Exchange Bank
Trust & Investment Management

TRUST & INVESTMENT UPDATE

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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

The final quarter of 2021 saw a continuation of the expansion from 2020's pandemic lockdown recession with the economy continuing to move forward at an accelerated pace relative to the past few decades. As the Delta variant surge came and went, the more transmissible (although possibly less severe) Omicron variant emerged as the latest stage of the pandemic during the quarter, the latest setback to the full reopening of the global economy. Meanwhile inflation roared to multi-decade highs due to continued global supply chain issues, changes in consumer behavior caused by the pandemic and trailing effects of multiple rounds of fiscal stimulus.

Domestic equity markets continued their broad advance during the quarter, as corporate earnings pushed towards records, even while inflation pushed to its highest levels in decades. At this stage of the bull market, and with traditional valuation measures making equities look to be on the more expensive side relative to recent history, it is earnings growth that should be the primary driver of stock returns moving forward. Luckily, record corporate earnings should continue for the foreseeable future as current consumption patterns are allowing companies to raise prices at a faster pace than costs thus far. Rising interest rates however, should begin to cause changes in market sector returns ahead, with high growth/low-to-negative earnings companies potentially underperforming as current earnings become more valuable than the possibility of future returns.

Meanwhile, international equity markets saw lower, but generally positive returns during the quarter with developed markets outperforming their emerging market counterparts. Higher vaccination rates and steadily reducing restrictions, primarily in Europe, drove positive returns there, while divergences in emerging market pandemic mitigation

MARKET PERCENTAGE TOTAL RETURNS AS OF DECEMBER 31, 2021

Index	Q4 2021	One Year	Five Years (annualized)	Ten Years (annualized)
Bloomberg U.S. Aggregate Bond Index	0.01	-1.54	3.57	2.90
S&P 500 Index	11.03	28.71	18.47	16.55
Russell 2000 Index	2.14	14.82	12.02	13.23
MSCI EAFE Index	2.69	11.26	9.55	8.03
MSCI Emerging Markets Index	-1.31	-2.54	9.87	5.49

strategies and growth rates caused wider variances in emerging market equities.

Fixed Income markets showed some relative stability during the quarter as long-term rates ended the quarter near where they started while short-term rates moved up in anticipation of a new rate hike cycle from the Federal Reserve. Rising expectations for the number of rate hikes in 2022, due to increasingly high inflation rates in a near full-employment economy, caused the yield curve to significantly compress, with the 2-10 year U.S. Treasury spread collapsing by 45 basis points from 1.24% to 0.79%. Credit generally held up well during the quarter, with municipals and lower credit quality corporates outperforming the broad market.

Looking ahead, economic normalization is going to depend on several factors, including the path of the pandemic in terms of future variants, potential for additional fiscal stimulus, reparation of global supply chains and evolving monetary policy considerations. Although we would expect financial markets volatility to increase as monetary policy in particular tightens, attempting to time market movements based on expectations surrounding interest rates and economic growth can make achieving long-term goals more difficult. As such, we always want to assist our clients in focusing on the proper time horizons for their needs in order to ensure that the appropriate asset allocation is in place to meet those goals.

Who Pays the Tax for My Trust?

Emily Menjou
Vice President & Personal Trust Fiduciary Manager

Having just started another tax season, I'm reminded that many clients and beneficiaries are unclear on the income tax implications associated with income earned in their trusts, and more specifically, who pays the tax? The question is straightforward, but the answer depends on a variety of factors. For example, is the trust a grantor trust or a non-grantor trust? Is income required to be distributed, or is it discretionary? Is income currently being distributed?

GRANTOR TRUSTS

The IRS generally defines a grantor trust as any trust "over which the grantor or other owner retains the power to control or direct the trust's income or assets." The grantor is the person who created and funded the trust, and often serves as trustee during his or he own lifetime with the ability to control the trust's income and assets. Revocable or living trusts are common forms of a grantor trust.

