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MARKET REVIEW
AUGUST 2017

TRUST COMPANY
of NORTH CAROLINA

SHOW ME THE INFLATION

The slogan for the state of Missouri is "The show me state." In the movie, *Jerry Maguire* , football player Rod Tidwell got his agent, Jerry Maguire, to shout at the top of his lungs "Show me the money!" When things are really important, and the stakes are high, you cannot just tell someone. You've got to show them. In our review and evaluation of the economy and markets, of critical importance is inflation. It is important to understand where and how much inflation is present in the current economy. Below we will try to show just where and how much inflation is present in the current economy. Investors who better understand inflation could arrive at better investment expectations than those otherwise unaware.

AHA, THERE IT IS.

The Federal Reserve Open Market Committee's (FOMC) preferred measure of inflation is the Personal Consumption Expenditure Implicit Price Deflator (PCE). Contrasted from the Consumer Price Index for Urban Consumers (CPI-U), which is a static basket of goods and a measure that is informally referred to as the CPI, the PCE measures changes in prices of a dynamically updated basket of goods and services. With all the advances in technology, as well as changes to consumer preferences over time, the FOMC seems justified to focus their attention on the PCE as it more closely follows what average, everyday people experience in terms of inflation.

Additionally, the FOMC tells us that they are watching wage inflation. The accepted economic theory is that as wages rise business owners eventually pass these costs along to consumers in the form of higher prices, just as businesses would pass along any other rise in the cost of production.

Shown in the first chart on page three are these inflation measures. Price inflation is represented by core PCE, without food and energy prices, and CPI. Wage inflation is measured by the annual percentage change in hourly compensation. During this expansion wage inflation has been relatively stable, ranging from about 2% to 3%. CPI has varied considerably from -2%, which is deflationary, to as high as 4%. However, core PCE, the measure that the FOMC thinks is most important, has been relatively stable, ranging from 1% to 2%. In the chart on page 3 labeled Wages and Goods Inflation the most recent reading is depicted. Wage inflation was last measured at about 2.5% but both goods inflation measures were about 1.5%. There you have it, inflation.

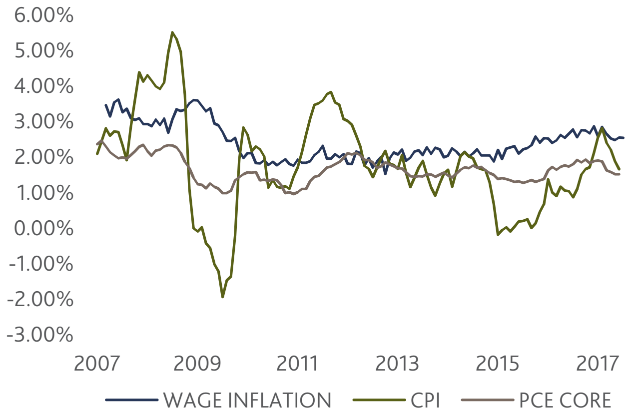
BUT SHOULD WE WORRY ABOUT IT?

Congratulations are due to the FOMC, somewhat. Inflation currently exists, albeit modest, and below the stated FOMC policy goal of 2.0%. Shown in the graph above, wage inflation has averaged between 2% to 3% during this entire expansion, and it has been that way when consumer inflation has been both rising and falling. Were the relationship between wage and consumer inflation to be strong, wouldn't core PCE have been higher over this period? Certainly the Fed hopes so, but it hasn't been the case. Finally, CPI seems to have headed sharply lower in the past few months. These do not seem to be strong signs that inflation is accelerating.

For the FOMC to devote so much of their time explaining their desire to continue tightening monetary policy, they must see signs of inflationary pressure building beneath

WAGES AND GOODS INFLATION

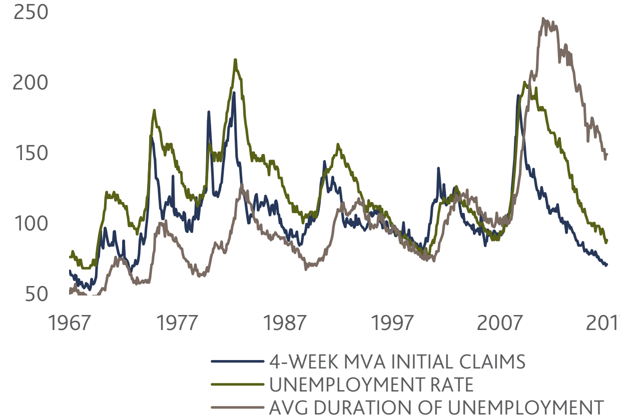
JANUARY 1, 2007 THROUGH JULY 1, 2017



Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis Past performance does not guarantee future results.

