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MARKET REVIEW
JUNE 2017

TRUST COMPANY
of NORTH CAROLINA

IS THE AMERICAN ECONOMY ANEMIC OR GOLDILOCKS LITE?

President Calvin Coolidge likely got it right when he said, "the business of America is business."[1] This ideology is so ingrained in the American psyche that a typical conversation starter among friends is "how's business?" Everybody wants to know the answer and just about as many have an opinion. Recently, we have noticed that there is a growing misperception regarding both the economy and markets. With the current business cycle in the ninth year of an expansion, a look back at the behavior of economic growth could help investors manage growth expectations.

50+ YEARS OF AMERICAN ECONOMIC GROWTH

During the current expansion, popular opinion on the economy has changed. From the onset, investors were hopeful that the zero interest rate policies would be the impetus for a desired "v-shaped" recovery. More recently, we have seen indications of worry that growth rates might not return to those of the "good ol' days." Was it as simple as popular opinion being too optimistic during the early days of the recovery, characterized as the years of 2010 and 2011? Are impatience and disappointment over lackluster growth responsible? Or, could other factors be at play?

To answer these questions it helps to start with the actual data. The graph on page three shows inflation adjusted Gross Domestic Product (GDP) measured quarterly beginning in the late 1940s. Though mostly a smooth upward trend, along the way periods in which economic activity has slowed are certainly visible. The easiest period to spot is the 2008-2009 recession that witnessed the sub-prime rooted bear market in stocks.

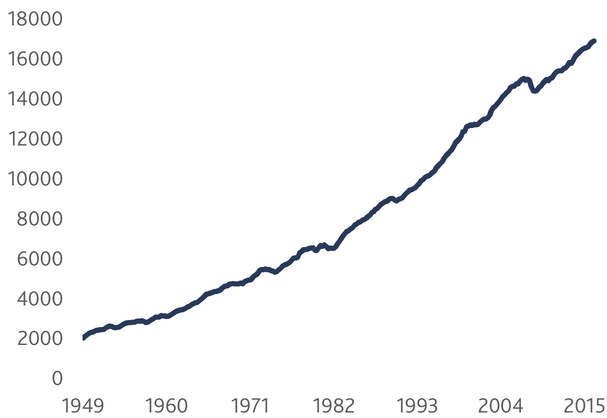
Investors can be forgiven for placing too much emphasis on this most recent recession as behavioral finance has found that vivid and more recent events tend to linger more in an investor's memory, often influencing behavior. Our review of the data attempts to remove this bias by making objective calculations and fairer comparisons.

The table on page three depicts the growth rates of GDP during the expansion periods over the past 50 years. Using the dates provided by the National Bureau of Economic Research[2] business cycle turning points as our objective guideposts to be consistent with the academic literature, we find some interesting trends.

The average growth rate during these periods was 3.53% for the expansions excluding the current one. A growth rate of 3.50% is used in policy setting by the Federal Reserve, and economists call it the potential growth rate. The malaise felt by the anemic recovery stems from the realization that the current expansion is less than potential. But, more is at play than just recent relative results.

REAL U.S. GDP GROWTH

1949 THROUGH 2016



Source: U.S. Bureau of Economic Analysis, Real Gross Domestic Product Federal Reserve Bank of St. Louis. Past performance does not guarantee future results.

POSTWAR U.S. ECONOMIC EXPANSIONS

RECOVERY	EXPANSION PERIOD	GROWTH RATE
Postwar	Oct '49 - Jul '53	6.85%
Mid 50s	May '54 - Apr '57	4.02%
Late 50s	Apr '58 - Apr '60	6.41%
JFK LBJ	Feb '61 - Dec '69	4.90%
Ford	Nov '70 - Nov '73	5.08%
Carter	Mar '75 - Jan '80	3.55%
Volker Shock	Jul '80 - Jul '81	4.39%
Reagan Expansion	Nov '82 - Jul '90	3.54%
Greenspan "Goldilocks" Era	Mar '91 - Mar '01	3.47%
Bernanke Recovery	Nov '01 - Dec '07	2.80%
Current	Jun '09 - Mar '17	2.01%

Source: Bureau of Economic Advisors. Past performance does not guarantee future results.

At first glance, the 4.0% to 7.0% growth rates in the 1950s, 4.9% in the 1960s and 5.1% in the early 1970s stand out as fairly impressive. Recalling that these are inflation adjusted numbers makes them more enviable.

