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 second quarter of 2023 saw further continuation of key economic and financial market themes from the first quarter and end of 2022, with falling but still elevated inflation rates, unemployment rates at generational lows and central banks continuing to raise short term interest rates in order to slow the global economy and bring inflation back in line with long-term targets. Economic stresses continued to percolate from the regional banking crisis that first emerged in the first quarter, with another regional lender failing in May due to the mismanagement of its balance sheet and reliance on low-cost, uninsured deposits, while the economic boost that was supposed to emanate from China's reopening continued to underwhelm.

Global equity markets moved broadly higher during the second quarter, with gyrations along the way partly due to the effective failures of additional financial institutions, both domestically and abroad, along with U.S. federal debt ceiling negotiations that went to the eleventh hour. Dollar strength and domestic index construction tilts toward Large Cap Growth stocks allowed U.S. equities to generally outperform international peers, as stocks tied to the Artificial Intelligence industry saw dramatic gains. Internationally, developed outperformed emerging markets as China's economic resurgence that was expected to be realized upon the lifting of coronavirus lockdowns wasn't looking as robust as expected, while the overhang of their property bubble and faltering consumption also weighed.

In fixed income markets, domestic interest rates continued to exhibit high levels of volatility during the second quarter, with a significant "bear flattener" pushing rates up across the curve, particularly at the short end as the banking turmoil re-flared and faded over the course of the quarter

MARKET PERCENTAGE TOTAL RETURNS AS OF JUNE 30, 2023

Index	Q2 2023	One Year	Five Years (annualized)	Ten Years (annualized)
Bloomberg U.S. Aggregate Bond Index	-0.84	-0.94	0.77	1.52
S&P 500 Index	8.74	19.59	12.31	12.86
Russell 2000 Index	5.21	12.31	4.21	8.26
MSCI EAFE Index	2.95	18.77	4.39	5.41
MSCI Emerging Markets Index	0.90	1.75	0.93	2.95

and recession expectations were pushed back. This flattening of the U.S. Treasury curve saw the slope of the 2s-10s spread move further into inversion from -0.58% to -1.06%, breaking through the 1% for the first time in decades. Broad fixed income market total returns were negative, with shorter maturities outperforming longer duration securities, and with credit outperforming Treasuries while high yield debt provided outright positive returns.

Looking ahead, resilient economic growth, fading inflationary pressures and robust labor markets continue to allow for the possibility of the mythical so called "soft landing" scenario that allows the economy to slow enough to bring inflation down to the Federal Reserve's 2% target without causing a severe recession. That scenario has been difficult to achieve in the past at the end of central bank interest rate hiking campaigns, although it is not completely unprecedented. With continuing crosscurrents of war in eastern Europe, slowdowns in China and western Europe, and the long and variable lags with which rate hiking cycles impact the economy, the jury remains out on whether the Federal Reserve and other central banks will continue to tighten the screws on the global economy. Eventually though, their goal of low and stable inflation will most likely be achieved, it is only a question of time and whether a recession is required to meet that goal.

Investing is Hard

By Bill Ryan, *Vice President & Investment Officer*

As financial professionals and fiduciaries, we are tasked with the prudent allocation of client assets that align an individual's long-term goals, objectives, and willingness to assume a specific level of risk.

To do our jobs effectively, we consider who our client is, then integrate that with the endless stream of economic and market data to make their money work for them. This data includes monetary policy, fiscal policy, employment, inflation, corporate balance sheets, corporate earnings, economic growth, consumer health, and equity valuations.

It's a lot to synthesize, and that's not even half of it.

To understand and serve our clients, it's helpful for us to understand behavioral economics—a field of study that combines economics and psychology to understand why and how people make decisions.

Its early origins can be traced back to Scottish economist Adam Smith (1723-1790) and, more recently, Herbert Simon (1916-2001), who coined the term "bounded rationality" to describe the limits of human decision-making. His work concluded that people are not perfectly rational actors and that we often make decisions using mental shortcuts—heuristics. This flew in the face of dominant economic theory, which is predicated on clear logic and rational decision-making.

Psychologist Daniel Kahneman won the Nobel Prize for Economics in 2002 for his groundbreaking work with Amos Tversky who developed several influential theories about how psychology affects economic behavior. Among these is Prospect Theory, which states that we assess losses and gains asymmetrically; that is, we feel the pain of a loss twice as intensely as we feel the pleasure of an equivalent gain.

Through additional research, they found that there are any number of biases we need to overcome in order to make better decisions. Neither investors nor their advisors are immune from a variety of biases that attempt to buffer them from loss (but which may also forfeit gains in the long run).

Below is a list of common biases that work inside us to influence decision-making to avoid the short-term pain of loss.

- **Anchoring bias** Over-relying on the first piece of information or action one hears or sees and anchoring their thoughts and decisions on that information.
  - What It Looks Like: Looking at a stock that has fallen 80% from its highs and thinking it must be a bargain because one has "anchored" on its former price, even though the stock may still be fundamentally overvalued.
- **Overconfidence bias** Overestimating one's knowledge, opinions and abilities.
  - What It Looks Like: Taking unnecessary risks or risks one is unaware of. For example, a young investor who has had early success may continually take greater risks that eventually lead to losing all their money.

