FIRST QUARTER 2021 – 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 & Institutional Trust Fiduciary Manager

Completing the roller coaster year that was 2020, the fourth quarter saw a continuation of the economic and financial market rebounds that came off the largest and fastest economic contraction in post-WWII history. Other remarkable aspects of last year's final quarter included the polarizing U.S. Presidential election, the approval of multiple coronavirus vaccines by the Food & Drug Administration as well as the signing of the fifth pandemic-era stimulus bill by the outgoing administration.

For markets and the economy, the uncertainty of the trajectory of the coronavirus pandemic and the results of the forthcoming Presidential and Congressional elections caused risk market volatility to stay elevated in the first part of the quarter. After the election though, it gave way to what markets thought would be a Goldilocks-type scenario with what appeared initially to be a divided congress, and positive vaccine trials data coming just days later. Since the pandemic's beginning, markets have been looking to the future to determine how long the recovery would take, with successful vaccines a key ingredient to the world getting back to life as we knew it. With positive vaccine efficacy rates and FDA approval of multiple vaccines, finally there may be light at the end of the COVID-19 tunnel.

Global equity markets continued their ascent in the fourth quarter, with broad-based double-digit returns around the world, led by developed international and emerging markets. International markets have trailed the U.S.

MARKET PERCENTAGE TOTAL RETURNS AS OF DECEMBER 31, 2020

Index	Q4 2020	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	0.67	7.51	4.44	3.84
S&P 500 Index	12.15	18.40	15.22	13.88
Russell 2000 Index	31.37	19.96	13.26	11.20
MSCI EAFE Index	16.05	7.82	7.45	5.51
MSCI Emerging Markets Index	19.70	18.31	12.81	3.63

stock market for most of the past few years, and the early part of the pandemic recession saw that same dynamic. For the past six months, we have started to see a reversal of those trends. A falling dollar has buoyed foreign assets, and the potential end of the pandemic in the coming year(s) may allow much of the world to rebound faster than previously anticipated.

In fixed-income markets, expectations for continued economic recovery continued to allow markets to push long-term interest rates higher, while short-term rates were held at the Effective Lower Bound (a.k.a. zero) by the Federal Reserve. This dynamic of long-term rates increasing faster than short-term rates (known as curve steepening) re-accelerated during the fourth quarter with the two- to 10-year U.S. Treasury curve increasing from 0.56% to 0.80%. Credit spreads also continued to tighten across all sectors of the fixed income markets, most notably for high-yield bonds which contracted more than a full percentage point during the quarter, to all-time low yields for the asset class.

Looking forward into 2021, the combination of incredible amounts of liquidity and stimulus continuing to be pumped into the economy (and markets), as well as progress on the COVID-19 vaccination front (both domestically and globally), should continue to create a generally positive environment for risk assets in the year(s) ahead. That said, there are still many unknowns regarding the trajectory of the virus and its variants and, as such, an ounce of caution is still required due to the potential for continued high levels of volatility ahead.

As always, maintaining the risk and reward profiles of our clients' investment portfolios continues to be Exchange Bank's primary concern, with a focus on achieving your goals in your expected time frames.

Current Stock Market Valuations

By Joe Williams,
Assistant Vice President & Investment Officer

One of the classic ways in finance to measure the value of a stock is through its P/E ratio or price to earnings ratio. This is the current multiple that investors are willing to pay for the company's earnings. The higher the ratio, the more investors are willing to pay for that company's earnings (usually because the future prospects look good) and vice versa. When we go through a recession, companies tend to sell less products or services (which usually means their earnings drop) and they usually see their stock price tumble. We experienced this with the economic lockdowns this past spring, but as more information about the virus and the economy became available (and after congress passed a $3 trillion stimulus package early in the lockdown) the stock market bounced back and then some.

A lot of people have expressed concern about the stock market hitting all-time highs and how it's disconnected from our current reality. On the surface that makes sense, but digging into the data a bit deeper can help explain why the "disconnect" isn't all that unusual. The average P/E ratio for the S&P 500 for the past five years is 17.4, and the average for the past 10 years is 15.6. Our current P/E ratio is in the low 20s—which effectively means investors are willing to pay a higher premium for stocks today than the five- and 10-year averages.

It is important to note that just because the P/E ratio is high doesn't mean it will always revert back to the mean quickly. P/E ratio is a moving target over time and reflects all of the current economic data. Part of the reason why the higher P/E ratio isn't overly concerning is because economic activity is expected to continue to pick up and improve over the next year. The stock market is looking toward the future (we call it forward looking) and is not necessarily focused on what is happening right now. With the news of some of the major vaccine results being substantially more effective than we could have hoped for, this has reinforced the markets belief that the potential end of the pandemic is near and a return to normal activity isn't that far off. Another set of factors worth considering is that interest rates and inflation are historically low and stocks tend to trade at higher P/E ratios during these times.

