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MARKET REVIEW
MARCH 2020

TRUST COMPANY of NORTH CAROLINA

NEGATIVE INTEREST RATES

In the aftermath of the 2008-2009 financial crisis, global central banks entered a brave new world of cutting policy rates to near zero and creating trillions of dollars, euros and yen to purchase government bonds, or so-called "quantitative easing." The intent of policymakers was to encourage banks to utilize their excess reserves for increased lending considering the paltry returns available for funds kept on deposit with the central bank. Increased credit creation, in turn, would be the elixir needed to jumpstart economic growth. In the U.S. these policies were most likely partially successful, while in Europe and Japan weak economic growth drove the European Central Bank (ECB) and Bank of Japan (BOJ) into the uncharted world of negative policy rates in 2014 and 2016, respectively. Today, the ECB's overnight policy rate is -0.50% and the world is awash with approximately $15 trillion of negative-yielding debt concentrated in the euro zone, Switzerland and Japan.

MECHANICS AND LOGIC

How do negative interest rates work? Are commercial banks in Europe and Japan charging their deposit customers for the privilege of having a savings account? In economies with negative policy rates, commercial banks are required to pay a small percentage to hold excess reserves with the central bank. For example, the ECB's Deposit Facility Announcement Rate is -0.50%. This means that a commercial bank that keeps 1,000,000 euros on deposit at the ECB for a year would see its balance shrink to 9,950,000 euros at the end of the year. In reality, the central bank is simply shrinking reserve balances of commercial banks in an attempt to motivate them to use that cash to either make loans or purchase government and corporate bonds to be placed on their balance sheets.

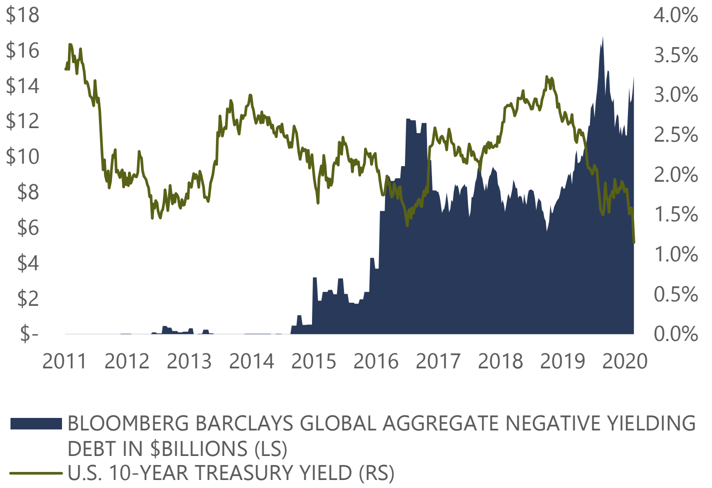
Because central banks' policy rates are a major driver of bond market yields, a large percentage of the available government and high quality corporate debt in the euro zone and Japan trades at negative yields. An investor who purchases one of these negative-yielding bonds receives a lesser amount in combined coupon and maturity payments than was paid at purchase. To many observers, this may seem illogical at best. Yet, there are several groups of buyers who would deem this behavior rational within their worldview. First, investors who expect pronounced economic weakness and seek safe-haven assets without much concern for price or valuation are likely buyers of bonds with negative yields. Next, there are forced institutional buyers including insurance companies and banks that may be mandated by regulatory requirements to purchase bonds irrespective of the yield. Many central bank asset purchase programs are designed to buy bonds at any yield level. Finally, there are market participants engaged in pure speculation or momentum-based strategies who would purchase negative-yielding debt in an effort to benefit from yields becoming increasingly negative over a short time frame.

UNINTENDED CONSEQUENCES

In theory, cutting interest rates should stimulate economic activity and boost inflation by encouraging companies and individuals to use cheaper financing to increase their spending. Some critics of negative interest rate policies (NIRP) claim this theory breaks down with negative rates because the unintended consequences cause more harm than good. The primary criticism is that NIRP can squeeze banks' profitability by narrowing net interest margins, the spread between income earned from lending and interest paid on deposits.