However, a more careful observation of the data indicates that the growth rate is slowing. Those 4.0% to 7.0% rates appear higher than the prevailing average 3.5% growth in the 1980s and 1990s. The Bernanke Recovery, which began a few months after the 9/11 terrorist attack, was even slower, being measured at 2.8%. The current pace of 2.0% shows further deceleration. With our belief that investment results take their cue from economic fundamentals, especially over the long term, investors need to be aware of this trend.

While there are many reasons we believe the pace of economic growth has slowed, a recent article in Foreign Affairs[3] magazine succinctly expresses a few key reasons. The article offers three trends as culpable. These are depopulation (falling birth rates), deleveraging (slowdown in borrowings), and "deglobalization" (retrenchment from global trade). With little seen to reverse them, these factors could remain a headwind for U.S. and global growth rates.

CONCLUSIONS AND INVESTMENT IMPLICATIONS

The pace of economic growth in the United States has slowed. Reasons for that deceleration include those mentioned above, plus the general aging of the American economic engine. Perhaps the genius of America was to seize the opportunity of the post-World War II economic environment to provide the industrial resources so badly needed by the rest of the world at that time. It could be that the excess profits earned during those boom times have set the bar for economic growth at an unrealistically high level.

If expectations are too high and headwinds have increased, then this latest expansion ought not be considered anemic. Rather, it can be viewed as similar to that of the 1990s Goldilocks period, when former Fed Chairman Alan Greenspan orchestrated a combination of modest inflation with enviable growth. The current expansion, with its lower inflation and slower growth, might be termed Goldilocks "lite." With the headwinds and global economic challenges facing the U.S., we ought to celebrate, rather than dismiss, our current economic growth.

As fundamental investors, our investment philosophy includes the belief that economic forces can shape opportunities in the markets. In an environment with relatively muted economic growth, investors with expectations unduly rooted in the past could be disappointed. With lower rates of return, but similar levels of risk, those sitting on the sidelines could have even greater challenges earning satisfactory rates of return. Being fully invested according to the strategic asset allocation ranges most suitable for your level of risk continues to be the best advice we can give.

[1] https://coolidgefoundation.org/resources/essays-papers-addresses-35/

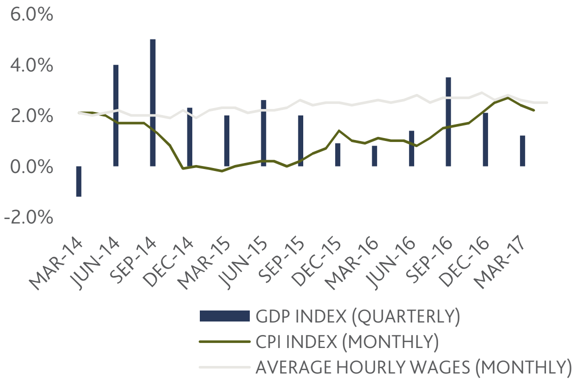
[2] http://www.nber.org/cycles.html

[3] "The Boom was a Blip", Ruchir Sharma, Foreign Affairs May/June 2017

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

MARCH 2014 THROUGH MAY 2017

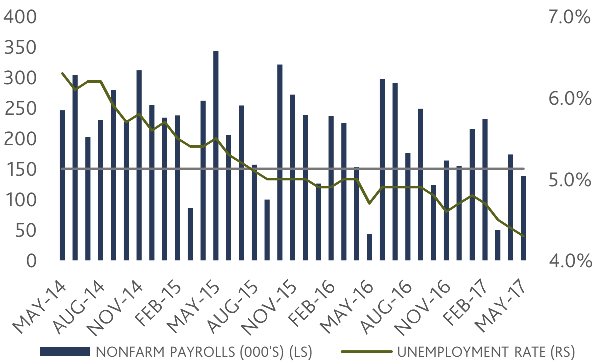


Source: Bloomberg

- U.S. economic growth fell less sharply in the first quarter than initially reported. GDP increased at a 1.2% pace above the first reading of 0.7%. The revision was driven by an upward revision in consumer spending growth to 0.6%, above the previously reported 0.3%.
- The core Personal Consumption Expenditure (PCE) price index rose 0.2% in April, above expectations of a 0.1% increase. The YoY reading for core PCE declined to 1.5%, below the 2.0% target.
- Core CPI, which excludes food and energy costs, rose 0.1% in April, helping offset the March decline of 0.1%. However, the reading came in below expectations for a 0.2% increase. Core CPI has risen 1.9% on a YoY basis.

