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MARKET REVIEW
FEBRUARY 2018

TRUST COMPANY of NORTH CAROLINA

MARKET BRIEF

LAISSEZ LES BONS TEMPS ROULER!

A popular greeting during Mardi Gras festivities is "Laissez les bons temps rouler," which loosely translates from French as "let the good times roll." This phrase aptly describes the pace of growth in the U.S. economy over the last several quarters.

A broad-based rebound in global activity and a reacceleration in U.S. corporate profits are among the two most widely touted and accepted explanations for the recent acceleration of domestic growth. This Market Brief documents the recent acceleration of economic growth and corporate profits. Determining if this activity is the beginning of a new sustainable trend or the final crescendo of a rollicking festival is a more difficult task.

ACCELERATING ECONOMIC GROWTH

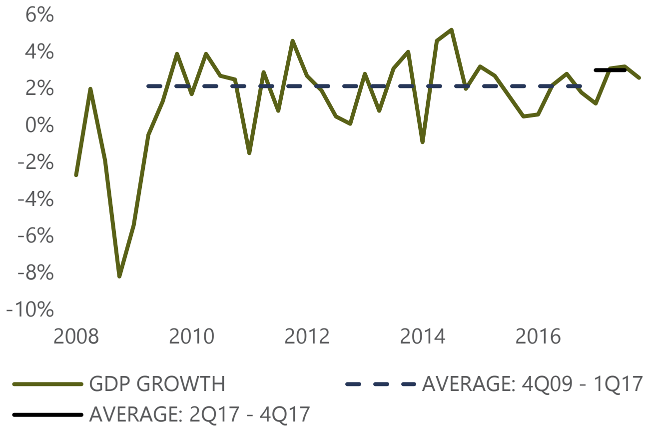
There has been much criticism over the slower-than-average pace of economic recovery following the sub-prime housing crisis recession of 2008-2009. Historically, the U.S. economy has rebounded quite strongly following a recession, only to slow down to a more sustainable pace as the expansion ages.

To get a sense of growth trends, we'll turn to the widely used measurement of annualized rates of quarterly U.S. Gross Domestic Product (GDP) growth. Data provided in the chart on the top left of page three covers a ten-year period which includes the recession and recovery. According to the National Bureau of Economic Research, the current expansion began in the fourth quarter of 2009.[1] The dotted line depicts an average growth rate of 2.1% from the first quarter of 2009 until the first quarter of 2017. The solid line shows a 3.0% average growth rate for the second through fourth quarters of 2018. The average growth rate for the roughly seventy years of post-World War U.S. economic history is 3.2%. In their 2011 best seller *This Time is Different*, economists Carmen Reinhart and Kenneth Rogoff argue that expansions following a recession induced by a financial crisis exhibit a slower pace of recovery due to the lasting damage of credit market excesses during the prior expansion.[2] It seems to us that the lackluster 2.1% level of average annual growth achieved in the current expansion up to the second quarter of 2017, may validate Reinhart and Rogoff's observations.

In any event, we believe investors should pay attention to the apparent economic acceleration of recent quarters, because at no point in the current expansion prior to 2017 were there three consecutive quarters with growth rates above 2.5%. True, there were quarters prior to the spring of 2017 in which the growth rate jumped to nearly 4.0%. Yet, that stronger pace never really held and was often followed by a slower pace. The recent corporate tax cut may make this trend more sustainable, but we'll need to see several more quarters of GDP data to call it a clear trend.

QUARTERLY U.S. GDP GROWTH

2008 THROUGH 2017



Source: Bloomberg. Past performance does not guarantee future results.

S&P 500 PROFITS

QUARTERLY FROM Q1 2010 THROUGH Q1 2018 (EST)

Source: Bloomberg. Past performance does not guarantee future results.

ACCELERATING CORPORATE EARNINGS

The 2015 nadir of year-over-year corporate earnings growth has been a focus of our attention for quite some time. As shown in the chart to the top right, the growth rate of corporate profits appears to have bottomed in the spring and summer of 2016, and then ramped up significantly in the fall of 2016 through 2017. Corporate America will likely slow from an earnings growth pace of 15-20%, but fourth quarter 2017 earnings releases are off to a strong start.

