Truist Advisory Services, Inc.

Global Perspective

Despite recent weakness, the U.S. dollar will maintain its dominance in the global financial system

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from the Investment Advisory Group
Truist Advisory Services, Inc.

TRUIST

Wealth

Executive summary & background

Eylem Senyuz
Senior Global Macro Strategist,
Portfolio & Market Strategy

Executive summary

Since the end of the second world war, the size and strength of the U.S. economy have supported the U.S. dollar (USD) and helped it become the dominant currency in the global economy, known as the world's reserve currency.

Recently, though, concerns have arisen that the USD will be replaced as the reserve currency. There are three primary reasons why we believe that the USD will maintain its dominance in the global financial system:

1. **The USD's network effects make it difficult to conduct trade in other currencies.**
2. **There is no viable substitute to replace the USD's liquidity, universal acceptance, availability, or stability.**
3. **The long-term strength of the U.S. economy is due to the three "I" factors—Institutions, Innovation, and Inclusion—not because the USD is a reserve currency.**

Accordingly, we expect the USD to maintain its reserve currency status both in the near and longer term.

Background

Lately, many headlines have touted the increased usage of other currencies.

- Saudi Arabia and China announced that they are open to trading in currencies other than the USD. China also funded a $12.2 billion new oil facility in the Kingdom.
- The Chinese renminbi replaced the USD as the most traded currency in Russia.
- Brazil agreed to trade more with China in renminbi, and its renminbi reserves surpassed those in the euro for the first time.
- India and the United Arab Emirates (UAE) are discussing using the Indian rupee for trade.
- Malaysia is rekindling the Asian Monetary Fund idea that died a couple of decades ago.
- France settled its first liquified natural gas (LNG) cargo using the Chinese renminbi.

Therefore, around the edges, these headlines indicate some erosion in the USD's importance on the global stage.

Over the last two decades, the USD's reserve currency status has been questioned multiple times. One of the most memorable episodes was in November 2004 when the popular weekly economic/business magazine, *The Economist*, ran an article titled "**The dollar's demise,"** raising existential questions about the USD's future. The magazine cited Federal Reserve Chair Alan Greenspan's speech where he infamously said**, "Given the size of the current account deficit, a diminished appetite for adding to dollar balances must occur at some point."**

Unsurprisingly, the magazine declared Alan Greenspan's words were of a huge moment, not because of the clarity of his message but because a highly credible, right-thinking economist admitted what many had long believed at that time—that the emperor had no clothes. The USD dropped to a record low after this speech, and many believed that the currency was doomed to lose its reserve status not too long in the future.

Executive summary & background continued

During the early years of the new millennium, **the European Union was on a strong footing**, with member countries enjoying strong growth rates, and the common currency reached new all-time highs against the USD nearly every other month. Again, in 2004, the basic assumption was the European Union was an immensely successful political union with benefits of unfettered free trade, capital, and labor mobility so great that the euro would eventually dethrone the U.S. as the world's new reserve currency.

During those years, **China was growing at double digits**, with many investors stampeding to invest in the country, and it was the top destination for global manufacturing lines. Chinese leadership – under President Hu Jintao and his Premier, Wen Jiabao – was pushing economic equality through the "Scientific Development Concept" – aiming for a socialist, harmonious society that was prosperous and free of social conflict. In foreign policy, China practiced soft power in international relations and, more importantly, diplomacy that promoted a business-friendly environment. At the time, the basic assumption was that China's economic growth rate would continue at that pace for many years, making it the world's largest economy and eclipsing the U.S. in a decade or so.

In Japan, **reformist Junichiro Koizumi was the prime minister** and was preparing the country for its next influential leader, Shinzo Abe. Shinzo Abe had a grand vision for his country with his three arrows strategy—also known as Abenomics—that involved (1) aggressive monetary policy, (2) fiscal consolidation, and (3) a growth strategy. Due to health reasons, Shinzo Abe couldn't finish his first term, but later in 2012, he implemented his transformative policies and became Japan's longest-serving prime minister.

