FOURTH 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*

Following the second quarter's increased volatility amid record high stock market levels, the third quarter of 2019 saw a continuation of the same themes. The "cross-currents" of solid domestic economic growth and tight labor markets, juxtaposed against slowing global trade and geo-political uncertainty, caused broad U.S. equity markets to again hit all-time highs during the quarter with occasional bouts of volatility mixed within. These uncertainties allowed the Federal Reserve to pivot for the second time this year, first transitioning from a tightening agenda to patience in the first quarter, and then moving into an easing cycle with two short-term interest rate cuts in the third, with the possibility of additional cuts moving forward. Meanwhile, the U.S. Dollar saw a significant appreciation due both to higher domestic interest rates (vs. other developed markets) as well as due to its role as a global safe-haven during times of economic uncertainty.

Equity markets were mixed during the quarter with multiple domestic indices hitting record highs early in the quarter only to pull back by quarter end. U.S. stocks generally ended the quarter in the green though, with large cap stocks again outperforming their small cap peers. International equity markets mostly saw losses once translated into U.S. Dollars (although many had positive returns in their local currencies), with Emerging Markets mostly underperforming developed markets due to their increased reliance on global trade.

In fixed income markets, the downward trajectory of long-term interest rates continued for a fourth straight quarter, as the combination of a slowing global economy, reduced inflation expectations and a Federal Reserve that moved to cutting shorter-term interest rates, led the yield curve to compress at a lower level than seen previously. This flattening caused the term spread between 10-year and two-year treasuries to drop from 0.25% to 0.05%, and the

MARKET PERCENTAGE TOTAL RETURNS AS OF SEPTEMBER 30, 2019

Index	Q3 2019	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	2.27	10.30	3.38	3.75
S&P 500 Index	1.70	4.25	10.84	13.24
Russell 2000 Index	-2.40	-8.89	8.19	11.19
MSCI EAFE Index	-1.07	-1.34	3.27	4.90
MSCI Emerging Markets Index	-4.25	-2.02	2.33	3.37

belly of the curve (centered around five-year treasuries) to invert relative to shorter-term rates. Inversions of various parts of the yield curve have historically been a semi-reliable predictor of economic recessions six- to 12-months out, but are not a guarantee. In particular, during the other occasions when the Federal Reserve cut rates partly in response to an inverted curve, recession was avoided over the coming year.

As we approach the end of 2019 and begin looking forward to 2020, a continuation of this year's subdued interest rates and increased stock market volatility look likely to persist as the issues weighing on the global economy do not appear set to reverse. Adding in next year's U.S. Presidential election, with an unknown Democratic Party challenger to the current administration, leaves many unknowns that may further impact the global trade order as well as both short- and long-term economic uncertainty. With so many possible but uncertain changes ahead, Exchange Bank continues to recommend focusing on the things that will impact our clients' abilities to meet their goals. Focusing on long-term risk and return needs, and avoiding being swayed by shorter-term "noise," can ensure those goals are met, and occasionally even exceeded.

What is ESG (or SRI) Investing?

By Joe Williams, *AVP & Investment Officer*

The acronyms ESG and SRI are often used interchangeably and refer to investing strategies that include subjective, non-financial factors alongside traditional financial factors. In other words, it's a strategy that takes into account revenues, margins and profits (the main financial factors investors take into account) as well as non-financial factors such as environmental, social and governance (ESG) or socially responsible investment (SRI) issues.

There are many factors that ESG investing takes into account. Companies that produce less waste or limit greenhouse gases or that emphasize employee and customer relations are a few examples. Other factors include executive pay, shareholder rights and possible exclusion of sectors like tobacco, weapons and gambling.

The different ESG factors may overlap or be separate for any given company and as such it may be difficult for an investor to decide where to start, if they are interested in taking a more ESG-focused approach with their investments. For example, a defense company that manufactures guns may rank high on governance but not appeal to investors because of social issues. Having an idea of what matters most to you and prioritizing accordingly is a good place to start. Being flexible also helps, as there is no perfect strategy that completely removes all environmental, social or governance impacts.

It's not hard to see the benefits of investing in companies with strong ESG factors. When companies expand their focus from maximizing profits to prioritizing stakeholders (customers, employees, vendors, society as a whole, etc.), volatility can be reduced and performance increased. According to a study done by Arabesque (a London-based asset management company), stocks of S&P 500 companies that ranked in the top fifth for ESG factors outperformed those in the bottom quintile by more than 25% from 2014 to 2018, all while reducing volatility.

While ESG investing doesn't remove all risk from investing, it can be beneficial to exclude companies that don't rank as high in ESG factors. Consider the recent experience of Volkswagen's emissions scandal (39% drop in its stock price in the fall of 2015), or the Equifax (34% drop in fall of 2017), Target and Yahoo's (3 billion accounts compromised) data breaches. According to a study by London-based Comparitech.com, it found that companies that suffered data breaches underperformed the Nasdaq Composite Index by 42% three years after the incident. It needs to be said that not every ESG investing strategy would screen out all of these companies, but ESG strategies can be effective at reducing this type of risk.

On the downside, one major drawback of ESG investing is a lack of standards for non-financial indicators. While it is becoming more common to see a sustainability report issued by the company along with its quarterly financial reports, there is no uniformity or common standard. These lack of standards open up the possibility of institutions abusing the marketing power of ESG strategies. The term "greenwashing" has become more prominent of late. Greenwashing refers to a marketing effort to make a company or fund seem more serious about ESG factors than it really is. Another issue is that ESG investing has not yet had a long track record and it remains to be seen how long-term performance will measure up with the broader market over extended periods of time. In addition, fees on ESG funds tend to be similar to other actively-managed investment products, which can cut your total returns over longer periods relative to more passive, market-cap weighted products.