The impact of the corporate tax cut from 35% to 21% has not yet been observed in this recent crop of earnings releases. However, the anticipation of rising earnings from a tax cut could have been a contributing factor to this most recent stage of the current bull market. The last two data points of the Quarterly Earnings line are the earnings estimates for the first and second quarter of 2018, and the abrupt turn higher in the trend line shows the optimistic consensus estimate forecast including the impact of tax cuts.

CONCLUSION AND INVESTMENT IMPLICATIONS

In 2017, we saw both acceleration in GDP growth and the continuation of a rebound in corporate profits. We believe it is important to acknowledge that the profit recovery occurred before the impact of the corporate tax cuts went into effect, so there could have been something powerful happening in corporate America. Though estimates vary, it is broadly expected that earnings could be anywhere from 15%-30% higher once the tax cuts are fully implemented into analysts' valuation models. Additionally, the benefit to GDP growth from the tax cuts is estimated to be from 0.25%-0.75% for the year. It has been quite some time since the U.S. economy experienced sustained sequential growth over 3.0%. This level of broad economic growth could support both further corporate profit growth and current equity market valuations.

In the final weeks of January, however, U.S. stocks experienced volatility not seen in years. Swings in the Dow Jones Industrial Average of several hundred points have seemed surprising to many investors – especially considering the underlying fundamental strength of the economy and better-than-forecast corporate profit reports.

Calling tops and bottoms in equity markets in the moment is extremely difficult, though with hindsight can seem easy. Investors and advisors would be wise to strive to rebalance when asset classes drift to the boundaries of permitted ranges so that their portfolios do not become unduly risky by having a larger equity allocation than desired.

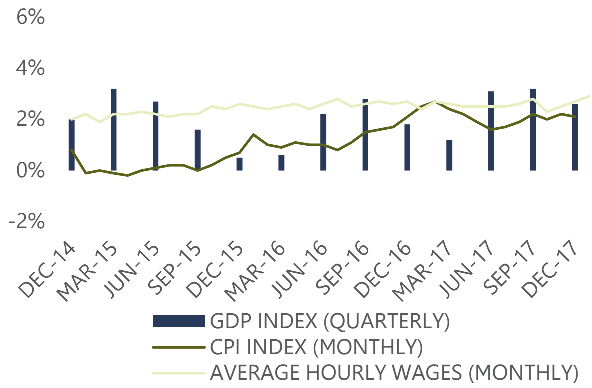
[1] http://www.nber.org/cycles.html

[2] Carmen Reinhart and Kenneth Rogoff, "This Time is Different: Eight Centuries of Financial Folly", 2009

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

DECEMBER 2014 THROUGH JANUARY 2018

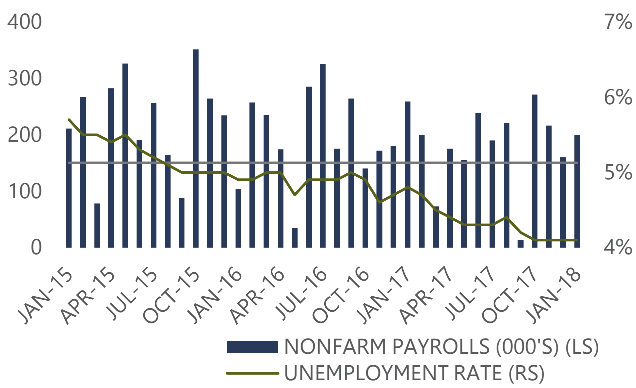


Source: Bloomberg

- U.S. GDP rose at a 2.6% annualized rate in the fourth quarter, weaker than the 3.0% growth rate economists were anticipating. Consumer spending grew at its fastest pace in over a year, while growth was hindered by a wider trade deficit.
- The Core Personal Consumption Expenditure (PCE) price index rose 0.2% in December. The YoY reading for Core PCE increased 1.5%, remaining below the Fed's 2.0% target.
- Headline CPI, which includes volatile food and energy costs, rose by 0.1% in December. The annualized rate for broad consumer prices declined to 2.1% from 2.2% in November.