- **Loss aversion bias** Prioritizing avoiding losses over realizing equivalent gains.
  - What It Looks Like: Taking less risk than one optimally should. For example, one may purchase a stock for $100, which then falls to $50. Suffering from loss aversion, one may unwisely hold onto the stock waiting for it to return to the price they paid; alternatively, they may sell it out of fear of further loss instead of allowing time for it to rise again.
- **Confirmation bias** Seeking out information that supports one's beliefs while avoiding or minimizing information that contradicts them.
  - What It Looks Like: One decides to purchase a stock after researching it. Because of the effort and time devoted to your research, they may discount or disregard research or evidence that contradicts their thesis and place more weight on evidence that supports their belief.
- **Hindsight bias** Misconception, after the fact, that one "always knew" that they were right.
  - What It Looks Like: Looking back to the Great Financial Crisis or the dot-com bubble, many financial professionals might say "all the signs were there" and that they knew disaster was right around the corner.
- **Availability bias** Judgements based on easily available information.
  - What it looks like: Making decisions based on news or information that is recent or vivid in one's mind. Think back to any time ***after*** any financial crisis; investors and advisors are so focused on inoculating portfolios against the same risks, that new ones are rarely seen.

So how do we safeguard ourselves against these self-protective tendencies? Cultivating specific habits of mind improves the quality of our decisions and results in better outcomes. Here are a few tips intelligent advisors and investors can practice minimizing bias for better results:

- **Document decisions.** Keep a record of your decisions and the rationale behind them. Not only will this keep you intellectually honest, but it will also provide a benchmark for the quality of your decisions over time.
- **Consider multiple sources of information.** Look for information that contradicts your thesis and be willing to engage with views that diverge from yours. You should be able to argue the opposite of what you believe to reach a more informed answer.
- **Be willing to change your mind.** Mental flexibility and willingness to admit mistakes is a superpower. The ability to leave ego and emotions out of decision-making is a trait the best investors have. Ned Davis of Ned Davis Research shares a story from early in his career when an older trader asked, "Do you want to be right, or do you want to make money?" Remaining curious about one's thoughts and emotions—and those of others—often leads to better decisions and outcomes.

Capital markets and the economy are dynamic, adaptive systems that are inherently difficult to navigate. At Exchange Bank, we seek to be advisors who understand our client's needs and goals, correctly interpret the dynamic nature of markets and the economy, help to reduce bias to improve decisions, and to help our clients realize long-term financial security and success.

Recent Economic Highlights

By Argus Research Company

U.S. GDP HUMMING ALONG

U.S. Gross Domestic Product expanded in 2Q at an annualized rate of 2.4%. Areas of strength included Personal Consumption Expenditures on Services, which rose at a 2.1% rate; Investment into Intellectual Property Products, which advanced 3.9%; Investment into Structures, which rose 9.7%; Investment into Equipment, which rebounded to a 9.7% growth rate; and Government Spending, which was up 2.6%. Segments of the economy that struggled included Exports-Goods; Consumer Spending on Durable Goods; and Inventories. The report also contains data on inflation. The PCE Price Index increased 2.6% in 2Q, compared with an increase of 4.1% in 1Q. Excluding food and energy prices, the index increased 3.8%, compared with an increase of 4.9% in the previous quarter.

EMPLOYMENT COOLS SLIGHTLY

The U.S. economy generated 209,000 new jobs in June, well below May's revised 306,000. The unemployment rate declined to 3.6% from 3.7% in May. Following a pause in interest rate increases at its June 13-14 meeting, central bank officials have suggested that monetary policy may not be restrictive enough to reduce inflation to 2%. Average hourly earnings increased $0.12 from the prior month and are now 4.4% higher year-over-year, an unchanged pace from May. The labor force participation rate was unchanged at 62.6%. Job gains continued in government, healthcare, construction, and social assistance. Employment was little changed in mining, quarrying, and oil and gas extraction; manufacturing; wholesale trade; information; financial activities; and other services.

Marin Office Now Open – Open House on October 19th

It is my pleasure to report that we have officially opened our new Trust and Investment Management office in Marin County. Our office is located just north of the Marin Civic Center at 3950 Civic Center Drive in San Rafael.

We will be hosting an Open House on the evening of Thursday, October 19th at our new location. If you have interest to attend, please contact Erin Dorado at 707.524.3151 for details.

Through our co-founder, Frank Doyle, and his early championing for the creation of the Golden Gate Bridge, we have deep ties connecting Exchange Bank to the Marin/San Francisco area which made moving into Marin County a natural next step.

Exchange Bank has been offering full-service Trust and Investment Management services since 1963 and we are one of California's largest community bank trust departments with over $1.3 billion in assets under administration.

With offices in Santa Rosa, Roseville, Los Altos and now Marin, our experienced team provides professional, personalized services in the areas of:

Trust Administration

- Estate Settlement
- Investment Management
- Retirement Services (IRA and plan management)

Emily Menjou
Vice President & Personal Trust Fiduciary Manager

Introduction of Debbie Campas

Dear Clients and Friends:

Debbie Campas, vice president and personal trust officer, will be managing customer relationships and helping to grow the Bank's presence in Marin County. Debbie has worked in the financial services industry for the last 30 years in different capacities, most recently serving as vice president and trust officer for another local community bank.

Debbie graduated with a bachelor's degree in Economics from California State University, Northridge. She completed her CTFA designation from the American Bankers Association and is a graduate of Cannon Financial Institute. Debbie is also a graduate of the Novato Chamber of Commerce Leadership class of 2022.

Please join me in welcoming Debbie to the Exchange Bank team.

Emily Menjou
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.

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.**