Fast forward nearly two decades to today from Greenspan's infamous 2004 speech, and the world looks very different than the basic assumptions or projections many had back then.

Our take

We acknowledge that there are near-term challenges to the USD's dominance, but there is no viable alternative to replace it, at least not yet. **Countries are free to trade with any currency they wish.** As a matter of fact, they do not even have to use any currency; they can barter. An oil-rich country can send barrels of oil to a banana-rich country to get a container full of bananas.

The question is, what happens if one country sells more goods or services and there are extra savings or reserves? Where are those savings stored? Is it in the USD or any other currency? If it is not stored in the USD, an alternative must exist. The apparent options are the euro, Japanese yen, and, more importantly, the Chinese renminbi.

If the Chinese renminbi is the alternative, then the questions become:

1. Would savers trust Chinese institutions?
2. Is the Chinese renminbi liquid enough to store excess savings?
3. Are financial markets in China open to all and offer the same sophistication as the U.S. markets?

We believe the answer to all questions above is a resounding "No." On the other hand, Europe has an opportunity to gain market share, which it has done since 2000—as a matter of fact, Europe has gained much more than China has. Since the COVID-19 crisis, the European Union (EU) has shown unprecedented solidarity by issuing a significant amount of jointly-backed debt. Even with that, the EU's integration is nowhere near that of the U.S., where 50 states formed a fiscal and military union.

The USD’s network effects

The USD is bought or sold in about 88% of global foreign exchange (FX) transactions, based on data from the latest Triennial Central Bank Survey conducted by the Bank for International Settlements, and the USD’s share has remained stable over the past 20 years. In contrast, the Chinese renminbi, which was non-existent in FX transactions outside of China, gained a 7% market share over the last decade (slide 8).

The USD is the preferred currency for foreign debt issuance and has been gaining market share in the issuance market since the global financial crisis. For debt issuance by sovereigns, quasi-sovereigns, and corporations in a currency other than that of their home currency, **64% have preferred to issue bonds in USD**, which is 4% higher than during the global financial crisis. On the other hand, the Chinese renminbi’s share is only at 2% (slide 9).

There is almost a trillion dollar’s worth of paper banknotes used in countries overseas—or **44% of all U.S. physical banknotes**—according to estimates by the Federal Reserve. There are two main benefits of paper currency held by foreigners. First, in order to accumulate USD, foreigners must sell goods and services, and in return, they receive money in only paper form. Second, the U.S. government does not have to pay interest on paper currency, and annual inflation erodes purchasing power of the banknotes that are floating around (slide 10).

Lastly, in the U.S., a common misconception is that most U.S. government debt is owned by foreigners, where there is a risk of them suddenly selling all the bonds at once. **Domestic entities, including the Federal Reserve, own the majority of U.S. government debt,** and the level of that ownership has moved back to 1999 levels, increasing with rates moving higher.

Our take continued

Foreign owners of U.S. debt will receive USD in electronic or paper form if they decide to sell, and the Federal Reserve can choose to buy excess debt offered in the market as it did during the pandemic. As of January 2023, China's U.S. Treasury holdings were valued at $860 billion and were 3.5% of total outstanding U.S. government bonds (slide 11).

No viable substitutes to the USD

To replace the USD's dominance in global finance, there must be an alternative to use in its place. The obvious ones include the euro, Japanese yen, and the Chinese renminbi.

1. **Euro:** The EU went through an existential crisis during the European financial crisis of 2015-16. Greece was forced to restructure its external debt and introduce capital controls. For three years, its citizens were forced to follow strict cash withdrawal limits from its banks. Greek equity indices were downgraded from developed markets status to emerging markets—and to this day, it is still a member of the emerging markets index. The banking system failed in Cyprus, and many depositors lost their savings. At one point, Greece was at the precipice of an abrupt departure from the EU. Thankfully, Greece did not exit from the EU, but a year later, the U.K., Europe's second-largest economy, did. The U.K.'s exit, known as Brexit, shook the EU at its foundation, and the unexpected trade frictions that it created slowed European and U.K. growth rates and productivity. In short, while many were expecting the euro to replace the USD as the world's new reserve currency, the euro muddled through very tough waters over the last two decades. Last year, the currency traded well below parity, 30% lower than at the end of 2004 (slide 12).