GLOBAL NEGATIVE YIELDING DEBT

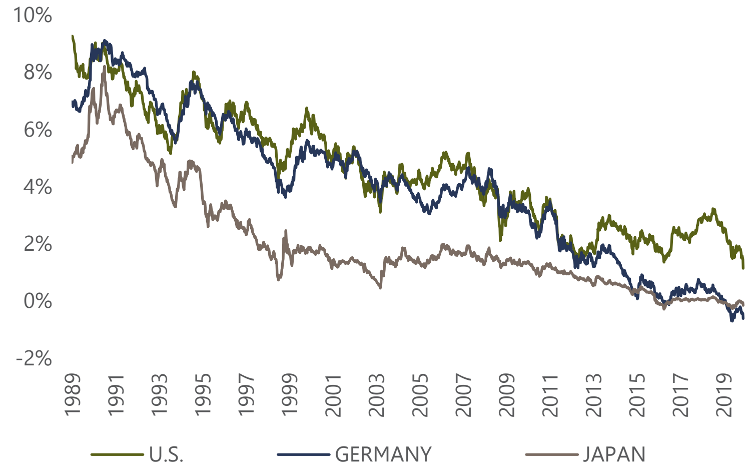
NEGATIVE YIELDING DEBT & U.S. 10-YR GOVT BOND YIELD



Source: Bloomberg
Past performance does not guarantee future results.

10-YEAR GOVERNMENT BOND YIELDS

U.S., GERMANY AND JAPAN



Source: Bloomberg
Past performance does not guarantee future results.

Federal Reserve research on European banks confirmed the claim that NIRP are associated with lower net interest margins and return on assets. Recent research suggests that lower profitability can lead to banks issuing fewer loans which stifles the intended stimulus effect of NIRP[1].

Banks are not the only institutions that face challenges with NIRP. Others, including insurers and pension funds, have target returns which they are required to achieve in order to pay their promised obligations. Low interest rates make it more difficult for these institutions to achieve their target return and cover their payouts. According to a survey conducted by asset manager Amundi SA of European pension plan providers with $2.1 trillion in assets, a 1% decline in interest rates would increase pension liabilities by 20% and reduce funding ratios by 10%. Half of the survey respondents said they felt the ECB's policies have "undermined the longer term financial viability of pension plans." Persistent use of NIRP could lead to a situation abroad where these institutions are unable to cover their promised payouts and require a capital injection from the government.

Another critical claim against NIRP is that it has led to distortions across financial markets. Negative yields have led foreign investors in search of better yields and low risk to purchase U.S. Treasuries. This trend is especially applicable among the institutional investors mentioned in the previous paragraph who need higher returns to meet their liabilities. The artificially higher demand for long-term U.S. Treasuries created by central banks' policies has applied downward pressure on U.S. yields. In addition, foreign demand for better yielding U.S. assets has contributed to a rise in the U.S. dollar given that these foreign buyers need to sell their local currencies and buy U.S. dollars to fund their Treasury purchases.

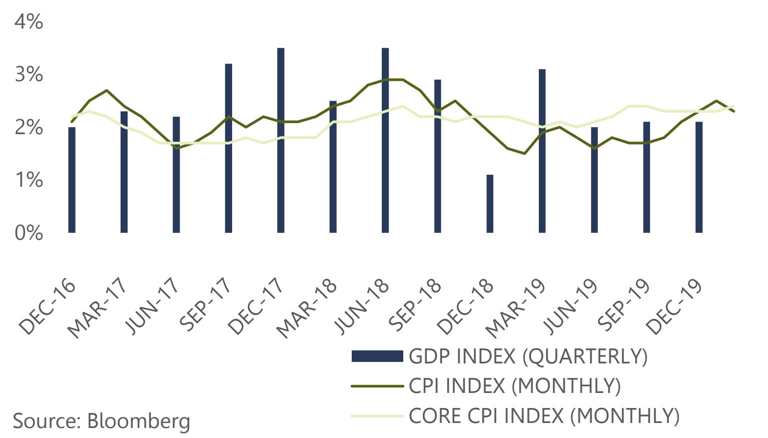
Unintended consequences of NIRP can also be seen in the economy. Real estate markets in some countries have seen a boost in demand from lower interest rates as cheaper financing made housing and commercial buildings more affordable. Increased activity in the real estate market helps stimulate the economy, but it can also create new problems if persistently low rates lead to imbalances between demand and supply such as in Europe. Throughout Europe, housing has become increasingly unaffordable as housing prices and rents soar. Since the ECB instituted NIRP in 2014, housing prices in many European countries have risen by as much as 50%. Europe's housing affordability issue has led some governments to intervene through rent freezes, higher property taxes, and subsidized housing programs. Besides contributing to social distress, soaring housing costs demand a greater share of consumers' income so they have less to spend in other areas which can weigh on economic growth.