LABOR MARKET

MAY 2014 THROUGH MAY 2017

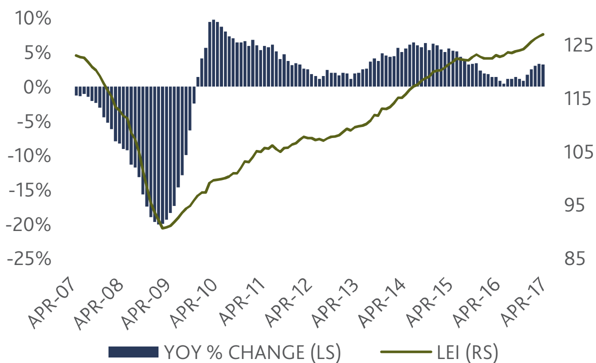


Source: Bloomberg

- U.S. nonfarm payroll employment increased in May, adding 138,000 new jobs, and coming in below consensus estimates. March and April payrolls were each revised downward. The economy is growing, but at a reduced pace.
- The unemployment rate fell by 10 basis points for the second straight month to 4.3%, the lowest reading since May of 2001. The drop might not indicate a strengthening labor market as the decline was due to fewer Americans looking for work and a drop in the labor participation rate.
- In May, average hourly earnings YoY came in at 2.5%, below economists' estimates of 2.6%, but matching April's rate of 2.5%.

LEADING ECONOMIC INDICATORS

APRIL 2014 THROUGH APRIL 2017



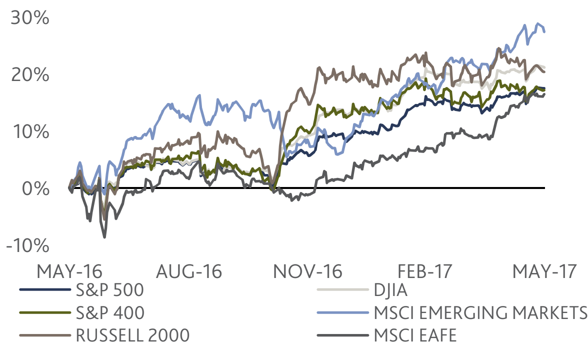
Source: Bloomberg

- The LEI index, published by the Conference Board, is comprised of ten economic components and is considered a helpful gauge for estimating economic activity for the subsequent three to six months. The LEI index increased 0.3% in April to 126.9, building on gains of 0.3% and 0.5% in March and February, respectively.
- The two largest contributors for the month of April were the interest rate spread, as well as the inverted average weekly initial claims for unemployment insurance.
- For the six-month period ending April 2017, the LEI increased at a 4.98% annual rate, more than triple the growth seen during the previous six-month period.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, MAY 2016 THROUGH MAY 2017

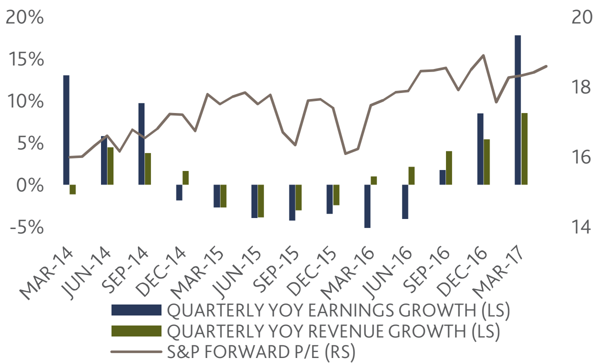


Source: Bloomberg

- Strong performance of foreign developed equities continued in May. European equities received a boost from centrist candidate Emmanuel Macron's victory in the French presidential election. The MSCI EAFE index gained 3.8% in May and is up 14.4% this year.
- The slowing post-election rally in domestic small cap equities finally reversed in May with a monthly decline of 2% for the Russell 2000 index. The weak performance can be partly attributed to growing skepticism over the president's ability to quickly enact his proposed policies including tax reform, deregulation, and infrastructure spending.
- Emerging market equities recorded a fifth consecutive monthly gain above 2% in May despite negative headlines including a corruption scandal in Brazil and China's sovereign credit rating downgrade by Moody's.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, MARCH 2014 THROUGH MARCH 2017

