SECOND QUARTER 2020 – 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*

After a promising beginning to the new decade for financial markets, the onset of the global coronavirus pandemic and associated lockdowns caused the beginnings of a shock to the global economy and left financial markets in distress by the end of the first quarter. From the domestic stock markets' worst ever first (calendar) quarter showing and commodity prices in seeming freefall to widening credit spreads in both corporate and municipal bond markets and a lack of liquidity in the world's largest liquid asset class (U.S. Treasury securities), financial market dislocations were observed virtually everywhere, with few safe havens truly living up to their reputations. As quarter end closed in, the Federal Reserve cut rates to their effective lower bound (near zero) and announced a litany of unconventional policy initiatives, while Congress passed the Coronavirus Aid, Relief and Economic Security (CARES) Act, providing the largest ever fiscal stimulus to taxpayers and other entities with a potential value exceeding $2 trillion. Even with all of these extraordinary stimulus measures, the unprecedented nature of the global pandemic and associated lockdowns are going to leave an indelible mark on the global economy and financial markets, possibly for an entire generation.

For global equity markets, 2020 began with a continuation of the bull market that began over a decade ago, in March 2009. The latest leg up began just after the Christmas holiday in 2018, in the midst of the U.S.-China trade war and with questions of whether the Federal Reserve would continue hiking short-term interest rates as their Summary of Economics Projections modeled at the time. The following year (2019), the Fed reversed course and not only held off on anticipated rate hikes, but actually cut rates three times in the back half of the year, allowing the longest post-war economic

MARKET PERCENTAGE TOTAL RETURNS AS OF MARCH 31, 2020

Index	Q1 2020	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	3.15	8.93	3.36	3.88
S&P 500 Index	-19.60	-6.98	6.73	10.53
Russell 2000 Index	-30.61	-23.99	-0.25	6.90
MSCI EAFE Index	-22.83	-14.38	-0.62	2.72
MSCI Emerging Markets Index	-23.60	-17.69	-0.37	0.68

expansion to continue. Markets rallied through the remainder of 2019, as well as the first month and a half of 2020, while the specter of a deadly wave of illness in China began showing signs of escalating into something bigger in January and early February. Domestic stock markets peaked on February 19, officially marking the end of the longest bull market in U.S. history, before falling precipitously into a bear market (a drop of at least 20% from recent highs) in the shortest time frame ever, as evidence piled up that the coronavirus pandemic could not be prevented and policy makers began instituting lockdowns in a majority of the developed world.

From a relative performance standpoint, the risk off environment that unwound markets in the second half of the quarter allowed U.S. dollar denominated assets to outperform their international peers. Large-cap companies, which tend to be less risky than small-cap companies and that are weighted more heavily to less capital intensive businesses (such as mega-cap technology), outperformed while growth outperformed value. Especially hard hit were firms in the energy and financial sectors, as the former dealt with a collapse in oil prices due to a flood of supply due to a price war between Russia and Saudi Arabia along with the significant demand destruction caused by the coronavirus pandemic and associated lockdowns, while falling interest rates and increased credit risk negatively impacted the latter.

In fixed income markets, the first quarter of 2020 saw a continuation of the “bull steepener” that began in earnest during the fourth quarter of 2019 with rates falling across the yield curve. The Federal Reserve dropped the Fed funds rate to near zero at an emergency meeting held just days before their scheduled March meeting, anticipating the enormity of the economic damage about to take place across the globe. Longer term rates also fell in anticipation of a slowing economy with lower long-term inflation expectations, and the spread in the U.S. Treasury yield curve (2-10 year spread) widened from 0.34% to 0.47% by quarter end. Additionally, credit spreads widened across multiple sectors of the fixed income markets, including those tied to traditionally safe municipal securities, which saw spreads widen to generational highs before falling back to still wide levels after the announcement of several new programs by the Fed to backstop everything from municipal securities to corporate bonds to bank loans and other debt instruments. These unprecedented policy changes by the Fed will be felt for years to come and will dramatically impact the price discovery mechanism across all fixed income markets going forward.