The unintended consequences of NIRP have led to a growing chorus of voices expressing concerns, including within the ECB. The Bank for International Settlements' chief economist, Claudio Borio, underscored the essence of these concerns last year when he stated in September, 2019 "Even at the height of the Great Financial Crisis of 2007-09, this would have been unthinkable. There is something vaguely troubling when the unthinkable becomes routine." Despite the mounting list of concerns surrounding the effectiveness of the NIRP experiment thus far, we would argue that it is premature to conclude that these efforts by central banks have been a failure.

[1] Molyneux, Philip, et al. "Bank Margins and Profits in a World of Negative Rates." *Journal of Banking & Finance*, vol. 107, 2019, p. 105613., doi:10.1016/j.jbankfin.2019.105613.

ECONOMY

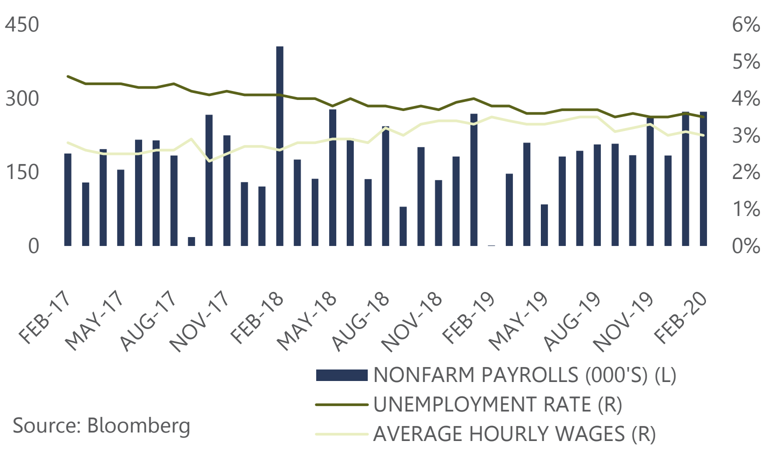
GDP AND CONSUMER PRICES
DECEMBER 2016 THROUGH FEBRUARY 2020



Source: Bloomberg

- The second estimate of fourth quarter U.S. economic growth was unchanged from the previous estimate of an annualized growth rate of 2.1%. Consumer spending was revised lower to 1.7% from 1.8% while contributions from trade and inventories were revised higher.
- The potential economic impact from COVID-19 led to economists lowering their first quarter GDP forecast to 1.5% from 1.7%. The impact is expected to be short lived, however, as growth projections for the second half of the year moved higher and the full-year forecast is unchanged at 1.8%.
- U.S. consumer prices, measured by the Core Consumer Price Index (CPI) which excludes volatile food and energy, rose 2.4% in February from a year earlier. This points to strengthening inflation before the outbreak escalated.

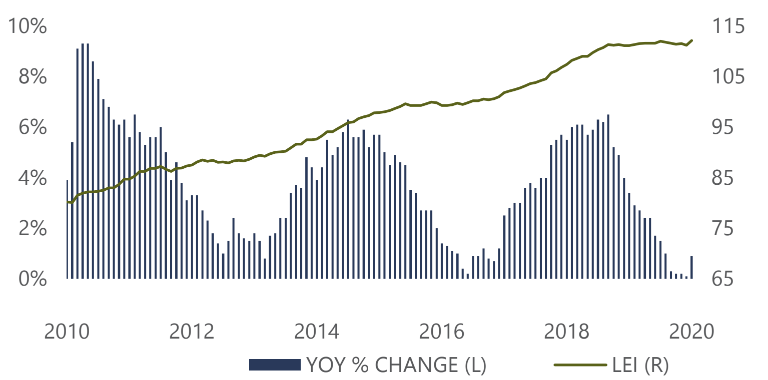
LABOR MARKET
FEBRUARY 2017 THROUGH FEBRUARY 2020



Source: Bloomberg

- The U.S. labor market posted another strong month by adding 273,000 jobs in February, easily topping estimates of 175,000. January was stronger than first reported, with the month's gain revised up to 273,000 from 225,000.
- Average hourly wages gained 0.3% from the previous month and are up 3.0% from a year prior. The unemployment rate dropped back to its half-century low of 3.5%.
- The recent employment numbers showed the labor market remained in a strong position before the COVID-19 outbreak intensified. The Federal Reserve has warned of possible economic disruptions should the outbreak spread further through the American workplace.

