Exchange Bank

Trust & Investment Management

TRUST & INVESTMENT UPDATE

TRUST & INVESTMENT MANAGEMENT GROUP

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Investment Review and Outlook

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

The beginning of the second quarter of 2021 saw a continuation of the broad trends that exemplified the first three months of the year, before the emergence of the Delta variant of the novel coronavirus appeared, putting into doubt some of the optimism of a return to normal that permeated the financial markets. U.S. Vaccination rates ramped up and peaked during the quarter before slowly grinding lower, while the global economy continued to rebound from the shortest and sharpest contraction in post-war history.

Global equity markets posted broadly positive returns during the second quarter, once again led by domestic, mega-cap growth names that have generally dominated market returns for the better part of the past decade. International equities, from both developed and emerging markets, saw mid-single digit returns, which included a tailwind from U.S. Dollar weakness. Labor shortages, along with supply chain and shipping problems, continued to persist but global corporate earnings continued their push toward record levels, with 2021 appearing set to eclipse 2019's record earnings numbers. Meanwhile, domestic fixed income markets saw a significant flattening of the yield curve in the second quarter, reversing a large portion of the record interest rate gains that were seen in the first three months of the year. With peak growth likely behind us, and the emergence of the new Delta variant, longer-term U.S. yields dropped during the quarter. Additionally, the Federal Reserve's current Quantitative Easing program, with U.S. Treasury and Agency Mortgage-Backed Securities purchases netting $120 billion/month over

MARKET PERCENTAGE TOTAL RETURNS AS OF JUNE 30, 2021

Index	Q2 2021	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	1.83	-0.33	3.03	3.39
S&P 500 Index	8.55	40.79	17.65	14.84
Russell 2000 Index	4.29	62.03	16.47	12.34
MSCI EAFE Index	5.17	32.35	10.28	5.89
MSCI Emerging Markets Index	5.05	40.90	13.03	4.28

and above reinvestments due to maturing debt, continuing apace, and overnight rates pinned near zero, the 2-10 year U.S. Treasury curve shrunk from 1.58% to 1.20%. Credit also outperformed during the quarter with credit spreads continuing to compress as the global economy continued to grow well above long-term trend.

Looking ahead, it appears that the crosswinds of fiscal and monetary stimulus along with increasing employment and wage gains pitted against a resurgence in the COVID pandemic through the novel Delta variant will continue to pose unique sets of risks, both to the upside and downside in terms of economic growth and inflation. As the employment situation continues to recover back toward the levels seen in February 2020, prior to the onset of the pandemic, a more "normal" environment may emerge with economic growth, inflation and interest rates more in-line with historical precedent. However, just like the pandemic was not on anyone's radar until just prior to it upending financial markets, we always must be prepared for a variety of scenarios that can play out, and be open to the possibility that our expectations for future market risks and returns may not match the reality that plays out.
As such, it is as important as ever for Exchange Bank to be there to help clients focus on their long-term goals and needs, ensuring they not be swayed by expectations of what financial and political pundits think is going to happen in the short term, and risk not meeting their long-term goals.

Road Ahead for Your Money

By Emily Menjou
Vice President & Personal Trust Fiduciary Manager

Exchange Bank was featured in the August 26, 2021 North Bay Business Journal article *Road ahead for your money: North Bay wealth managers unpack what's known and possible in this challenging year.* Here is the content in case you missed it.

In the pandemic, more people saved. Did they sock money away in safer, but lower return vehicles like saving or money market accounts? And if so, are they already moving money to more return-driven investments?

We found that people applied their excess liquidity based on their nature. Some clients took a risk and invested in cryptocurrency and meme stocks, while more risk-averse clients held savings in short term fixed income vehicles or money market accounts.

For the investments that Exchange Bank continued to manage during the pandemic, we counseled our clients to make financial decisions based on their long-term goals and financial needs, not based on fear or emotion due to short term market volatility. While some of our clients shifted to more conservative allocations, most maintained their pre-pandemic target allocations.

Related, have you moved on your outlook, now that there are signs that the economy is quickly shaking off the pandemic, to a more aggressive stance with your investment suggestions for clients.

No. If you think about the story of the turtle and the hare, Exchange Bank is the turtle. Our process-based approach includes making a long-term plan and sticking with it, to help our clients achieve the most desirable outcome given their unique goals and risk tolerances. There is considerable evidence that changing asset allocation in an attempt to time the market is very destructive to long term performance. We believe that slow and steady wins the race, and we manage investments accordingly.

You have experienced the very brief recession from the pandemic, perhaps even the Great Recession of a few years back. Survived or thrived? Did you learn some lessons that you take forward now?
The pandemic has highlighted so many life lessons, and one of the biggest takeaways for me is the importance of planning. On the investment side, we know it is important to have a plan and stay the course. On the trust administration side, we've all been reminded that life is fleeting, and there is no time like the present to complete an estate plan.

On the flip side of planning, we also learned the vital importance of flexibility as the pandemic rules were continually changing. We had to learn new ways of connecting with our clients, advisors and staff, including virtual meetings and working from home. While we are happy to be back in the office, we will keep our ability to connect virtually should future emergencies arise and for the comfort of our clients.

Real estate is hot, at least for now. What are the investment opportunities there, or is it something you'd suggest people go easy on?

Real estate investing certainly has its benefits and many of our clients come to us with significant real estate exposure. It is important to recognize the associated risks including vacancies, difficult tenants, repair costs, liquidity issues, and changes in the real estate market. While we do manage real estate in many of our portfolios (particularly in trust administration), real estate is not a key component of our investment management strategy. Instead, we favor well diversified portfolios of high-quality, low-cost investment vehicles which help to minimize risk while maximizing return for our clients.