One way for P/E ratios to go lower is obvious: stock prices can plummet. Another less obvious way is that companies can start to earn more money, and that is what the market currently seems to be expecting. The overall P/E ratio (and stock prices) isn't as concerning after taking into consideration the prospects of a return to "normal" soon, low interest and low inflation. Many analysts have made the case that with those economic data points in mind, the value of the stock market is actually pretty close to average for its historic norms.

Recent Economic Highlights

By Argus Research Company

GDP EXPANDS 4% IN 4Q

After two quarters of wild swings, the U.S. GDP growth rate settled down in 4Q20 to an annualized 4.0%. The fourth-quarter increase in real GDP reflected increases in exports (at a 22% rate), business investment (25%), consumer spending (2.5%), housing investment (33.5%), and inventory investment. Those were offset partially by a decrease in government spending (down 1.2%). Imports, a subtraction in the calculation of GDP, increased. For 2020, real GDP decreased 3.5% (from the 2019 annual level to the 2020 annual level), compared to an increase of 2.2% in 2019. On an absolute basis, despite two quarters of recovery, current GDP of $21.5 trillion is about 1% below pre-pandemic levels. Meanwhile, COVID-19 continues to spread, despite the early rollout of vaccines. While we do not expect a double-dip recession in the coming quarters, the country's recovery from the pandemic is likely to remain a challenge, with growth in the low single digits likely.

BETTER GLOBAL GROWTH FORECAST FOR 2021

The IMF now projects global growth of 5.5% for 2021—up from its prior forecast of 5.2% and a rebound from the global GDP decline of 3.5% in 2020. The IMF expects that emerging markets will grow the fastest (at an average rate of 6.3%). Developed economies are expected to grow at an average rate of 4.3%, the Eurozone should grow at a 4.2% clip, and U.S. growth is forecast at 5.1%. We take this with a grain of salt, as catalysts for economic weakness abound in Europe; two of the BRICS, Brazil and Russia, are forecast to grow a relatively modest 3.6% and 3.0%, respectively; and Japan is expected to grow just 3.1%. Much of the global recovery will depend on the distribution of COVID-19 vaccines, and we anticipate that wealthier nations will have more success in this area.

DECEMBER PAYROLLS DECLINE

The U.S. economy lost 140,000 jobs in December. Notable job losses occurred during the month in leisure, education and government, while jobs increased in the temporary help and courier segments. In December, 23.7% of employed persons teleworked, up from 21.8% in November. The number of unemployed, at 10.7 million, was up 5 million from February 2020. The Labor Department reported that another 787,000 people filed initial unemployment claims, and the total of continuing claims was 5.2 million, down from 6.2 million a month earlier but still showing a weak employment environment. We expect that the unemployment rate will remain high (and the Fed will keep interest rates low) in 2021 as the U.S. economy slowly recovers.

HOUSE PRICES SURGING

The housing market—a major pillar of U.S. economic growth pre-pandemic—is rebounding. Existing home sales, which were down 32% in May from January 2020, have been rising consistently since late spring and are closing in on a 100% increase from their

May lows. Building permits, a leading indicator for the industry, peaked in January 2020 at 1.55 million units and are now back above that level (based on data through November 2020). They too have risen more than 50% from April's lows. Prices have held up as well. The S&P/Case-Shiller National Home Price Index is one of the most closely watched barometers of the housing market. Data for October 2020 showed that home prices rose 7.9% year-over-year—the highest rate in six years. Meanwhile, inventory levels are tight: currently there is a low 4.1-month supply of existing homes for sale (the average range is 4.5-7.5 months), according to the U.S. Census Bureau. On the other side of the pandemic, we expect demand for homes—with yards between neighbors and no elevator buttons to press—to remain strong.

FED HOLDS STEADY ON RATES

At its recent Open Market Committee meeting, the Federal Reserve decided to maintain the federal funds rate at a rock-bottom 0.00%-0.25%. The action (or non-action) had been widely expected given the current high level of unemployment and little pressure on inflation. The vote was unanimous, and the Fed continues to forecast no changes in rates through at least 2022. In his comments after the meeting, Fed Chairman Jerome Powell noted that he believed the bigger risk to the economy is doing too little, rather than doing too much (remember that the central bank is also purchasing $120 billion in Treasuries and mortgage-backed securities each month). One thing we don't expect the Fed to do is to lower interest rates to below zero. Although that strategy has been used in some countries, it is not clear to Chairman Powell that the tool works; after all, the economies in Europe and Japan that have deployed negative rates continue to struggle. Further, he does not think it is appropriate in the U.S., given the country's dependence on money-market mutual funds.

Email Delivery of Wealth Management Update
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.

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.**

Tax Deadlines

Dear Clients,

It's hard to believe we are already in the first quarter of 2021. We understand this can be a busy and hectic time and we are available and 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 and 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. As always, please let us know if you have any questions or if there is anything we can do to help.

Emily Menjou
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