Looking ahead, due to all of the unknowns associated with the coronavirus pandemic as well as additional potential policy responses, forecasting economic data far into the future becomes a guessing game at best. Although the fundamentals of the global economy look dismal as we fall into a recession of unknown depth and length, underestimating the ability of monetary and fiscal policy-makers with effectively a no-limit credit card and monetary printing press, could mean the eventual recovery happens just as quickly and forcefully as the recession occurred. Attempting to time these inflection points has proven to be a difficult task for even the brightest institutional investors, but even individual investors can have a good investing experience over the long term by finding the right portfolio mix with the appropriate levels of risk and expected returns to meet your goals, even if it means some bumps in the road along the way.

Why Does Diversification Always Feel Like You’re Losing?

By Joe Williams, *Assistant Vice President*

Depending on your goals, net worth, and risk tolerance, chances are your investments are in a mix of marketable securities such as stocks and bonds. You’ve likely heard why it is important to have an allocation to both bonds and stocks (diversification, safety, income production and growth, etc.) but somehow as an investor it generally feels like you’re never quite “winning.” For instance, in a down market, your portfolio has lost value and that never feels good. In an up market, your portfolio hasn’t achieved the full return of the “market” or the S&P 500 Index. In a sideways market, it doesn’t produce enough income or increase in value. In all of these scenarios, you may never be fully satisfied with the results of your portfolio, so why do investment professionals continue to beat the drum of asset allocation?

Recently, I came across some research from BlackRock (the world's largest fund company by Assets under Management) that looked at the performance of a diversified portfolio composed of 60% stocks (U.S. Market, International and Small Caps) and 40% bonds (total U.S. Bond Market and High Yield) over the last 20 years. This covered significant market events that many of us have experienced personally, including the dot-com crash, the financial crisis of 2008/09 and finally the coronavirus pandemic. Starting in March of 2000 and ending December 2002, this diversified portfolio had a decline of 17.7%, which hurts! However, the market as a whole (S&P 500) had a 39% decline during this time period. This was the dot-com bust that hit technology stocks particularly hard. Then, from January 2003 until December 2007, the diversified portfolio had a total return of 73.8%, while the market had an 82.9% return. The gain on the diversified portfolio was nice, but the market was clearly better, and in some cases this can leave you wanting more. In 2008, the diversified portfolio lost 24% while the market lost 37%. Similar to the dot-com bust, losing a quarter of the value of your portfolio hurts, but if you stayed invested your portfolio recovered. From 2009 until the end of 2019 the diversified portfolio had a nice return of 191.7% which made up for the dot-com bust and the financial crisis of 2008. However, the market during that period had a return of 351%, far outpacing the diversified portfolio. This can be a tough pill to swallow, knowing that you're leaving something on the table by choosing a diversified portfolio. In 2020 (through the first quarter), the diversified portfolio declined 13.1% while the market declined 19.6%. This most recent quarter hurt financially and is still in our collective memories because we're still in the thick of it.

What does all this have to do with allocating your portfolio and feeling like you're losing? Well, the total return of the market from March 2000 to March 2020 was 154.8%, not bad for a 20-year run with major financial disasters contained within. What about that diversified portfolio you ask? Well, the total return during that same time period was 175.6%, beating the market. In dollar terms, if you had $1,000,000 invested in the S&P 500 Index versus the same $1,000,000 invested in this hypothetical diversified portfolio, by March 31 2020 the S&P 500 Index portfolio would be valued at $2,547,940, while the diversified portfolio would be valued at $2,755,560. How is that possible?

The diversified portfolio with a balance between stocks and bonds had higher lows than the market and recovered quicker. While it missed the highest highs of the market, it more than made up for that by reducing volatility in the tough stretches. Reducing the volatility is the primary reason why (we) investment professionals often talk about diversification and proper asset allocation but in some cases it can perform just as well or better than the market. So while your portfolio's performance may never seem to fully satisfy you, if it's well diversified and properly allocated, chances are your portfolio is actually "winning."