RELATIVE LABOR MARKET STRENGTHS

JULY 1, 1967 THROUGH JUNE 1, 2017



Source: U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis. Past performance does not guarantee future results.

these broad readings. Why, then, hasn't wage inflation worked its way through to goods inflation? A simple explanation is that there might be still additional slack in the labor markets preventing wages from rising.

Slack in the labor market represents both the availability and willingness of Americans of working age to become employed. The duration of unemployment and initial claims for unemployment insurance are direct measures of excess supply, or slack, in the labor markets. The chart above labeled Relative Labor Market Strengths tracks the unemployment rate, 4-week average of initial claims for jobless benefits, and average duration of unemployment since the late 1960s. For ease of comparison, each is scaled to an index value of 100 as of December 2007.

As shown in the chart, relative to past cycles, both the current levels of unemployment and initial claims for jobless insurance are near lows and are examples that the economy is near full employment. However, the average duration of unemployment remains persistently high. The fact that there are significantly more individuals receiving unemployment benefits could be the explanation behind the weakness in the relationship between wage inflation and goods inflation at this point in the economic cycle. While this measure has fallen as of late, it has a long way to go compared to other cycles.

CONCLUSION AND INVESTMENT IMPLICATIONS

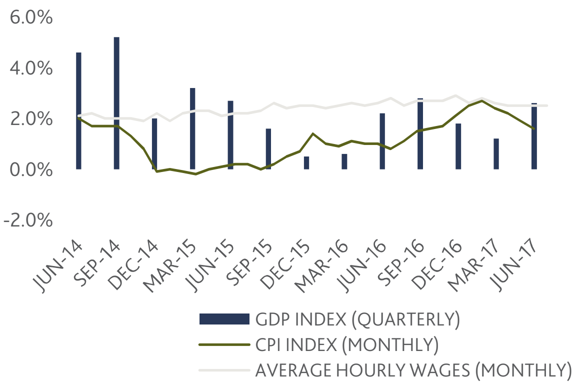
That the Fed is focused on their dual mandate of stable prices and maximum employment is hardly in doubt. Certainly their goal of tightening monetary policy before inflation has taken hold deserves merit. But, slack in the labor force, as demonstrated by the longer duration of unemployment, could prevent an acceleration of wage inflation. With little indication that neither wage nor goods inflation is accelerating, the FOMC may be in the midst of another year of tightening monetary policy at a pace that is slower than announced.

Investors ought to take comfort in the slower pace of rate hikes, which are essentially pre-announced, and remain fully invested according to their goals and objectives. If the Fed were prone to surprise announcements, it would make more sense to have a larger allocation to cash and absolute return strategies. Surprises in the markets do happen, but at least during the current cycle the hyper focus on signs of building inflation are not readily apparent. Once these signs appear strong enough to no longer dismiss, Fed action could be welcomed, not questioned.

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

JUNE 2014 THROUGH JUNE 2017

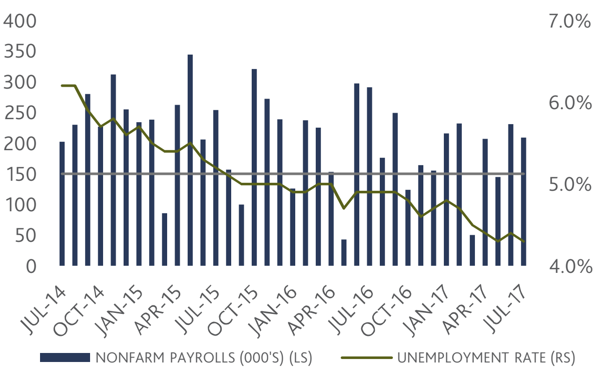


Source: Bloomberg

- U.S. economic growth increased at an annualized rate of 2.6% in the second quarter. Consumer spending, the largest part of the economy, grew 2.8%. Business spending, characterized as nonresidential fixed investment, climbed 5.2%.
- The core Personal Consumption Expenditure (PCE) price index rose 0.1% in June, in line with consensus forecasts. The YoY reading for Core PCE was unchanged at 1.5%, below the 2.0% target.
- Core CPI, which excludes volatile food and energy costs, rose by 0.1%, compared with expectations for 0.2%. Core CPI increased at an annualized rate of 1.7% for June.

