Exchange Bank

Trust & Investment Management

TRUST & INVESTMENT UPDATE

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Investment Review and Outlook

By Matthew C. Kelman,
Vice President & Institutional Trust Fiduciary Manager

Following the roller coaster in economic data and financial markets that was 2020, the first quarter of 2021 saw a slower, more measured and stable growth rate across the U.S. economy due to a receding set of coronavirus statistics and additional fiscal and monetary stimulus being released by the U.S. Treasury and Federal Reserve. Accelerating rates of vaccination and a collapse in the number of new daily infections throughout the quarter has allowed us all to (finally!) see the light at the end of the pandemic/lockdown tunnel. In addition, financial markets moved more forcefully to a risk-on tone through the quarter, with reversals in many of the market trends from last year.

Global equity markets saw widespread gains during the first quarter, led by U.S. stocks which benefited from higher rates of vaccination and multiple rounds of sizeable stimulus packages relative to the rest of the world. With a rotation away from "stay at home" stocks to more traditional sectors of the economy, as the country began to reopen, value and cyclical stocks significantly outperformed their growth and defensive counterparts, while a risk-on mentality caused small-caps to outperform large-caps. International markets also posted positive, although more subdued returns, for the quarter, with Emerging Markets marginally lagging their developed peers.

In fixed income markets, an outsized leap in long-term interest rates defined the quarter, while the Federal Reserve kept the short end of the yield curve pinned near zero. In what was the

MARKET PERCENTAGE TOTAL RETURNS AS OF MARCH 31, 2021

Index	Q1 2021	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	-3.37	0.71	3.10	3.44
S&P 500 Index	6.17	56.35	16.29	13.91
Russell 2000 Index	12.70	94.85	16.35	11.68
MSCI EAFE Index	3.48	44.57	8.85	5.52
MSCI Emerging Markets Index	2.29	58.39	12.07	3.65

largest quarterly bear-steepening of the past three decades, the 2-10-year U.S. Treasury curve increased from 0.80% to 1.58%, a truly historic move, with the 10-year Treasury seeing a near doubling in yields in a mere three months. Increasing twin deficits and a falling U.S. dollar, along with supply chain disruptions and the impacts of base effects from the year ago period, coincided to cause inflation expectations and break-evens to lurch higher. Whether the coming increases in inflation are "transitory" (in Fed parlance) remains to be seen, but the mere possibility of a higher, longer-term inflation regime, facilitated by the Fed's recent changes in policy, meant investors demanded higher premiums for holding longer-dated debt.

Looking ahead to the rest of 2021, with the worst of the pandemic long behind us, and significant monetary and fiscal stimulus continuing to act as tailwinds, the U.S. economy looks set to stay in high gear for the foreseeable future. What that means in the short-term for financial markets is anyone's guess, but the possibility of a "double-dip" recession looks increasingly unlikely, with an increasing possibility of an economic overheat. Should the economy rebound more quickly than policy makers expect, it is possible additional course corrections could be needed to contain inflation. In the meantime, all of the stimulus thrown at the economy has bought time for a more organic recovery to take over as the year progresses.

Recent Economic Highlights

By Argus Research Company

GDP EXPANDS 6.4% IN 1Q

The U.S. GDP growth rate accelerated in 1Q21 to an annualized 6.4%. The consumer and government sectors were the key drivers of this growth, as personal consumption expenditures rose at a 10.7% rate and government spending at a 6.3% rate, offsetting a 5% decline in gross private domestic investment and a 1.1% dip in exports. Drilling deeper, we note that consumer spending on durable goods increased 41.4% and spending on nondurable goods rose 14.4%. Services spending increased 4.6%. Spending on equipment rose at a 16.7% rate and spending on intellectual property products rose at a 10.1% rate. Residential investment increased at a 10.8% rate. On an absolute basis and despite three quarters of recovery, current GDP is still about 1% below pre-pandemic levels. The National Bureau of Economic Research has not yet declared the recession over. We look for solid above-trend GDP growth through 2023.

GOOD NEWS ON GLOBAL GROWTH

The International Monetary Fund (IMF) expects the world economy to grow by 6.1% in 2021, up from its 5.5% forecast in January. The IMF also projects growth of 4.4% in 2022. India and China are expected to set the pace this year, with forecast rates of 12.5% and 8.6%, respectively. Emerging markets are expected to expand their economies at a 6.7% rate, with the U.S. forecast to grow 6.4% and Europe 4.4%. Much of the global recovery rate and durability in GDP will depend on the distribution of vaccines.