LABOR MARKET

JANUARY 2015 THROUGH JANUARY 2018

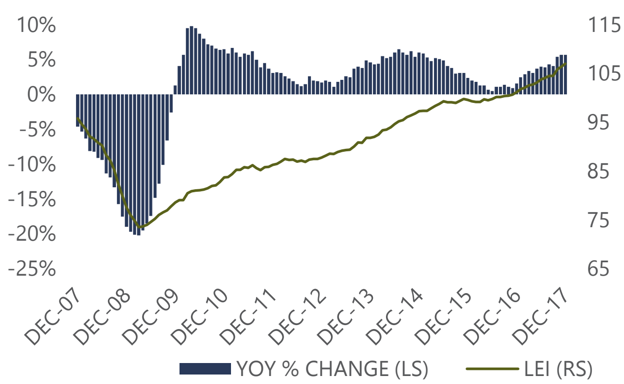


Source: Bloomberg

- U.S. nonfarm payroll employment rose in January, adding 200,000 new jobs, coming in 20,000 jobs ahead of the Bloomberg consensus estimate. The January payroll addition was slightly higher than the average monthly addition of 181,000 in 2017.
- Average hourly earnings increased 0.3% for the month and 2.9% on an annualized basis, the largest gain since the beginning of 2009. Eighteen states and several notable, large U.S. corporations began 2018 with higher minimum wages.
- The unemployment rate remained unchanged at a 17-year low of 4.1%. Hiring remained broad based across industries, including increases in manufacturing and mining.

LEADING ECONOMIC INDICATORS

DECEMBER 2007 THROUGH DECEMBER 2017



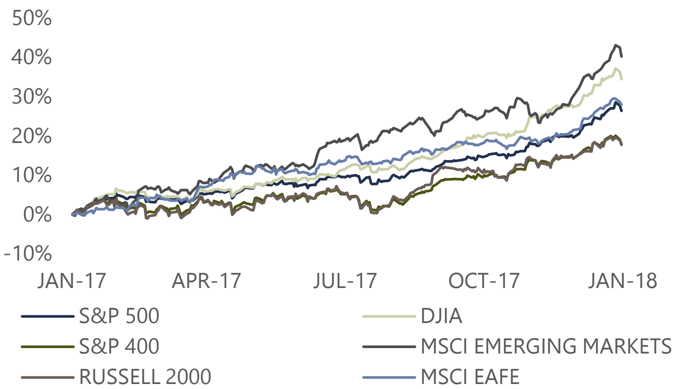
Source: Bloomberg

- The Conference Board LEI Index 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 December to 107.0, following an increase of 0.5% in November.
- December's strong index reading points to continued momentum in the economy for the first half of 2018. Market commentators have suggested the LEI is likely to be further bolstered by the passage of the tax plan.
- The base year of the composite index (corresponding to a level of 100) was recently changed to 2016 from 2010. This revision does not affect the underlying economic nature of the index.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, JANUIARY 2017 THROUGH JANUARY 2018

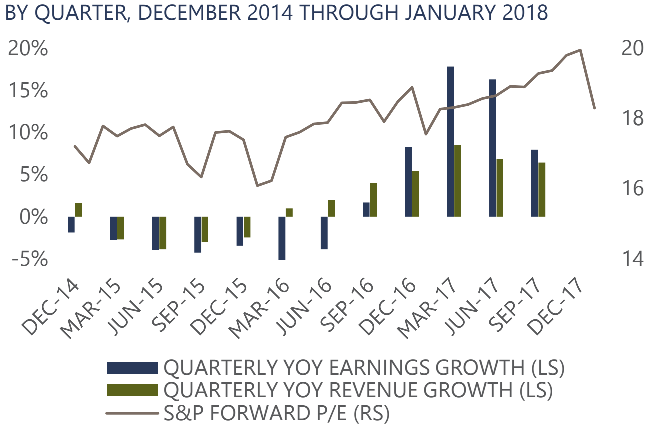


Source: Bloomberg

- Global equities continued their ascent throughout most of last month as the S&P 500, MSCI EAFE, and MSCI Emerging Markets indexes all returned at least 5.0% in January. The S&P 500 and MSCI Emerging Markets experienced their best monthly performance in almost two years with gains of 5.6% and 8.3%, respectively.
- Rising interest rates and higher inflation expectations contributed to a risk off sentiment in the last three days of the month. The S&P 500, MSCI EAFE, and MSCI Emerging Markets each lost 1.4% or more during that period. Before this decline the S&P 500 was up 7.5% year to date which would have been its best January since 1987.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, DECEMBER 2014 THROUGH JANUARY 2018

