FIRST QUARTER 2020 – 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*

Closing out the year, the fourth quarter of 2019 provided a solid finish for global stock markets and risk assets as the significant volatility that was seen earlier in the year gave way to a series of fresh all-time market highs for U.S. equities by year end. The continuation of the Federal Reserve's second half about-face, with a series of three short-term interest rate cuts concluding in October (after beginning the year with expectations for multiple rate hikes), and positive developments on a potential U.S.-China trade truce, allowed optimistic market sentiment to return in a more robust fashion. Those changes, along with continued solid economic growth, a half-century low unemployment rate, and subdued inflation rates lifted market sentiment and provided a positive outlook for the year ahead.

In the fourth quarter, global equity markets continued their ascent, rounding out 2019 with most major markets producing double-digit returns for the year. Emerging market equities outperformed their developed market peers (including the U.S.) during the final three months of the year, at least partially due to their previous underperformance caused by trade uncertainties that appeared to be close to some sort of resolution at year end. Domestic stocks continued their streak of solid returns, with small-capitalization stocks outperforming their large-cap peers, and cyclical industries such as Technology and Financials leading the way.

In fixed income markets, there was a bit of a reversal from the prior quarters, with the yield curve steepening for the first time in a year. With the Federal Reserve cutting short term rates at their third straight meeting in October, along with signs of a détente in the U.S. China trade conflict, the spread between short- and long-term rates expanded significantly during the quarter. The spread on two-year and 10-year treasuries expanded from 0.05% to 0.34%, with the entire curve taking on a more normal slope, after the various inversions

MARKET PERCENTAGE TOTAL RETURNS AS OF DECEMBER 31, 2019

Index	Q4-2019	One Year	Five Years (Annualized)	Ten Years (Annualized)
Barclays U.S. Aggregate Bond Index	0.18	8.72	3.05	3.75
S&P 500 Index	9.07	31.49	11.70	13.56
Russell 2000 Index	9.94	25.52	8.23	11.83
MSCI EAFE Index	8.17	22.01	5.67	5.50
MSCI Emerging Markets Index	11.84	18.42	5.61	3.68

seen earlier throughout the year. This normalizing yield curve seems to suggest that the worst predictions of recession for the U.S. economy may be behind us, and that barring an unexpected shock, the Fed should be on hold with rates at least through this year's election season.

Looking forward, election years often provide a source of additional uncertainty for both the stock and bond markets, which can lead to higher levels of volatility for each. Historically, this volatility tends to peak in the second and third quarters of the year as the primaries give way to the eventual candidates and platforms that will shape the general election. By the beginning of the fourth quarter the markets typically attempt to price in the probable victor, although as seen in the last presidential election, polls can be wrong and markets may behave in unpredictable ways. As such, attempting to make timing calls on inflections in the markets is often not a profitable endeavor. At Exchange Bank, we continue to believe that the tried-and-true method of building efficient portfolios to last over the long-term market cycles, and ignoring the shorter-term noise of election seasons, will help ensure that our clients will be able to meet their long-term goals.

Viewing Stock Market Risk

By David Rapoport, *Vice President*

Do you view risk as the likelihood of asset price declines over relatively short, or even extended, periods of time? Or, do you consider risk as the prospect of permanent capital loss? If the latter is your concern, for stocks in particular it may make more sense to see risk as reflected by inherent fundamentals. For stocks, individually and collectively, earnings measure value and determine long term performance.

A recent piece from Alger Management, sourcing data from FactSet and Nobel Laureate economist Dr. Robert Shiller, highlighted a key fact. Over ten year periods since 1970, Standard & Poor's 500 earnings per share have never declined. Yes, the annual growth rate has fluctuated considerably, between about one and ten percent, but these decade long results have never been negative. Historically, long term earnings per share growth has been the norm, and remains the bedrock upon which future capital gains are built.

So, when you think about equity risk, especially in the broadly diversified index-based strategies that Exchange Bank favors as the primary components for your portfolio, remember the decade by decade record of consistent earnings growth generated by well-established U.S. companies over the last half century. At Exchange Bank Trust and Investment Management, we do. Our ongoing review of both industry and academic research continues to inform our portfolio strategies. While there are certain situations in which stock market risk may not be appropriate, even retirees should thoughtfully consider the history and likelihood of corporate earnings growth, as a protector of purchasing power, and, therefore, a contributor to lifestyle maintenance.

Recent Economic Highlights

By Argus Research Company

Steady, Slow Growth Expected in 2020-2021

Can we expect continued growth in the current economy (which now boasts the longest expansion on record)? As Argus has frequently said, expansions don't die of old age — but rather from problems that emerge as they evolve. Looking into 2020-21, their forecast is for continued growth, as the positives in the economy (low interest rates, rising stock market, low jobless claims) outweigh the negatives (trade wars, geopolitical developments, relatively flat yield curve, slowdown in PMI new orders). However, they do expect the growth rate to slow in the first half of 2020. In 2020, their forecast is that overall growth will average in the 2.2% range, down from 2.3% in 2019 and 2.5% in 2018. Their forecast for 2021 GDP growth is 1.6%.

Low Odds for a Recession

The first reading of GDP for the fourth quarter of 2019 was 2.1%, close to the Argus forecast of 2.2%. The current economic expansion is the longest on record, but there are no clear signs pointing toward a recession. From quarter-to-quarter, capital expenditures may be weak or the consumer sector may be strong, or vice versa. In the 60 years since 1960, the U.S. economy has experienced eight recessions. If they each last on average one year, then the odds of a recession this year, or any year, is around 13%. Of course, the economy is not so simple. Recessions are caused by complex factors, including overvalued assets, commodity shocks, geopolitical events and monetary failures, among others. One thing is consistent about all recessions; the employment environment looked strong heading into each. In fact, unemployment was at cycle lows on average a mere seven months before recessions began. By the time the economy was contracting from that unemployment cycle low, the unemployment rate had risen (on average) 50 basis points. Currently, unemployment of 3.5% is at a cycle low. We will be watching the trend in the unemployment rate — even though it is so low now — as a potential predictor of an economic slowdown.