INFLATION SOARING AT PRODUCER LEVEL

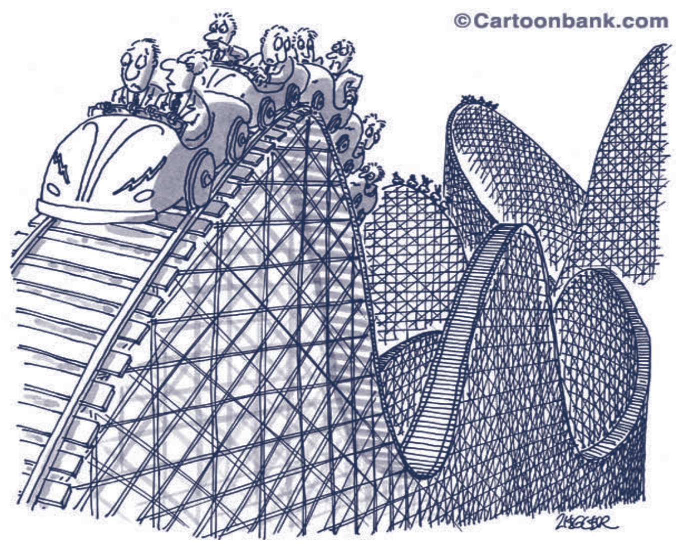
Pricing pressures are starting to pick up—primarily at the producer level—and it should not be too long before more mainstream measures of inflation start to tick higher as well. Even so, we don't think the U.S. Federal Reserve is too worried. Chairman Powell has said that the central bank is willing to let inflation rise above its 2% target in exchange for a continued decline in unemployment. Argus Research Company tracks 14 inflation measures on a monthly basis. On average, they indicate that prices are rising at a 6.2% rate, ahead of last month's 3.8% reading. But drilling down to core inflation (which is obtained by averaging core CPI, market-based PCE ex-food & energy, and the 10-year TIPs breakeven interest rate), the reading is 1.8%, only slightly above last month's 1.7%. The big increases in recent months have come at the producer level, as the PPI for intermediate unprocessed goods is now 42% and the PPI for intermediate processed goods is 13%. Much of this price activity has been driven by the recent recovery in commodity prices, including oil. The Fed's inflation forecasts call for core inflation of 2.2% in 2021 and 2.0% in 2022.

PRODUCTIVITY PICKS UP

Productivity is an important driver of long-term economic and income growth, and we keep a close watch on trends measured by the Labor Department. The post-war decades of the 1950s and 1960s were good years for productivity, which averaged 2.8% growth during this period of solid economic expansion. Productivity decelerated in the 1970s, before picking up again as the internet transformed the economy in the 1990s. Productivity dropped, though, after the Great Recession of 2007-2009, and many economists expect a slow recovery on the other side of the pandemic. But that does not have to be the case. Granted, low rates of interest and inflation during the previous decade imply that governments have been unable to spur investment. Yet governments are now spending to pull economies out of recession, and productivity rose in 2020 at the fastest rate in 10 years. In addition, complex productivity initiatives like artificial intelligence take time to register in an economy. As the global economy returns to normal, some things will change: more companies will digitize operations, provide opportunities for remote work and accelerate automation. We expect these enhancements to result in productivity gains.

LEADERS & LAGGARDS IN 1Q21

Breadth has been impressive so far this year, and every sector turned in a positive performance in 1Q21—though last year's laggards were generally the leaders. Take Energy, for example. The sector fell 37% in 2020 and lagged the market in 2019. This year, Energy is the leading sector, with a gain of 29%. The Financial Services sector also turned things around in 1Q, rebounding from a 4% slide in 2020 to a 15% advance so far in 2021. Other market-beating sectors in 2021 include Industrial (+11%, after underperforming the market last year), Materials (+9%), Real Estate (+8%) and Communication Services (+8%). The turnaround in sector performance hints at a shift in the market toward value investing and away from growth investing. Indeed, the three primary growth sectors—Technology, Healthcare and Consumer Discretionary—are barely in the black in 2021.



"Did I mention this roller coaster was funded by our firm's bitcoin holdings?"

Treasured Collections

Emily Menjou
Vice President & Personal Trust Fiduciary Manager (Collector of houseplants)

Have you ever seen hundreds of thousands of buttons, maybe even a million buttons, all catalogued by color and size? How about a collection of ceramic cats—172 to be exact—meticulously placed all throughout a home?

When named as Successor Trustee or Executor, we get to help families settle their affairs and transfer wealth and in the process, we've encountered some pretty fascinating collections. Sometimes it's hundreds of pieces of museum quality artwork hung all over the walls, and sometimes it is a collection of antique guns found hidden beneath the floorboards of a family cabin. The same estate also had a robust collection of casino chips.

No two families are exactly alike, and no two estates are exactly alike either. We take great care to honor our clients and to ensure their wishes are met, no matter what they've collected along the way. One client had an affinity for shoes with dozens of pairs (all unworn) stacked neatly in her closet in their original boxes. Pocket watches, bolo ties, thimbles, radio antennas, model airplanes and musical instruments make the list as well.

What happens with these items is just as unique as the collections themselves. In some cases, it is as simple as delivering the treasures to a loved one as outlined in the trust or will, while other times an auction or estate sale may be held. Some estates call for donation of items to local charities. Many collections we encounter have monetary value worthy of appraisal, while others carry their value in sentiment.

Whatever the case, it is our duty to ensure that these collections are handled in accordance with our clients' wishes, and we must do so with impartiality and prudence. Whether it's matchbooks or classic cars, fishing poles or pearls, we are continually intrigued and thankful to our clients for trusting us with their treasured collections.

Exchange Bank Welcomes Chris Stafford, AVP, Personal Trust Officer

I am pleased to introduce and welcome Chris Stafford to the Trust & Investment Management team.

Chris is a member of the California Bar and has been an estate planning attorney for over 10 years. Chris has an associate's degree from Santa Rosa Junior College and a bachelor's degree in English Literature from Sonoma State University. He also has a Juris Doctor (J.D.) law degree and a post-Juris Doctor (LLM) degree in Taxation (with honors) from Golden Gate University, School of Law.

Chris swims with SRVA Masters Swim Team and has coached his son's Little League teams and his daughter's CYO basketball team. Chris is eager to coach basketball again once restrictions are lifted. Chris and his family have recently moved back to Sonoma County after having lived in San Francisco and Danville since his graduation from SSU.

Chris will serve as assistant vice president/trust officer and will oversee a portfolio of revocable and irrevocable trusts, estate settlements, and investment agency accounts. Please join me in welcoming Chris to our team.

Emily Menjou, CTFA
Vice President, Personal Trust Fiduciary Manager

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.

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