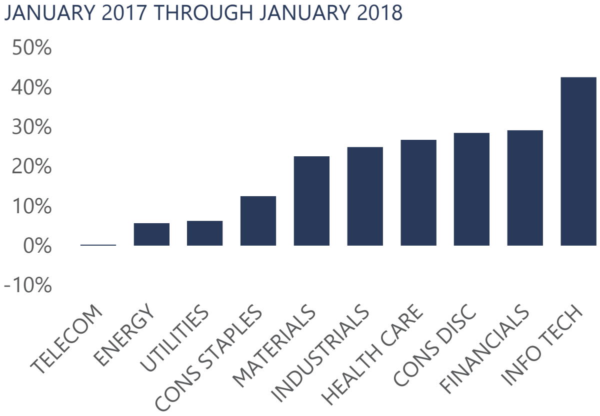


Source: Bloomberg

- Nearly 50% of S&P 500 companies have reported Q4 2017 earnings. Earnings growth is on pace to accelerate to 12.6% from 7.3% in Q3 2017. If earnings growth stays above 10% for the quarter it will be the third time in the last four quarters the S&P 500 reported double-digit growth.
- S&P 500 revenue growth is on pace for 6.9% in Q4 2017.
- During January, analysts increased their Q1 2018 earnings estimates by over 4%. This is the largest upward earnings revision during the first month of a quarter in over a decade. The decrease in the corporate tax rate appears to be the main contributor to the upward revisions.

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

JANUARY 2017 THROUGH JANUARY 2018



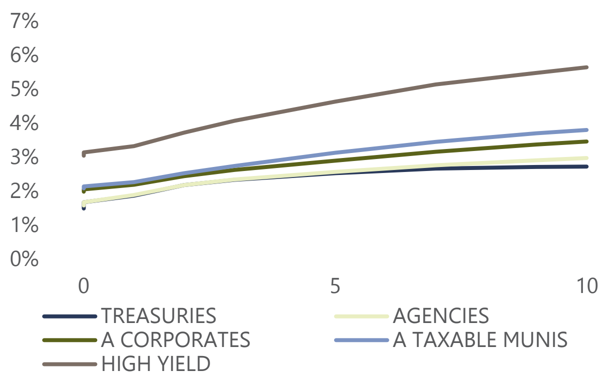
Source: Bloomberg

- Consumer discretionary was the best performing S&P 500 sector in January with a gain of 9.3% boosted by the multiline retailer industry group's 11.3% monthly return. Some retailers experienced a multi-year high for holiday sales growth in 2017.
- The Financials sector was among the top performng sectors last month, benefitting from strong earnings trends, higher interest rates, and increased credit growth.
- Interest rate sensitive sectors including utilities and real estate were the only S&P 500 sectors with a loss last month. Multi-year high bond yields pressured these sectors, which tend to have larger dividend yields than the broad market.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JANUARY 31, 2018

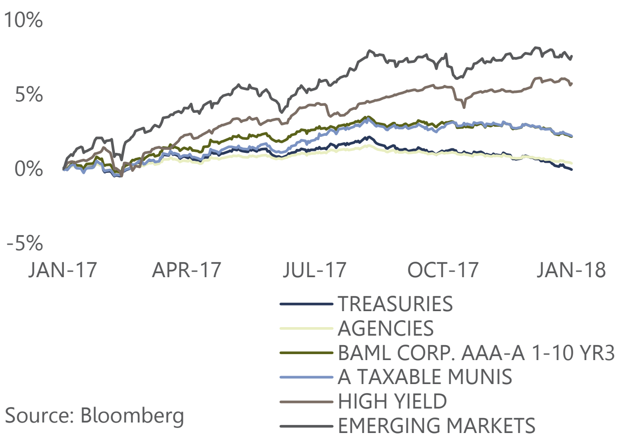


Source: Bloomberg

- The yield curve (the yield differential between the 2-year U.S. Treasury note and the 10-year bond) steepened somewhat throughout January, as rates across the curve climbed higher, with the 7-year Treasury note increasing the most in yield.
- At least part of the move higher in yields appeared to be driven by expectations for higher inflation, as implied 10-year U.S. breakeven inflation rates climbed 13 basis points in January.
- After finally flattening in the fourth quarter of 2017, Bloomberg's BVAL AAA Baseline Curve, a measure of tax-exempt muni yields, steepened 37 basis points in January. The front end of the curve has been kept down by declines in 30-day visible supply.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JANUARY 2017 THROUGH JANUARY 2018