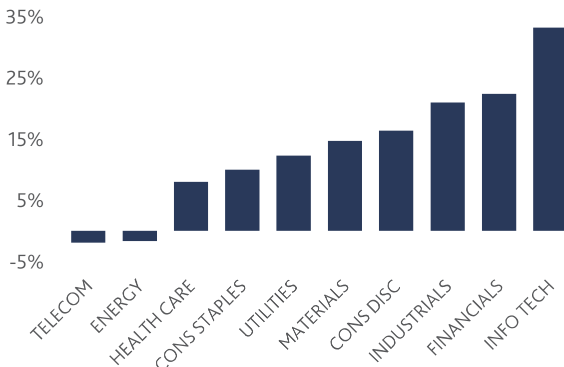


Source: Bloomberg

- Over 90% of S&P 500 companies have reported first quarter earnings through mid-May. S&P 500 earnings growth YoY is on pace for 16.5%. This will be the strongest growth since Q3 2011 (16.7%) and it will also be the first time the S&P 500 has experienced three consecutive quarters of YoY growth since Q1 2015. Sales growth YoY is on pace for 5.2%.
- Earnings and sales surprise percentages are on pace to exceed the one-year and five-year averages. Surprises are the difference between reported numbers and analysts' estimates. Larger surprises indicate better-than-expected growth and typically support stronger equity performance.

S&P 500 SECTORS 12-MONTH RETURNS (PRICE)

MAY 2016 THROUGH MAY 2017

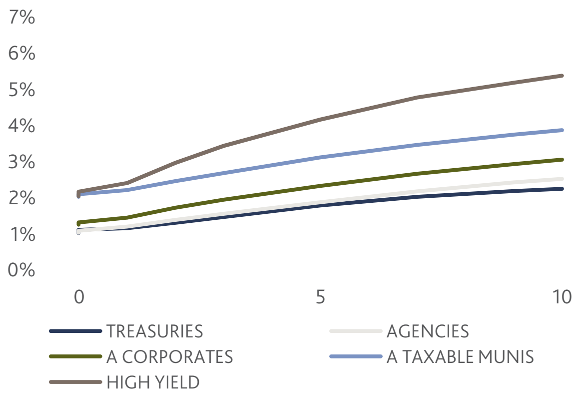


Source: Bloomberg

- Growth is significantly outperforming value this year with returns of 13.8% and 2.9%, respectively. This is a sharp reversal from last year's trend of value outperforming growth. Value has been weighed down by energy and financials which are among the worst performing sectors this year. Growth is receiving a strong boost from technology which is the best performing sector by a wide margin.
- The energy sector has declined every month this year amid concern about the oil market's chronic oversupply. The post-election rally in financials has faded in recent months due to growing skepticism of President Trump's ability to enact his proposed policies including deregulation.

FIXED INCOME

CURRENT YIELD CURVES

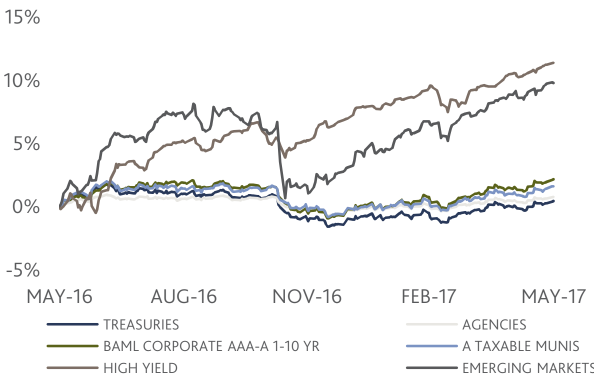


Source: Bloomberg

- Building upon the flattening that occurred in April, the yield difference between the 10-year U.S. Treasury and the 2-year U.S. Treasury once again fell. As was the case in April, the decline in the 10-year yield accounted for the entire flattening of the curve.
- The flattening occurred as inflation numbers continued to disappoint. In fact the Citi Economic Surprise Index for the U.S. finished near a 12-month low, indicating that most recent macroeconomic data reports had failed to meet expectations.
- As economic data disappointed in May, the political environment also grew more volatile, calling into question the "reflation" trade and whether current long-term yields were too high. Even still, investors should remain attentive to potential mounting inflation pressures.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