LEADING ECONOMIC INDICATORS
JANUARY 2010 THROUGH JANUARY 2020



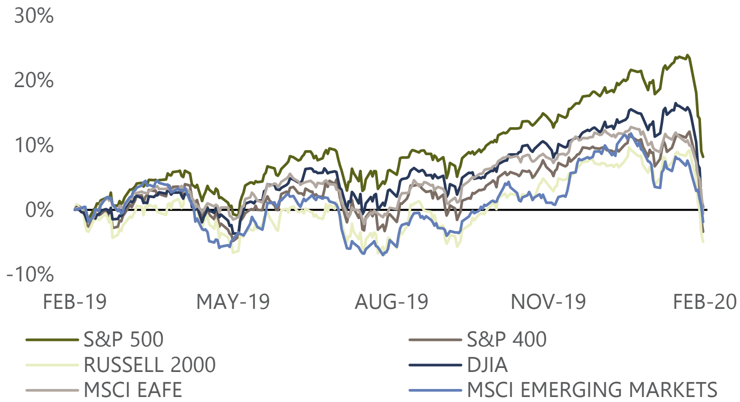
Source: Bloomberg

- The U.S. Conference Board Leading Economic Index (LEI) surprised to the upside in January with a 0.8% gain. The substantial jump turned the six-month growth rate slightly positive after falling by 1.4% in the previous month.
- Jobless claims and building permits, the two biggest laggards in the LEI during December, rebounded to become the two largest contributors in January. Of the ten components, only average weekly manufacturing hours and new orders had negative or no contribution.
- The rebound in the January LEI was an encouraging sign of the current economic expansion’s resilience, but the resurgence of COVID-19 cases outside mainland China has reduced the prospects of another strong reading for most of the underlying components.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, FEBRUARY 2019 THROUGH FEBRUARY 2020

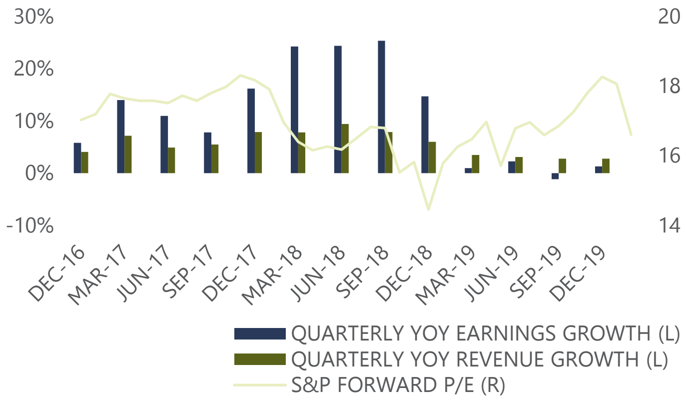


Source: Bloomberg. Past performance is no guarantee of future results.

- In the first half of February, equities recovered some of the losses from late January on easing COVID-19 fears and supportive fourth quarter earnings reports. A second wave of virus cases outside China led to a market selloff in the second half of the month that included the S&P 500's quickest correction and worst weekly loss since the financial crisis in 2008. Most domestic stock indexes posted a monthly loss over 8.0%.
- Losses were more pronounced in developed market equities compared to emerging markets due to outperformance in China. China was the only major country with a positive monthly return as Chinese stocks benefited from a declining growth rate in new virus cases.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, DECEMBER 2016 THROUGH FEBRUARY 2020