2. **Japanese yen:** Since 2004, the transformative leader, Shinzo Abe, managed to implement his three arrows strategy during his second—and much longer—term, but the result was a Japanese yen that was much lower than the USD with little economic growth or productivity gains to show for it. Japan's economy has grown by 17% in real terms since 2000, while the U.S. has grown 58%. Japan is in a steep population decline, losing one person every minute, which is faster than any other developed country. It is hard to find a good reason to keep extra savings in a country that is in a permanent decline in terms of growth or population (slide 13).

3. **Chinese renminbi:** During the early years of the new millennium, the hope was that China would eventually adopt Western-style capitalism that would benefit all parties involved. Instead, Chinese capitalism is looking more like "Surveillance Capitalism," where every move is recorded, and without warning, wealth can be taken away from participants with no legal protection against the state. For local citizens and entities, China runs strict controls on capital mobility, where there are limits to sending money overseas. These limits are there for a reason—to stop savings flowing to other currencies, mainly to the USD. It would be hard to convince foreign investors to keep their savings in renminbi when the local savers want to do the complete opposite. Since 2004, the Chinese currency has appreciated against the USD. However, this is not because it was gaining market share in reserve balances or global trade, but because the currency was pegged to the USD for a long time at an undervalued level. This allowed the currency to gain competitive market share against export-oriented economies in Asia and Europe. Once the peg was removed, the currency started to gain.

Our take continued

No viable substitutes to the USD (continued)

3. **Chinese renminbi continued**
   Last year, Xi Jinping appointed himself for an unprecedented third term with no apparent end to his presidency. In foreign policy, the country adopted what is known as “wolf warrior diplomacy," replacing the previous President Hu Jintao's use of cooperative rhetoric and the avoidance of controversy. Over the last decade, the Chinese growth rates dropped to low single digits, surveillance capitalism shackled private enterprises, and the common prosperity drive curtailed the optimized capital allocation. While China achieved an active role on the world stage, the fault lines with the West became much more visible. Distrust between China and the West, especially with the U.S. but also with India, Australia, and the EU, grew to worrisome levels (slide 14).

Bottom line: There is no alternative to the USD—the long-term strength of the U.S. economy is well supported by the three “I” factors

The USD will remain the reserve currency, not because crude oil or other commodities are traded in USD or because two far away countries prefer to trade in USD.