In recent years, we have seen increased interest in ESG strategies. At Exchange Bank we take seriously our clients' desires for investment strategies that meet their risk and return needs. For some, this also means meeting their personal environmental-, social- and governance-conscious goals as well.

Recent Economic Highlights

By Argus Research Company

GDP GROWTH SLOWING, BUT FED ON WATCH

The U.S. Department of Commerce announced that its first estimate for 3Q19 GDP growth was 1.9%, down from 2.0% in the prior quarter and 3.1% in 1Q. Even so, the current expansion (40 consecutive quarters of growth) has become the longest ever. Can the outlook be for continued growth? Well, as is frequently said, expansions don't die of old age — but rather from problems that emerge as they evolve. Looking at the final months of 2019 and 2020, we project continued growth, as we think the positives in the economy (low interest rates, rising stock prices, low jobless claims) outweigh the negatives (trade war-related uncertainty and a relatively flat yield curve).

JOBS GROWTH STEADY, WAGE GROWTH SLOWS

The U.S. economy generated 136,000 jobs in September, down from 166,000 in August. The unemployment rate dropped to 3.5%; jobs growth in July as well as August was revised upward; and wage growth eased to 2.9% year over year. The employment environment, so strong for so long, has slowed in 2019, with a trailing six-month average of 154,000 new jobs per month compared to the 2018 average of 213,000. We suspect this slowdown largely has been caused by disruption in DC: first, the lengthy federal government shutdown, and lately the increasing uncertainty spawning from trade wars. As well, the economy is at the stage of the cycle when jobs growth tends to slow. We think the employment environment will continue to show modest growth. Industries with good jobs growth in September included government, healthcare and professional and business services. Construction, manufacturing, financial and leisure & hospitality hiring was little changed month over month. The slow wage growth comes as the biggest surprise, and the Fed likely will want to stay ahead of the slowing inflationary trend with further rate cuts.

GLOBAL STOCKS AT DISCOUNT

The yield on the S&P 500 is 1.9%, below the global average of 2.8%. A review of price/sales ratios tells a similar story. The U.S. ratio is 2.1x, well above the global average of 1.3x. P/E ratios? More of the same. The current trailing P/E ratio for the S&P 500 is 18.7, versus the global average of 15.7. 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 given currency, security and political risks; indeed, U.S. stocks are outperforming EAFE in 2019, and have been fairly consistently over the past five years.

INNOVATION INVESTING

If U.S. corporations weren't innovating, the domestic economy would be contracting, not expanding. U.S. GDP was about $1 trillion in 1930 and almost $20.7 trillion in 2018—a more than twentyfold increase. By contrast, the U.S. population has less than tripled during that time. The delta is, in large part, due to innovation. Innovation helps companies grow and lowers their risks. Many innovative companies are not start-ups, but instead mature businesses. They innovate by disrupting industries, launching new products, being first to new markets and improving existing products.

Tax Form Deadlines

By Emily Menjou, *VP & Personal Trust Fiduciary Manager*

Dear Clients,

It's hard to believe we are already in the fourth quarter of 2019. With year-end fast approaching, another tax season is also right around the corner. We understand this can be a busy and hectic time and we are standing by, ready to assist you. Below is a rough timeline of when you can expect to receive your tax documents from Exchange Bank:

- **1099 Tax Information Statement (for agency accounts and tax reserves):**
  The IRS deadline to provide Form 1099-DIOB is February 15, with an option to extend to March

15. Due to delays at the fund level and complex reporting requirements, we expect to mail the majority of our 1099s by late February with the balance to be mailed in early March.

- **Form 1099-R & 5498 (for retirement accounts):** If you've received a distribution from your retirement account, your 1099-R will be issued on or before the January 31 deadline. If a contribution was made to your IRA, your Form 5498 will be issued on or before the deadline of May 31.
- **Form K-1 and Grantor Letters (for trusts):** These forms are a component of each trust's fiduciary income tax return and carry the same filing deadline that you have as an individual (April 15). You should expect to receive your K-1 or Grantor Letter by mid to late March, with a few exceptions to be issued in early April.

We will make every effort to expedite our tax reporting documents in hopes of creating a smooth and easy tax season for all. If you haven't received your tax documents within the time periods specified above, please contact your account officer for a status update. And always, please let us know if you have any questions or if there is anything we can do to help.

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:

It is my pleasure to introduce AVP & Trust Officer Cathy Larson. Cathy joins our already strong Trust & Investment Management team in Silicon Valley, bringing a valuable mix of skills and expertise as we continue to develop Exchange Bank's footprint in a new area. In her role, Cathy will manage a diverse portfolio of personal trust and estate settlement accounts, while networking and building connections with families and advisors in Silicon Valley.

Cathy brings a strong fiduciary background with over 10 years of experience in trust administration from Northern Trust in Chicago and San Francisco. She graduated with honors from DePauw University in Greencastle, Indiana with a B.A. in Economics.

Cathy enjoys being a trusted advisor for her clients, helping to implement their estate plans and achieve their financial legacy goals. She's spent the last 20 years raising two children and actively volunteering in the Silicon Valley community. She and her husband are recent empty nesters and are looking forward to exploring the Bay Area bike trails as well as traveling abroad.

I hope you'll join me in welcoming Cathy and that you'll have the chance to meet her soon.

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