Inflation talk abounds, without real clarity on its direction. What's your advice now to cover the future risks if inflation spikes, or are you not seeing that as a true risk at this point?

Inflation has always been a natural occurrence in our economy. We continue to believe that the best way to achieve long-term investment success is to select an asset allocation which optimizes risk and return, with a strong emphasis on low-cost investment vehicles. Our advice to clients is to be well aware of the internal costs of their portfolios, as these costs are a drag on their returns and could hinder the success of their investments.

From what you have seen in your practice, the three qualities of an ideal investor are, and why?

The expression "*Good things come to those who wait*" is particularly true when it comes to investing. An ideal investor typically exhibits patience and discipline, as investing is a long-term prospect and investors are best served when they can avoid emotional reactions to market risk. It also helps when investors have an understanding of investment concepts such as the efficient market hypothesis, the importance of diversification, and how costs can affect a portfolio's performance.

Recent Economic Highlights

By Argus Research Company

GDP EXPANDS 6.5% IN 2Q

U.S. GDP growth accelerated only slightly in 2Q21, to an annualized 6.5%. The consumer sector was the key driver, as personal consumption expenditures on goods rose at an 11.6% rate and expenditures on services rose at a 12% rate, offsetting a 3.5% decline in gross private domestic investment, a 1.5% dip in government spending, and a depletion of inventories. Within gross private domestic investment, spending on equipment increased at a 13.0% rate and spending on intellectual property products increased at a 10.7% rate. So there is strength in capital spending. Residential investment declined at a 9.8% rate, and investment in structures declined as well. After four quarters of recovery, current GDP of $19.4 trillion on an absolute basis is finally above pre-COVID levels. Indeed, recently the National Bureau of Economic Research said that the COVID-19 recession was over (and has been since the economy troughed in April 2020).

ROUND-TRIP RECOVERY COMPLETE

Recent data illustrates that the economy is still expanding, though some white-hot growth rates in certain sectors are starting to cool. The primary driver of GDP over the next few quarters is likely to be the country's physical health, as the nation recovers from the COVID-19 pandemic. Trends here have turned negative in recent weeks. The employment environment is in better shape than it was a year ago, but still far from full strength. Consumer confidence is mixed. Auto sales have recovered, but inventories are low due to bottle-necks. And the housing market, which had been strong in 1H21, is starting to cool as house prices soar. The GDPNow forecast from the Federal Reserve Bank of Atlanta is 6.3% for 3Q21.

FINALLY, AN UPSIDE PAYROLLS SURPRISE

The U.S. economy added 850,000 jobs in June, up from the tepid average of 426,000 in the previous two months. The unemployment rate ticked higher to 5.9%. The re-opening trend was prominent, as job gains were led by sectors such as leisure and hospitality (+343K) and local government education (+155K). Industries including professional and business services, as well as retail, also added jobs. Manufacturing and construction were little changed. The labor market continues to reflect the impact of the pandemic, as the shape and character of the workforce is changing as the economy recovers. The current number of jobs is approximately 6.7 million lower than the pre-COVID February 2020 level, according to Automatic Data Processing. The labor force participation rate remains a low 61.6%, below the historical average of 65%. Last month, 14% of employed persons teleworked because of the pandemic. Pre-pandemic, that reading was 3.0%. The Labor Department recently reported that 364,000 people filed initial weekly unemployment claims, down from 385,000 a month earlier. Though trending in the right direction, the data indicates that the employment environment is still under stress.

GLOBAL INTEREST RATES TICK LOWER

Long-term interest rates in many countries have declined modestly in recent weeks, as global market participants expect GDP growth to slow into 2H21. Rates are at zero or negative in Europe and Japan. At the other end of the spectrum, spiraling inflation has lifted Turkish 10-year bond yields to 16.7%. In Brazil, where prices are also rising fast, the 10-year government bond yield is 9.1%. Long-term rates in many industrialized regions are in the 0.5%-1.5% range. Inflation expectations also are modest in these areas, averaging around 2.5%. On the economic forecasting front, the relatively higher rates in the United States indicate that its economic recovery could lead the way for industrialized nations over the next few quarters.

Q3 Dividends

Shari DeMaris
EVP, Chief Financial Officer

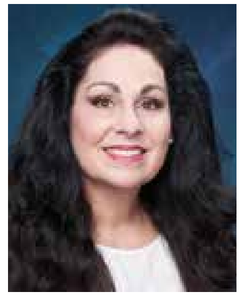
Exchange Bank Declares Third Quarter Cash Dividend – August 23, 2021

On August 17, 2021, the Exchange Bank of Board of Directors declared a quarterly cash dividend of $1.20 per share on common stock outstanding to shareholders of record at the close of business on September 3, 2021. The dividend is payable September 17, 2021. The cash dividend is unchanged from the prior quarter's dividend of $1.20 per share.

50.44% of the Bank's cash dividend goes to the Doyle Trust which funds the Doyle Scholarships at the Santa Rosa Junior College.

What's New in T & I

Exchange Bank Promotes Michelle Gordon, Investment Officer



I am pleased to announce that Michelle Gordon has been promoted to investment officer. Michelle has been managing our investment process for more than two and a half years, but it has been our plan to share her with our clients since she first joined our team.

She completed the very difficult prestigious process of earning her Certified Financial Planning (CFP) designation this year and is now ready to use her knowledge and experience to help our clients achieve their financial goals.

Michelle has deep roots in Sonoma County; she's lived here for many years, raised a family, led a local church community with her husband and taught advanced mathematics in a local high school. She brings great knowledge and life experience into her new role.

Please join me in congratulating Michelle on her promotion and serving as an officer of Exchange Bank's Trust and Investment Management Department.

John Mackey
SVP and Managing Director of Investment & Fiduciary Services

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.**

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