Recent Economic Highlights

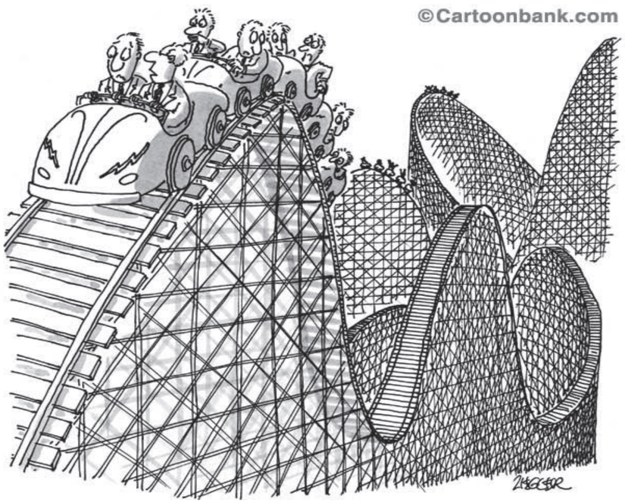
By Argus Research Company

1Q GDP GROWTH DOWN 4.8%

The U.S. economy contracted at a 4.8% rate in 1Q20, as the nation shut down to combat COVID-19. Personal consumption expenditures declined 7.6%; private domestic investment fell 5.6%; exports were down 8.7%. Of note, this was with about two weeks of "stay at home" orders. The 2Q results will be even uglier. Positives? Consumer spending on nondurable goods jumped 6.9%, investment in intellectual property products increased 0.4% and federal government spending rose 1.7%. A 15% decline in imports also supported GDP. The numbers are certain to get worse before they get better. Yes, some states are starting to reopen, and the economy should get a boost from government spending. But consumer spending is likely to be altered for months, if not years.

HOUSING MARKET STARTS TO TURN DOWN

The housing market—a major pillar of U.S. economic growth in recent years—is starting to falter due to the pandemic. Building permits, which are a leading indicator, peaked in January at 1.55 million units and are now down 13% (through March) and likely headed lower. New home sales were down 4% month-to-month in February, though they were still up 14% year-over-year. Prices have not fallen yet. The S&P/Case-Shiller National Home Price Index for January 2020 showed that prices gained 3.9% year-over-year. But that survey was taken before the U.S. economy was shut down.



They call this ride the "New Normal," but personally, I prefer the carousel.

BROAD STOCK MARKET WEAKNESS IN EARLY 2020

Through March 31, all 11 GICS sectors had negative performance for the year-to-date, and the S&P 500 was off 20%. On a three-year basis, two clear trends emerge: the Technology sector has outperformed three years in a row, while the Energy sector has lagged badly three years in a row. Will the trends reverse later this year? We think that is doubtful. Investors are eager to allocate capital to innovative IT companies that are connecting people and making corporations more efficient. Meanwhile, the Energy sector is facing "peak demand" forecasts at some point in the next two to three decades, suggesting that the long-term growth outlook is severely capped. In addition to IT, other sectors for "secular" long-term EPS growth include Healthcare, which is on the front lines fighting COVID-19, and Financial Services.

HIGH VOLATILITY IS NEW NORMAL

The VIX Volatility Index remains at elevated levels and we think investors should expect volatile market conditions through at least the balance of 2020. This forecast fits with our Three Levels of Recovery Theory. We look for public health to recover first, with widespread testing by mid-year, treatment options by year-end and a vaccine in early 2021. The second level of recovery will be the economy, helped in large part by the government. We look for historically weak economic numbers in 2Q20 and 3Q20, before the economy moves back to a flat line in 4Q and grows again 2021. The third level of recovery will be earnings and the stock market. Stock investors will anticipate a turnaround in earnings and bid shares higher.

INFLATION MEASURES FALLING

The Fed is backstopping mortgage markets, money-market mutual funds, small businesses, mid-sized businesses, corporate debt and some state and local governments. As such, the central bank is likely to double the $4.1 trillion in assets on its balance sheet at year-end 2019. Meanwhile, most inflation measures remain below the Fed's target of 2.0%; some are even pointing toward deflation. The Fed's focus now must be on keeping the economy intact. But down the road, there may be a large bill to pay in inflation. That's because as the Fed's balance sheet is ballooning, so is the U.S. federal deficit. At some point, the dollar may weaken if economies in other countries improve faster, and capital may then flow out of the U.S.

COMMODITY PRICES TUMBLE

Trade issues have hammered commodities over the past two years, and now the coronavirus is piling on. Commodities investors are accustomed to the volatility. The last time the commodities market bottomed was in January 2016, when oil prices were below $30 per barrel and copper was below $4,500 per metric ton, according to the World Bank. Oil is already there, but copper is still above $5,000. We think underlying economic fundamentals are favorable for most commodities (except oil), but project volatility from the virus. A stable or falling dollar would help.

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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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