MAY 2016 THROUGH MAY 2017

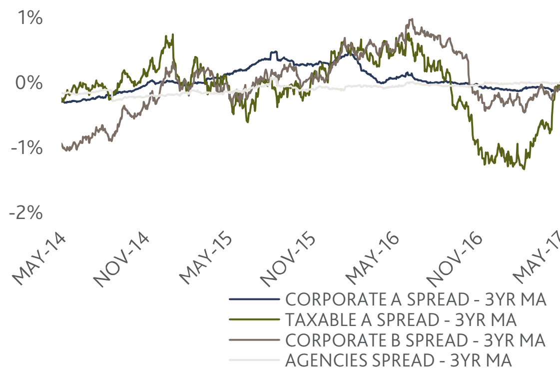


Source: Bloomberg

- High yield and emerging market bonds continue to maintain their strength over the rest of the market, with EM again marginally outperforming high yield on a one-month basis, but still trailing high yield for the best performing fixed income asset class over the last 12 months. Every fixed income sector posted positive returns in May.
- Following a post-election sell-off in emerging market and high yield bonds, income-seeking investors have since driven spreads to well below historical average levels.
- Among the more risk-averse asset classes, investment grade corporate bonds have surpassed taxable muni bonds as the best performer.

SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE

MAY 2014 THROUGH MAY 2017

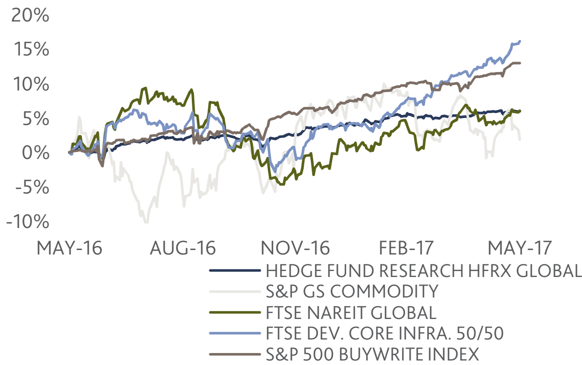


Source: Bloomberg

- Most asset class spreads remain at tighter-than-average levels to U.S. Treasuries, with taxable munis finally breaking above their historical average. Investment grade corporate bond spreads are again tightest relative to historical average.
- Tight spreads, particularly in riskier asset classes, tend to signal turning points in the credit cycle. While spreads did widen slightly this month, defaults remain below their historical norms, meaning this cycle may still have legs.
- The value of municipal bonds has improved over the last six months, having reverted to within a half of a percent of their historical mean. With a dwindling supply expected in the summer months, these may tighten.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
MAY 2016 THROUGH MAY 2017

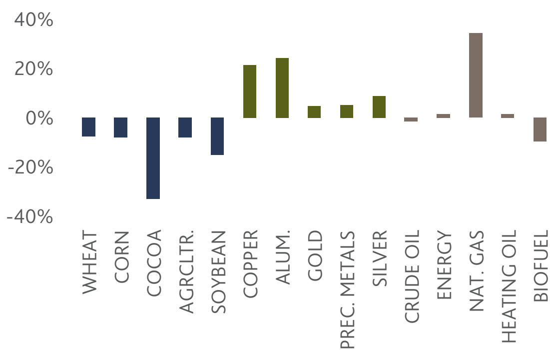


Source: Bloomberg

- Commodities experienced a volatile May, as crude oil prices plunged nearly 8.0% in the first week of the month, then surged 11.4% higher to about $51 per barrel before slipping to nearly $48 per barrel. Prices of several industrial metals struggled in May. Most notably, continued concerns surrounding excessive Chinese capacity helped iron ore prices plunge 17.0% in May, after falling 14.4% in April.

- Continuing a trend of recent months and quarters, global infrastructure was the top performing area of clients' alternative investment strategy allocations in May. Further declines in U.S. bond yields during May could have supported investor interest in the global infrastructure asset class which typically exhibits significant exposure to higher yielding companies that own electric utilities, toll roads, and energy distribution networks.

COMMODITIES, 12-MONTH SPOT RETURNS
MAY 2016 THROUGH MAY 2017



Source: Bloomberg

- Natural gas continues to be one of the top performing commodities on a trailing twelve-month basis. Market commentators have suggested that this is largely due to last spring's suppressed price levels and a warmer-than-expected summer of 2016. Expected supply increases from the U.S. Appalachia region may keep a lid on prices in 2017.

- Led by Saudi Arabia and Russia, in the final week of May, the Organization of Petroleum Exporting Countries (OPEC) officially extended its global crude oil production cut for another nine months through March 2018.

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