The powers retained by the grantor to control or direct the trust assets result in ownership for income tax purposes. Therefore, any income or deduction earned by the trust will be taxed on the grantor's individual income tax return, subject to applicable individual income tax rates. If the grantor is acting as his or her own trustee, the trust need not file a separate return as the trust's income can be reported under the grantor's social security number. In cases where there is an independent trustee, the trustee will typically provide the grantor with a Grantor Letter – a tax reporting document which passes income and deductions through to the grantor's individual returns.

NON-GRANTOR TRUSTS

Any trust that is not a grantor trust is classified as a "non-grantor" trust. A trust established as a non-grantor trust is itself a taxable entity, requiring a separate income tax return to report income from assets which are owned by the trust. Most irrevocable trusts are non-grantor trusts.

In a typical scenario, the trust is required to pay income tax at the trust level for income which is retained within the trust. If the trust requires that net income be distributed to beneficiaries, the income is generally passed through to the beneficiary for tax purposes, regardless of whether it is actually distributed. For a discretionary trust where income is not required to be distributed, income flows to the beneficiary's tax level to the extent it is actually distributed to the beneficiary, with undistributed income to be taxed at the trust level. In either case, capital gains taxes are generally paid at the trust level.

For non-grantor trusts, the trustee must file a fiduciary income tax return and issue a Schedule K-1 to the beneficiary, showing the amount and classification of trust income to be included on the beneficiary's individual tax return.

TAX CONSIDERATIONS

It is important to note that trusts and individuals are subject to significantly different tax rates, which increases the importance of understanding tax treatment of grantor and non-grantor trusts. Tax brackets for trusts are compressed with trusts hitting the top tax rate (37% for 2022) for taxable income over $13,451, as compared to individual taxpayers who can report over $500,000 of income before hitting the highest tax rate. As always, we recommend that you consult with a licensed tax professional for advice and guidance around your unique circumstances and how these rules may apply to you.

Recent Economic Highlights

By Argus Research Company

GDP SOARED 6.9% IN 4Q

The rate of growth in U.S. GDP accelerated sharply in 4Q21, to an annualized 6.9%, above the 2.3% rate recorded in 3Q. Full-year GDP growth averaged 5.6%. There were several pockets of strength in 4Q, including Investments into Intellectual Property Products (up 10.6%) and Personal Consumption Expenditures on Services (up 24.5%). Inventories reversed a three-quarter decline and increased sharply. Segments of the economy that struggled a bit included PCE-Durable Goods (up only 0.5%), PCE-Nondurable Goods (-0.1%), and Investment into Structures (-11.4%). The PCE price index rose 6.5%, compared to an increase of 5.3% in 3Q. Excluding food and energy prices, the PCE price index rose 4.9%, compared to an increase of 4.6% in 3Q. The 4Q GDP report is a snapshot of the economy between the Delta and the Omicron variants. We look for slower -- but positive -- growth in 2022-2023.

INFLATION AND THE FED

Pricing pressures are percolating at the producer level, and mainstream measures of inflation are elevated as well. While inflation has been elevated for the past several months, the markets lately seem to have lost confidence that the central bank can bring prices under control in the near term. At its latest Open Market Committee meeting, the Fed, as expected, opened the door to a series of fed funds rate hikes in the months ahead. In its statement after the meeting, the central bank commented that "with inflation well above 2% and a strong labor market, the Committee expects it will soon be appropriate" to raise the fed funds rate. The current fed funds target rate is 0.00%-0.25% and has been at this rock-bottom level since the early days of the pandemic. Fed Chair Jerome Powell noted that the Fed's meeting in March is likely to mark the start of the rate hikes. By then, the bank also will have completed its asset purchasing program.

Exchange Bank Announces Fourth Quarter and Year Ending 2021 Earnings

Shari DeMaris
EVP, Chief Financial Officer

On February 17, 2022, Exchange Bank announced results for the fourth quarter and year ending 2021, reporting net income after taxes of $9.85 million in the fourth quarter of 2021, compared with $9.24 million for the same quarter in 2020, an increase of 6.60%. The Bank achieved net income for the year ended December 31, 2021 of $36.41 million.

"We achieved these solid financial results again with a steady focus on our core mission—assisting our customers, especially our commercial customers, during very difficult economic times," said Troy Sanderson, president and CEO.