Source: Bloomberg

- High yield and emerging market (EM) bonds continue to maintain their strength over the rest of the market. EM outperformed high yield on a one-month basis and pushed ahead with its continued outperformance over high yield on a trailing 12-month basis.
- Outside of EM and high yield, taxable municipal bonds overtook investment grade corporate bonds just slightly as the best performing traditional bond sector over the last twelve months tracked on the chart to the left.
- U.S. Treasuries and Agencies have posted a negative return thus far in 2018 as investors began to account for more Fed rate hikes and potentially higher levels of future inflation.

SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE

JANUARY 2015 THROUGH JANUARY 2018

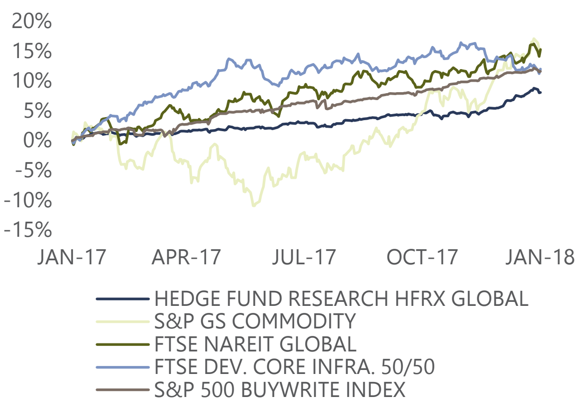
Source: Bloomberg

- Municipal bond spreads in the 1-10 year part of the curve tightened in January after widening in the fourth quarter. Tightening was especially clear in the earlier years of the curve, as the fourth quarter issuance frenzy subsided and muni supply declined.
- Agencies appear relatively inexpensive compared to their spreads over the last three years and compared to where other parts of the bond market trade in relation to their historical spread levels.
- Tight spreads, particularly in riskier asset classes, can signal turning points in the credit cycle. Despite narrow spreads, high yield defaults remain below their historical average, suggesting the current credit cycle may still have legs.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

JANUARY 2017 THROUGH JANUARY 2018

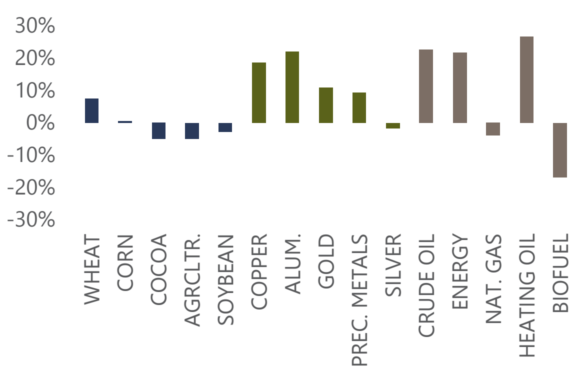


Source: Bloomberg

- All five of the alternative asset class indexes tracked in the chart at left posted January total returns that fell short of the MSCI All Country World Index's 5.7% return and exceeded the Bloomberg Barclays US Aggregate Bond Index's return of -1.2%.
- Global Infrastructure was the only alternative asset class shown at left not to participate in January's equity market upside, as rising interest rates across developed markets put pressure on utility sector stocks during the month.
- The SPGSCI trade-weighted commodity index surged 18.3% in the four months ending January 31, driven by a 37.1% climb in U.S. crude oil futures over the same period.

COMMODITIES, 12-MONTH SPOT RETURNS

JANUARY 2017 THROUGH JANUARY 2018



Source: Bloomberg

- U.S. crude oil prices remained well-bid in January, climbing 7.1% to close the month at $64.73 per barrel. This level is 92.5% higher than its $33.62 per barrel price at the end of January 2016. Higher prices may spur a ramp up in production moving forward. The U.S. Energy Information Administration recently estimated U.S. production will eclipse its 1970 peak of 9.6 million barrels per day in 2018.
- While U.S. production appears to be trending higher, Middle East production growth might be limited in 2018. The Organization of Petroleum Exporting Countries (OPEC) and its allies decided to extend their current production cuts until the end of 2018.