Inflation Below Fed's Target

The Federal Reserve has moved to the sidelines after lowering rates three times in the second half of 2019, primarily because numerous inflation measures are running at or below the central bank's stated goal of 2.0%. For example, the Fed's favorite measure, the Personal Consumption Expenditure Consumer Price Index ex-Food and Energy (core PCE) rate, is up only 1.6% year-over-year; the widely-followed Consumer Price Index is up at a 2.3% rate; and the core CPI (ex Food and Energy) is also up 2.3%. Despite a low unemployment rate, wage growth is at only 2.9%. Deeper in the pipeline, there are signs of possible deflation. The Intermediate Producer Price Index for Unprocessed Goods is down 7.3% over the past year, and the Intermediate Producer Price Index for Processed Goods is down 1.7%.

December Jobs Report Surprises on Downside

The U.S. economy generated 145,000 jobs in December, while the unemployment rate was steady at 3.5%. The employment environment slowed a bit in 2019, with a monthly average of 189,000 new jobs per month compared to the 2018 average of 213,000. Argus suspects the slowdown has been caused largely by disruption in DC, including the trade war. In addition, the economy is at the stage of the cycle (late) when jobs growth tends to slow. The expectation is that the employment environment will continue to show modest growth, supporting overall economic expansion, and that the jobs report gives the Federal Reserve the back-drop to remain on the sidelines in 2020 after three rate cuts in the second half of 2019.

Impressive Breadth in 2019

Investors enjoyed an exceptional year in 2019, as all 11 stock market sectors posted positive performance. On a three-year basis, two clear trends emerge: the Information Technology (IT) sector has outperformed three years in a row, while the Energy sector has lagged badly three years in a row. Will the trends reverse in 2020? Investors are increasingly eager to allocate capital to innovative IT companies that are connecting people and making corporations more efficient. Meanwhile, the Energy sector is likely to face "peak demand" at some point in the next two to three decades, suggesting a sharp cap on the long-term growth outlook.

Year-End Insider Sentiment

Argus Research Company recently looked at insider-sentiment barometers from Vickers Stock Research, comparing year-end readings with those in late 2007 before the Great Recession began. First is the One-Week Sell/Buy Ratio for shares that trade on the NYSE. In 2009, the reading was 8.13. That is a very negative result as the barometer is bearish above 2.50. Today, the ratio — at 3.79 — is nowhere near the scary level from 2009. Also in 2009, the Total One-Week Sell/Buy Ratio was at 4.77. That's bearish, but represented calm insider-trading activity on the NASDAQ that was offset by the very bearish activity (detailed above) on the NYSE. Today, the reading is benign and the relationship between the NYSE and the NASDAQ is balanced. Other major gauges are inconclusive and suggest the beginning of 2020 is not a cause for fear among corporate insiders.

The Value of a Trust Company

By John E. Mackey, *Senior Vice President*

Why is it so important to choose a trust company to help your family manage investments? Exchange Bank's Trust & Investment Management Department is often asked this question when we encounter families and business owners who are tackling important topics such as reaching their personal financial goals, managing the transfer of their wealth to the next generation in a way that promotes important family values, helping their employees save for retirement and creating or enhancing their legacy. As with many things in life, the answer to the question depends on several considerations.

The first consideration depends on the purpose of the help needed. A trust company is built to do more than just manage investments. A trust company is able to manage assets other than marketable securities such as real estate, partnership interests and collectables such as art. They also maintain appropriate principal and interest accounting that is required by law for a trustee of an irrevocable trust. They are also able to provide financial reporting to families and other beneficiaries including charities and can step in and help with many financial affairs such as paying bills and expenses when needed. All of these services can be provided for a single, bundled fee, saving considerable money.

The second consideration is based on the relationship between a client and an advisor. In a brokerage firm, an advisor is typically paid via commission for the sale of a product to the client. More recently, many brokers have changed aspects of their fee structure to charge fees based on the value of the assets that they are managing. Either way, they are required to ensure that the products they sell are suitable for their client. This system works well when a broker is consistently outperforming markets to help a client reach their goals. In truth, few if any, brokers actually outperform markets over a long time-frame. The costs associated with transactions (commissions, timing mistakes and taxes) erode long-term performance in almost all cases.

A trust company follows only two principles in their relationship with clients. Their investments must be managed as a fiduciary, with the client's interest first, and they must be invested according to the Prudent Investor Rule. Managing as a fiduciary means that investments are chosen to meet the investor's goals with the least expense. Managing investments according to the Prudent Investor Rule requires the use of diversification to manage risk. The result of following these two principles is that our clients' investment portfolios are designed to provide the best returns available from capital markets without the negative impact of risks taken trying to outsmart them along with the corresponding expenses.

Finally, when a family is most in need of support from experienced professionals, a trust company is able to gather assets, communicate with a spouse, children and other beneficiaries (such as charities) and prepare required accountings and help file the necessary tax returns. Perhaps the most important reason to put your trust in a trust company is that they are built to provide this same level of service to your family far into the future when your legacy needs them the most.

Upcoming Events

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

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

Tuesday, May 12, 2020 | 2:00pm–5:00pm

Vintners Inn | Santa Rosa

(Now called Vintners Resort)

GUEST SPEAKERS:

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

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

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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.

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