The Bank continues to support its customers, providing payment deferrals to borrowers who have been negatively impacted by the COVID-19 virus. Exchange Bank expended tremendous internal resources participating in the 2021 round of the SBA Paycheck Protection Program (PPP) under the CARES Act. As a result of this effort, they were successful in providing loans to 1,094 small businesses in the community with loan balances totaling approximately $125 million. This is in addition to the $260 million in PPP loans made by the Bank in 2020.

"We are extremely proud of our lending teams," said Sanderson. "Their work on the PPP loan program in 2021 again provided a desperately-needed lifeline to over one thousand small businesses, many family-owned, in our community."

Exchange Bank's net income for 2021 was $36.41 million, compared with $33.70 million in 2020. The increase in earnings can be attributed to increases in non-interest income of $2.11 million and decreases of non-interest expense of $4 million. These increases in net income were offset by the decline in net interest income. The Bank's 2021 results were heavily influenced by the changing patterns of behavior by both business and consumer clients as well as the fiscal and monetary response of the U.S. Government to the coronavirus pandemic. The Bank's net interest income declined from $96.38 million during the 12 months ended December 31, 2020 to $93.55 million the same period in 2021. During a period of time when treasury yields remained anchored near historic lows, the Bank's margin was negatively impacted by declines in yields on loans and investments that surpassed the Bank's ability to affect a similar decline in interest expense through a lower cost of funds. As a result, the Bank experienced a decline of $2.83 million in net interest income for the 12 months ended December 31, 2021 compared with the similar period in 2020. The loss of interest income was somewhat offset by the increase in interest income totaling approximately $466.54 million. The Bank's net interest margin decreased from 3.46% in 2020 to 2.87% in 2021. The Bank expects net interest margin challenges to continue into 2022.

Non-interest income increased from $21.54 million in 2020 to $23.65 million in 2021. The Bank's Trust & Investment Management department exceeded $10 million in income for the first time, ending the year with $10.48 million in income as compared to $8.95 million for 2020. During 2021, the Bank continued to witness significant declines in various elements of deposit service fee income that are directly associated with a weaker level of personal consumption and low interest rates. Fees related to customer account usage were down $435 thousand in 2021 when compared to 2020.

Also adding to the increased net income for 2021 was the Bank's focus on controlling operating expenses. Adjusting to an environment of generally slower business activity, the Bank was successful in reducing operating expenses during the 12 months ending December 31, 2021, by approximately $4 million or 5.82%. During 2020, the Bank had one-time expenses related to its core operating system conversion of approximately $2.3 million before taxes.

The quality of the Bank's loan portfolio remains strong; however, due to the economic uncertainty that exists today, the Bank elected to strengthen its reserve for potential future losses with a provision for loan loss totaling $2.00 million during 2021. The Bank took a provision for loan loss of $1.80 million during the similar period in 2020.

Overall, the Bank's balance sheet growth for the year ending December 31, 2021 was bolstered by deposit growth. Total assets increased to $3.53 billion as of December 31, 2021, up from $3.14 billion in 2020, an increase of 12.67%. Gross loans decreased from $1.73 billion in 2020 to $1.51 billion in 2021. Forgiveness of SBA PPP loans accounted for $133.22 million of the decrease.

The Bank experienced a dramatic increase in deposit balances which were up year-over-year by approximately $401 million or 14.42%. This increase in deposits was due in part to the business deposits totaling approximately $125 million relating to the deposit of PPP loan funds received by Bank clients. In addition, proceeds from loan forgiveness and paydowns of $133 million added to cash balances. An additional source of deposits totaling $144 million came from both business and consumer customers who chose to hold more liquid assets during this period of great uncertainty. The increase in deposits led to a material decline in deposit service fee income as a result of the waiver of fees associated with higher customer compensating balances. It is possible the Bank could experience a significant runoff of the excess deposits due to their unusual and short-term nature as they are used to support small business and consumer-related expenses over the next year.

The Bank also grew its investment portfolio by $467 million in 2021 as a result of the increase in deposits during 2021.

The Bank's capital ratios remain well in excess of the regulatory definitions of "well capitalized." As of December 31, 2021, the Bank reported total risk-based capital of 21.50%.

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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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