LABOR MARKET

JULY 2014 THROUGH JULY 2017

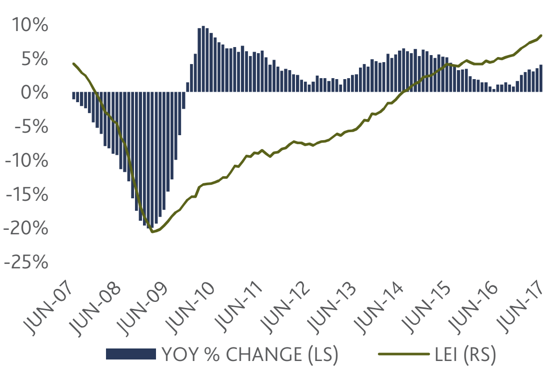


Source: Bloomberg

- U.S. nonfarm payrolls added 209,000 jobs in July, coming in above the consensus estimate. Leisure and hospitality employment saw its largest increase of jobs since September 2015 with 62,000 new jobs. June's payroll was revised up to 231,000 from previously reported 222,000 new jobs.
- The unemployment rate dropped 10 basis point to 4.3% tying the 16-year low that occurred in May. For the year, it has declined 40 basis points and matches the most recent median forecast from the Fed for 2017.
- In July, average hourly earnings increased 0.3% compared to a 0.2% increase in June which was the largest increase in five months on a YoY basis. July's strong labor market performance supports the Fed's plan to gradually raise the inflation rate to its 2% target.

LEADING ECONOMIC INDICATORS

JUNE 2014 THROUGH JUNE 2017

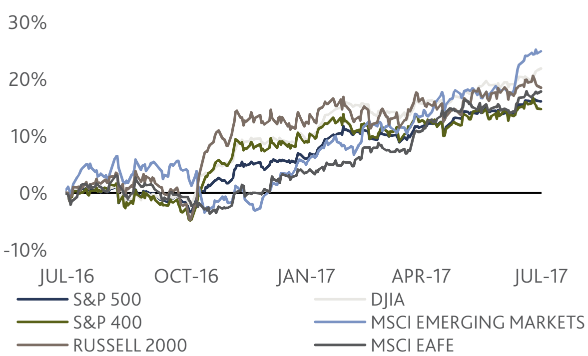


Source: Bloomberg

- 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 0.6% in June to 127.8, building on gains of 0.3% and 0.2% in May and April, respectively.
- After months of weakness, housing permits were the largest contributor to the LEI in June.
- Jobless claims were the sole detractor from the Index in June, contributing -0.1% to the LEI Index.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS
PRICE APPRECIATION, JULY 2016 THROUGH JULY 2017

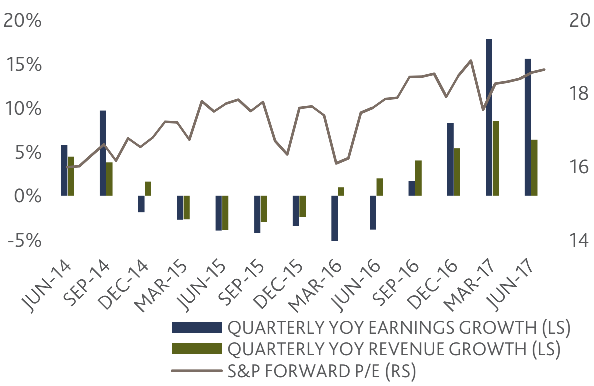


Source: Bloomberg

- Emerging market equities gained 6.0% in July marking their strongest monthly performance since last March. Brazil and China were the best performing countries globally last month with gains of 10.9% and 8.6%, respectively. Brazilian equities jumped after the country's Senate approved a major overhaul of labor rules. Chinese equities received a boost from better-than-expected second quarter GDP YoY growth of 6.9%.

- The S&P 500 returned 1.9% last month as domestic large cap stocks were supported by a strong start to the second quarter earnings reporting season, further weakness in the dollar, and encouraging economic data.