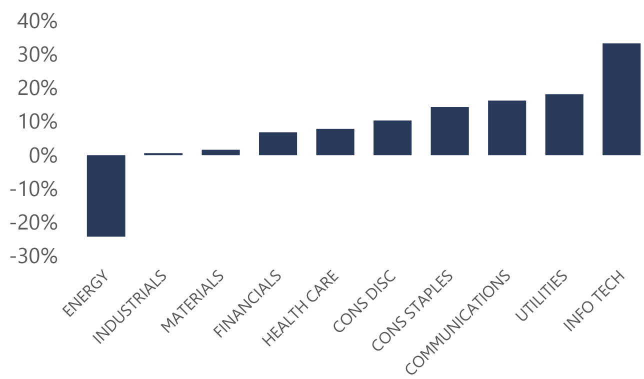


Source: Bloomberg

- The S&P 500 avoided an earnings recession by posting positive growth in the fourth quarter after contracting in the third quarter. Modest earnings growth of 1.3% was better than analysts' forecast for a 1.3% decline. Excluding energy's 43.7% earnings decline, the S&P 500 earnings grew 4.0%. Revenue growth of 2.8% beat analysts' estimates for 2.3% growth.
- The technology, consumer discretionary, and utilities sectors were the largest drivers of the S&P 500's better-than-expected growth with each sector posting growth rates more than 6.0% above analysts' estimates.
- Analysts forecast negative first quarter earnings growth followed by an improvement later in the year, but estimates may be revised lower due to the COVID-19 outbreak.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

FEBRUARY 2019 THROUGH FEBRUARY 2020



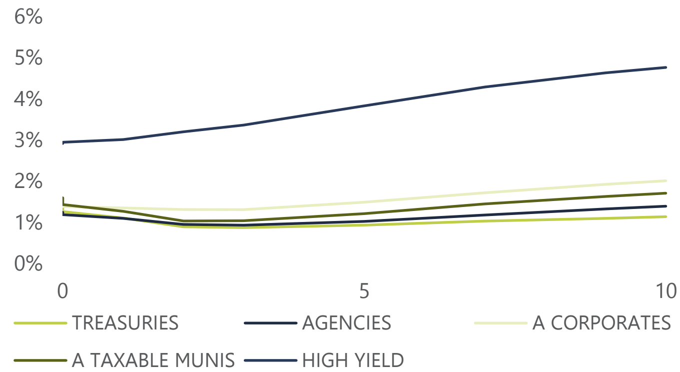
Source: Bloomberg

- The energy and financials sectors led the stock market decline with both sectors posting double-digit losses in February. Mounting concerns regarding weaker oil demand amid the COVID-19 outbreak resulted in energy shares plummeting in line with oil's 13.6% decline. The financials sector was impacted by the yield curve inverting again and the steep decline in the 10-year U.S. Treasury bond yield to an all-time low of 1.2%.
- Communications and health care sectors performed the best in February as both lost close to 6.5%. In communications, "stay-at-home" stocks such as Netflix and some video game makers performed relatively well. In health care, some biotechnology stocks rose amid hopes for a coronavirus vaccine.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF FEBRUARY 2020

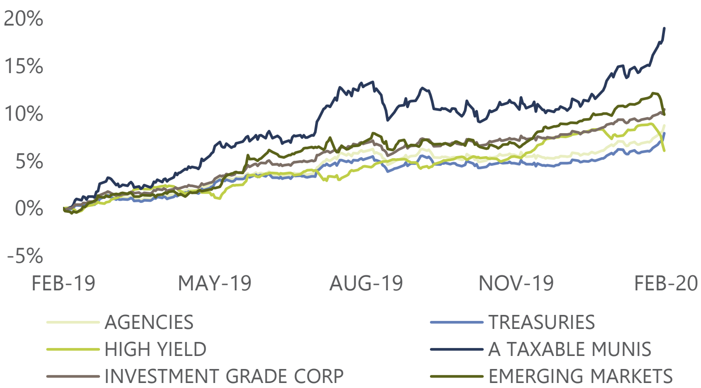


Source: Bloomberg

- The U.S. Treasury yield curve shifted lower in February due to elevated demand for safe haven assets amid the COVID-19 outbreak.
- The 10-year and the 30-year Treasury yields moved sharply lower in February and finished the month at all-time lows of 1.15% and 1.68%, respectively.
- The yield curve fell back into inversion in February as the 3-month Treasury yield finished the month 0.14% higher than the 10-year Treasury yield. The yield curve inverted last May for the first time since 2007 and returned to positive territory in October.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