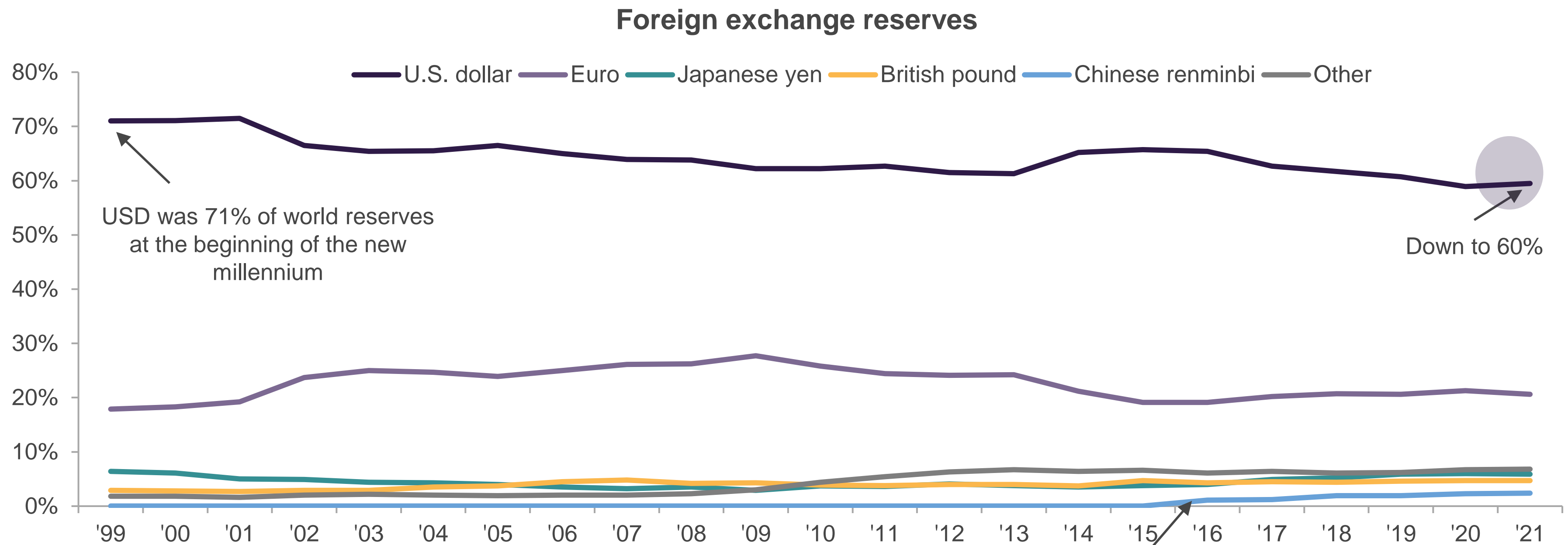
It will remain the reserve currency due to three primary factors that support the U.S. economy’s strength and dominance in the global financial system.

1. **Institutions** in the U.S. provide a supportive background for the economy. These include the rule of law, clear separation of power, strong intellectual property rights, relatively independent monetary policy, and fair and open elections.
2. **Innovation** depends on strong intellectual property rights, where the rule of law allows it to bloom.
3. **Inclusive** society allows ideas to flourish from every angle; human resources are used at maximum levels, and almost limitless capital allows those best ideas to generate compounded growth and productivity.

There is no other country that can offer these exceptional attributes at the scale of the U.S. Like many who made the same mistake in 2004, let us not overestimate the trajectories of other currencies relative to the USD.

Since the end of 1999, the USD has lost some ground in terms of reserves, but still, 60% of the world's reserves are stored in the USD