S&P 500 YOY EARNINGS & REVENUE GROWTH
BY QUARTER, JUNE 2014 THROUGH JUNE 2017



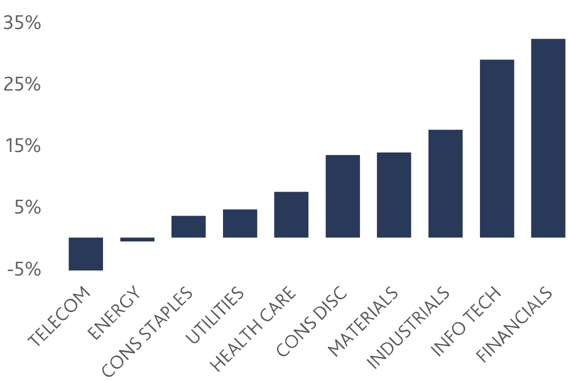
Source: Bloomberg

- Earnings growth of S&P 500 companies is on pace for two consecutive quarters of double-digit growth for the first time since 2011. S&P 500 second quarter earnings growth YoY is on pace for 11.3% following 17.9% growth in the first quarter. Almost 60% of companies in the index have reported results, representing about 70% of the index's market cap.

- S&P 500 sales are on pace for 6.3% growth YoY versus the pre-reporting season analysts' estimate of 5.7%. The energy and financials sectors are experiencing the highest level of sales growth.

- The financials and technology sectors have reported the best overall numbers thus far as they remain the only sectors to report earnings and sales above analysts' estimates and double-digit earnings growth.

S&P 500 SECTORS 12-MONTH RETURNS (PRICE)
JULY 2016 THROUGH JULY 2017



Source: Bloomberg

- In July, the energy sector posted its first monthly gain of the year as the price of oil reached $50 per barrel for the first time since May. Oil prices rose after Saudi Arabia announced further oil production cuts and OPEC said it was considering a crackdown on countries not honoring their deal to reduce global oil supply by 2%.

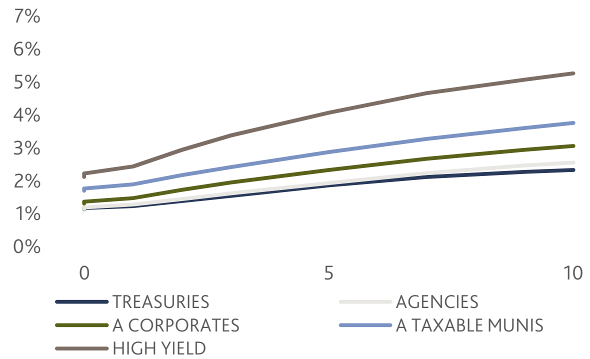
- Strong earnings growth helped the technology sector rebound 4.3% last month after falling 2.8% in June. The S&P 500 technology sector index reached a record high last month, closing above its previous all-time high set in March 2000 near the dot-com bubble peak.

- Healthcare was among the worst performing sectors last month amid political uncertainty following Republican Senators' unsuccessful vote to repeal parts of the Affordable Care Act.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JULY 2017

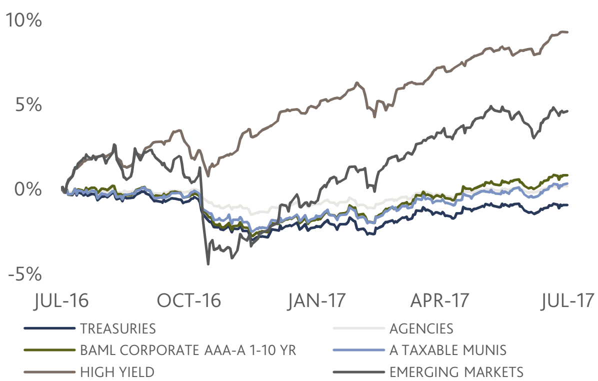


Source: Bloomberg

- The steepness of the U.S. Treasury yield curve remained relatively unchanged during the month of July as yields on both 2-year and 10-year Treasury notes declined during the month.
- Over the month of July, the decline in market expectations for another Fed rate hike this year appears to have caused a slight decline in yields. Yields moved lower even as the Citi U.S. Economic Surprise Index continued to recover from its mid-June trough, suggesting economic data reports have grown more positive over the last month and a half.
- Recently, part of the Treasury curve experienced an inversion as T-bills due in October began to offer more yield than those maturing later in the year due to the debt ceiling being reached.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JULY 2016 THROUGH JULY 2017