FEBRUARY 2019 THROUGH FEBRUARY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- Each of the fixed income sectors shown in the accompanying chart generated a healthy price return above 6.0% over the past 12 months as yields have continued to decline over the period.
- Taxable municipal bonds performed better than other areas of the bond market over the past 12 months with a 19.0% price return. The next best performing bond segment, intermediate-term investment grade corporate bonds, had a price return of 10.5% over the same period.
- Each of the fixed income sectors shown in the accompanying chart has maintained a positive rolling one-year price return since March of 2019.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

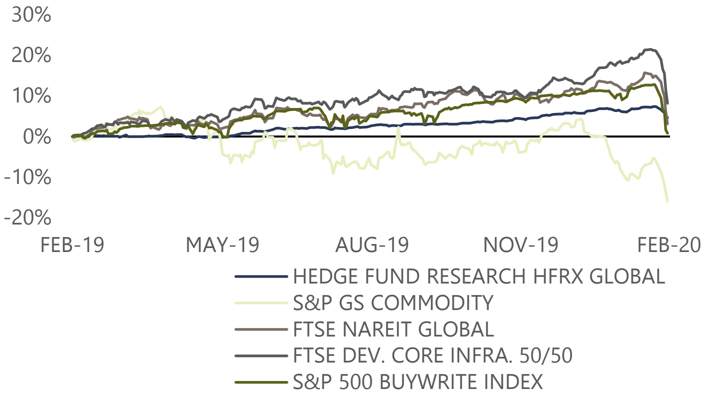
FEBRUARY 2017 THROUGH FEBRUARY 2020

Source: Bloomberg

- Spreads for all of the fixed income sectors shown in the accompanying chart, except taxable municipals, moved above their two-year average spreads in February after being below them in January .
- The two fixed income sectors with corporate credit exposure, Corporate A and Corporate BB, saw their spreads widen during the month, signaling that investors view corporate credit as becoming riskier.
- Single A-rated taxable municipal bonds were the only fixed income sector that experienced spread tightening during the month.

ALTERNATIVES

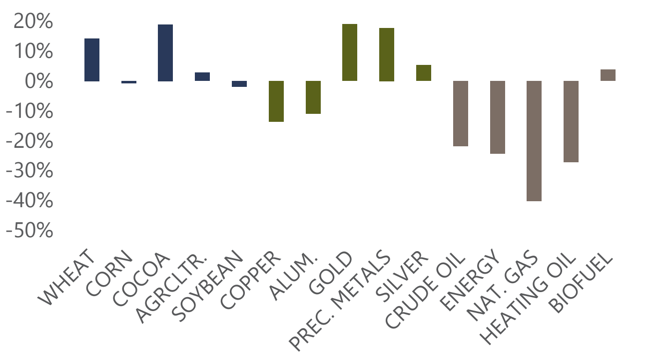
ALTERNATIVES, 12-MONTH RETURNS
FEBRUARY 2019 THROUGH FEBRUARY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- The global hedge fund asset class was the only one of the five alternative asset class indexes shown on the chart to the left to provide significant downside protection against sharp declines in global equity markets during the second half of February.
- Most energy and industrial metal prices remained under pressure from growing concerns about how hard the global economy would be hit by the spread of COVID-19. U.S. oil prices declined 13.6% in February to close the month under $45 per barrel following a 15.6% decline in January.
- In recent weeks, the International Energy Agency (IEA) indicated its expectation for global oil demand to decline by 435,000 barrels per day in the first quarter.

COMMODITIES, 12-MONTH SPOT RETURNS
FEBRUARY 2019 THROUGH FEBRUARY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- U.S. crude oil prices entered bear market territory in early February following a rapid 20% decline from an eight-month closing high above $63.00 per barrel on January 6 to below $50 per barrel.
- Travel restrictions, curfews and quarantines across large swathes of China in response to the COVID-19 virus have caused market participants to anticipate a significant reduction in oil demand in coming months.
- Gold remains one of the only bright spots across the commodities complex, as the precious metal advanced 5% in the first two months of 2020 following an 18% advance in 2019. Gold's popularity among investors has increased in response to heightened global geopolitical tensions, falling global interest rates and uncertainty surrounding the COVID-19 virus.

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
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