultimately lead to reduced confidence in U.S. sovereign securities.

Déjà Vu All Over Again

By Dimensional Fund Advisors LP

February 2019

Investment fads are nothing new. When selecting strategies for their portfolios, investors are often tempted to seek out the latest and greatest investment opportunities.

Over the years, these approaches have sought to capitalize on developments such as the perceived relative strength of particular geographic regions, technological changes in the economy, or the popularity of different natural resources. But long-term investors should be aware that letting short-term trends influence their investment approach may be counterproductive. As Nobel laureate Eugene Fama said, "There's one robust new idea in finance that has investment implications maybe every 10 or 15 years, but there's a marketing idea every week."

What's Hot Becomes What's Not

Looking back at some investment fads over recent decades can illustrate how often trendy investment themes come and go. In the early 1990s, attention turned to the rising "Asian Tigers" of Hong Kong, Singapore, South Korea, and Taiwan. A decade later, much was written about the emergence of the "BRIC" countries of Brazil, Russia, India, and China and their new place in global markets. Similarly, funds targeting hot industries or trends have come into and fallen out of vogue. In the 1950s, the "Nifty Fifty" were all the rage. In the 1960s, "go-go" stocks and funds piqued investor interest. Later in the 20th century, growing belief in the emergence of a "new economy" led to the creation of funds poised to make the most of the rising importance of information technology and telecommunication services. During the 2000s, 130/30 funds, which used leverage to sell short certain stocks while going long others, became increasingly popular. In the wake of the 2008 financial crisis, "Black Swan" funds, "tail-risk-hedging" strategies, and "liquid alternatives" abounded. As investors reached for yield in a low interest-rate environment in the following years, other funds sprang up that claimed to offer increased income generation, and new strategies like unconstrained bond funds proliferated. More recently, strategies focused on peer-to-peer lending, cryptocurrencies, and even cannabis cultivation and private space exploration have become more fashionable. In this environment, so-called "FAANG" stocks and concentrated exchange-traded funds with catchy ticker symbols have also garnered attention among investors.

The Fund Graveyard

Unsurprisingly, however, numerous funds across the investment landscape were launched over the years only to subsequently close and fade from investor memory. While economic, demographic, technological, and environmental trends shape the world we live in, public markets aggregate a vast amount of dispersed information and drive it into security prices. Any individual trying to outguess the market by constantly trading in and out of what's hot is competing against the extraordinary collective wisdom of millions of buyers and sellers around the world.

With the benefit of hindsight, it is easy to point out the fortune one could have amassed by making the right call on a specific industry, region, or individual security over a specific period. While these anecdotes can be entertaining, there is a wealth of compelling evidence that highlights the futility of attempting to identify mispricing in advance and profit from it.

It is important to remember that many investing fads, and indeed, most mutual funds, do not stand the test of time. A large proportion of funds fail to survive over the longer term. Of the 1,622 fixed income mutual funds in existence at the beginning of 2004, only 55% still existed at the end of 2018. Similarly, among equity mutual funds, only 51% of the 2,786 funds available to US-based investors at the beginning of 2004 endured.[1]

What Am I Really Getting?

When confronted with choices about whether to add additional types of assets or strategies to a portfolio, it may be helpful to ask the following questions:

1. What is this strategy claiming to provide that is not already in my portfolio?
2. If it is not in my portfolio, can I reasonably expect that including it or focusing on it will increase expected returns, reduce expected volatility, or help me achieve my investment goal?
3. Am I comfortable with the range of potential outcomes?

If investors are left with doubts after asking any of these questions, it may be wise to use caution before proceeding. Within equities, for example, a market portfolio offers the benefit of exposure to thousands of companies doing business around the world and broad diversification across industries, sectors, and countries. While there can be good reasons to deviate from a market portfolio, investors should understand the potential benefits and risks of doing so.

In addition, there is no shortage of things investors can do to help contribute to a better investment experience. Working closely with a financial advisor can help individual investors create a plan that fits their needs and risk tolerance. Pursuing a globally diversified approach; managing expenses, turnover, and taxes; and staying disciplined through market volatility can help improve investors' chances of achieving their long-term financial goals.

Conclusion

Fashionable investment approaches will come and go, but investors should remember that a long-term, disciplined investment approach based on robust research and implementation may be the most reliable path to success in the global capital markets.

1. US-domiciled mutual fund data is from Morningstar. For methodology details, see Dimensional Fund Advisors Mutual Fund Landscape brochure.

Dear Clients and Friends:

It is my pleasure to introduce Trust Officer, Cathy Colgan. Cathy joins our team through Exchange Bank's acquisition of the California division of American Trust's wealth management business. With almost 40 years of trust administration experience, Cathy brings an unrivaled depth of knowledge to our team. Cathy will lead our Silicon Valley office, which is currently located in San Mateo.

Cathy holds the highly regarded Certified Financial Planner designation and is a graduate of Cannon Financial Institute. She also attended San Jose State University and Foothill Community College. Cathy is a member of the Peninsula and Santa Clara Estate Planning Councils, along with the Silicon Valley and San Mateo Bar Associations. She is also heavily involved with the planning of the annual Kasner Estate Planning Symposium held at Santa Clara University Law School, and is a longstanding board member of the El Camino Hospital Planned Giving Council.

Our acquisition of American Trust's California division is part of Exchange Bank's strategic plan to expand into contiguous areas of the state. This expansion will allow us to provide our trust and investment management services to more families across California. In addition, having another office outside of Sonoma County provides an added benefit of geographic diversification for disaster recovery purposes, which is of increased importance after California's recent wildfires.

Please join me in welcoming Cathy to our team.

Emily Menjou
Vice President & Personal Trust Fiduciary Manager

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**.

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