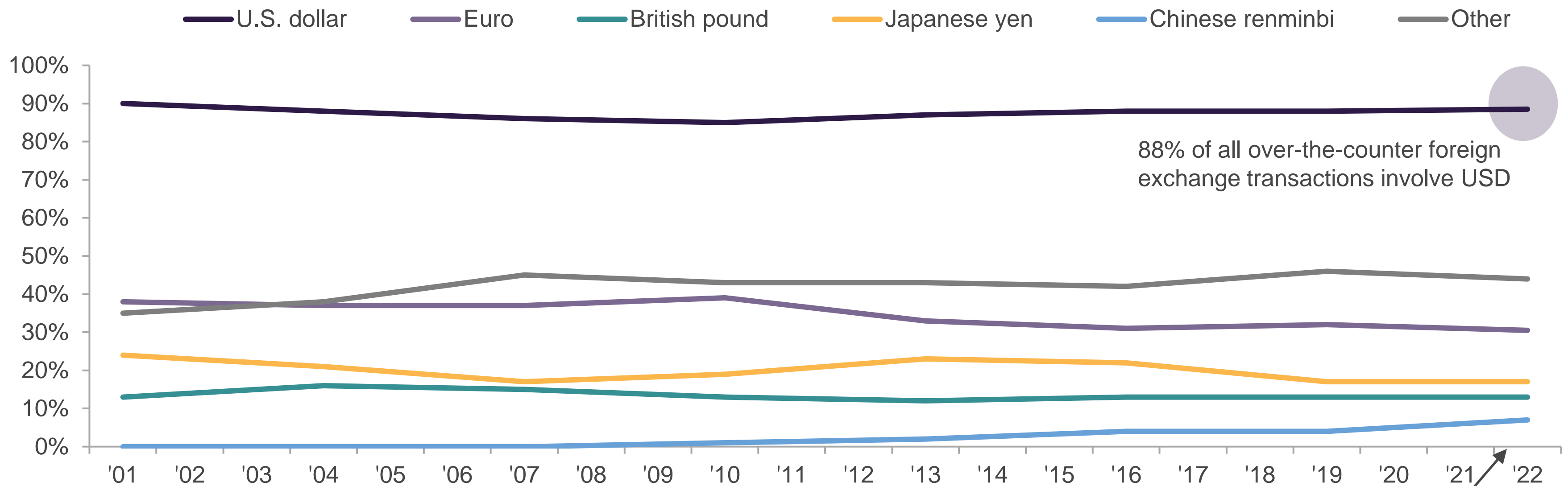
According to International Monetary Fund (IMF) data, the USD has lost some of its share in reserves to other currencies since the beginning of the new millennium. Contrary to popular belief, most gains were in the euro and other currencies (such as the Canadian and Australian dollar) rather than in the Chinese renminbi. In 2015, the Chinese renminbi started appearing in reserve data, but the pace of gain is much slower than in headline news.



Data source: Truist IAG, IMF

The USD is dominant in international transactions

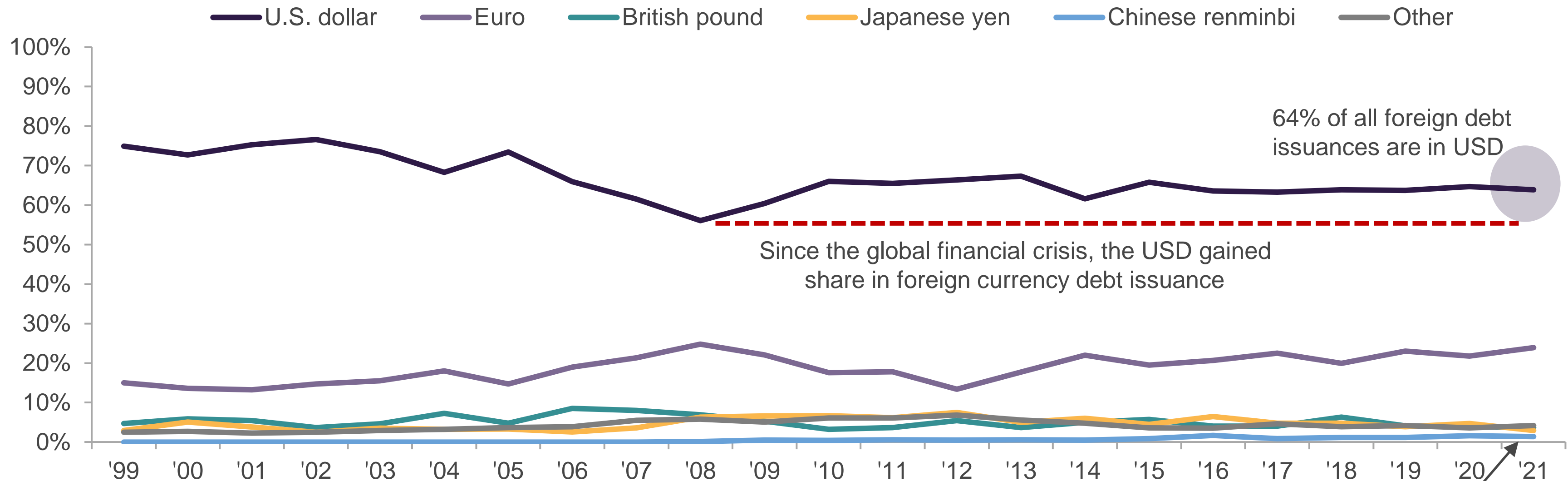
According to the latest Triennial Central Bank Survey from the Bank for International Settlements, the USD is bought or sold in about 88% of global FX transactions. This share has remained stable over the past 20 years. In contrast, the Chinese renminbi, which was non-existent in FX transactions outside of China, gained a 7% market share over the last decade.