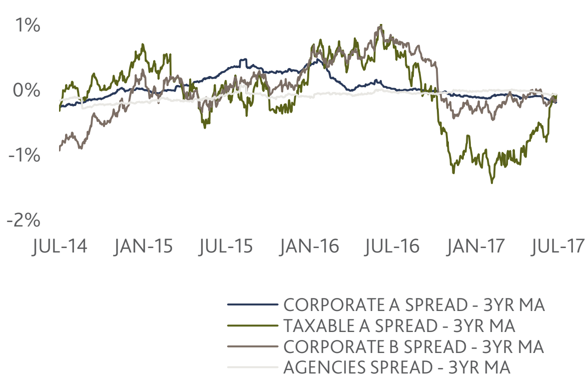


Source: Bloomberg

- 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 significantly trailing high yield for the best performing fixed income asset class over the last 12 months.
- 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 traditional asset classes, investment grade corporate bonds remain the best performer, followed by taxable municipal bonds.

SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE

JULY 2014 THROUGH JULY 2017



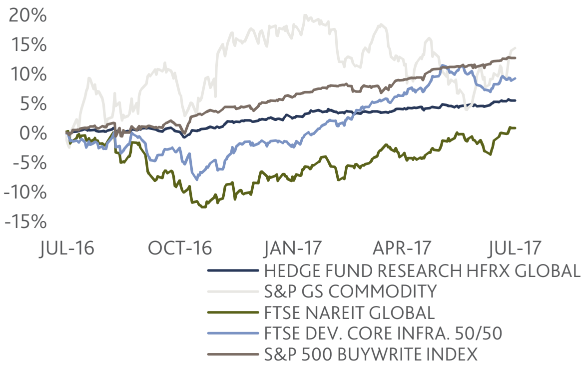
Source: Bloomberg

- Most asset class spreads remain at tighter-than-average levels to U.S. Treasuries, with agencies being closest to 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 twelve 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

JULY 2016 THROUGH JULY 2017



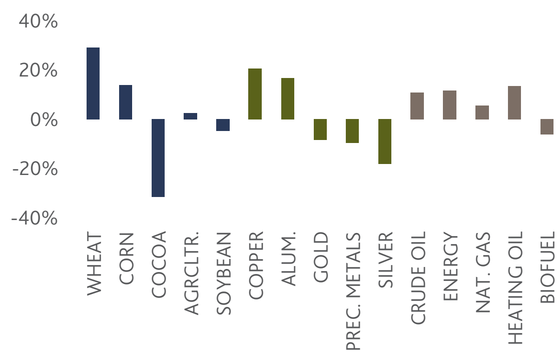
Source: Bloomberg

- An allocation to alternative strategies would have benefited fixed income investors for the twelve-month period ending July 31, 2017, as all five of the broad alternative investment indexes shown in the graph to left outperformed the -0.5% total return of the Bloomberg Barclays U.S. Aggregate Total Return Index over the period.

- The ascent of crude oil prices to around $50 per barrel by the end of July, and the decline in longer dated U.S. interest rates thus far in 2017 have been tailwinds for commodities and global real estate, respectively. Both asset classes continue to exhibit significant volatility, with one-year standard deviation of returns of 10.3% and 9.9% compared to 4.6% for global equities, as measured by the MSCI ACWI Index.

COMMODITIES, 12-MONTH SPOT RETURNS

JULY 2016 THROUGH JULY 2017



Source: Bloomberg

- At a late-July meeting of the Organization of Petroleum Exporting Countries (OPEC), Saudi Arabia indicated it would further curtail its daily oil production to offset rising output from fellow OPEC members Libya and Nigeria. Daily shipments from Saudi Arabia, OPEC's largest producer, will be capped at 6.6 million barrels a day beginning in August – about 13% lower than a year earlier.

- Brazil's corn production in the 2016-2017 season will climb 45% from last year according to USDA forecasts. This sets the stage for heightened competition between Brazilian and American farmers to win orders from the world's largest importers including Japan and Mexico. Market commentators expect robust supply to put pressure on prices heading into the fall and winter.

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