Data source: Truist IAG, BIS Triennial Central Bank Survey of FX and OTC Derivatives Market – last survey was in 2022, survey is done once every three years with a start year of 2001.Years in between survey years are interpolated. Percentages add up to 200% because every foreign exchange transaction includes two currencies.

The USD is the preferred currency to issue foreign debt and has been gaining market share since the global financial crisis

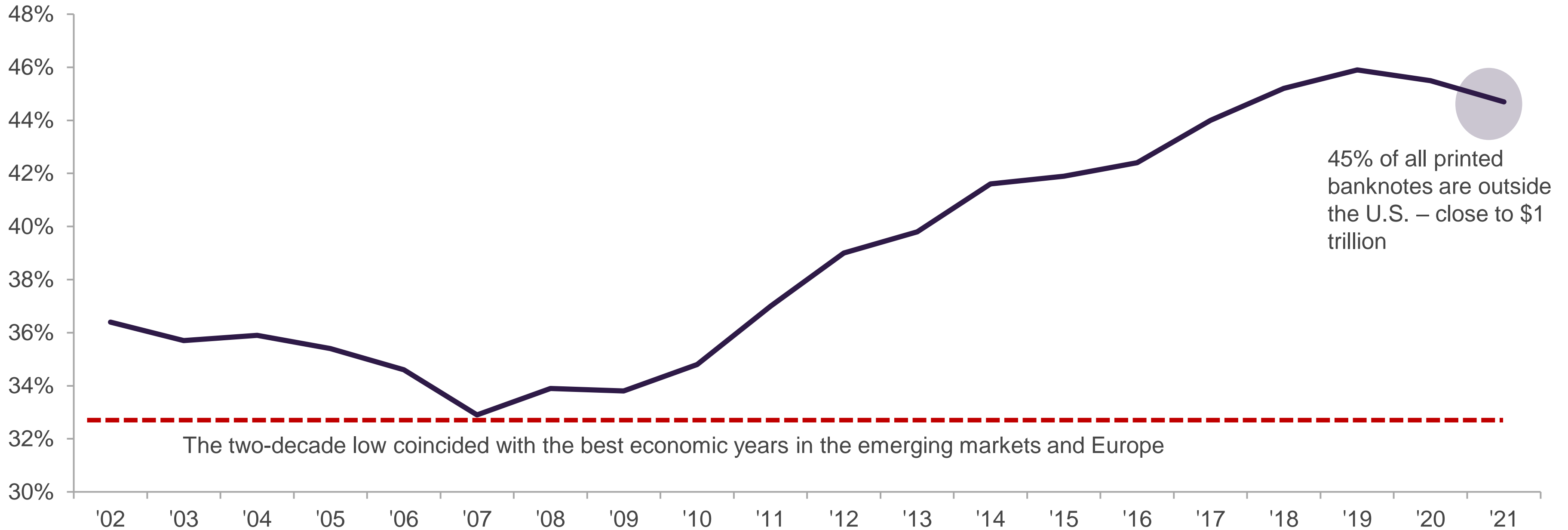
The debt issuance by sovereigns, quasi-sovereigns, and corporates in a currency other than that of their home country is also dominated by the USD. The percentage of foreign currency debt denominated in the USD has remained above 60%. Since the global financial crisis, the USD has gained a higher share in foreign currency debt issuance. The Chinese renminbi is at 2%.



Data source: Truist IAG, Federal Reserve Economic Data

There are almost as many physical U.S. dollars outside the U.S. as in the U.S.

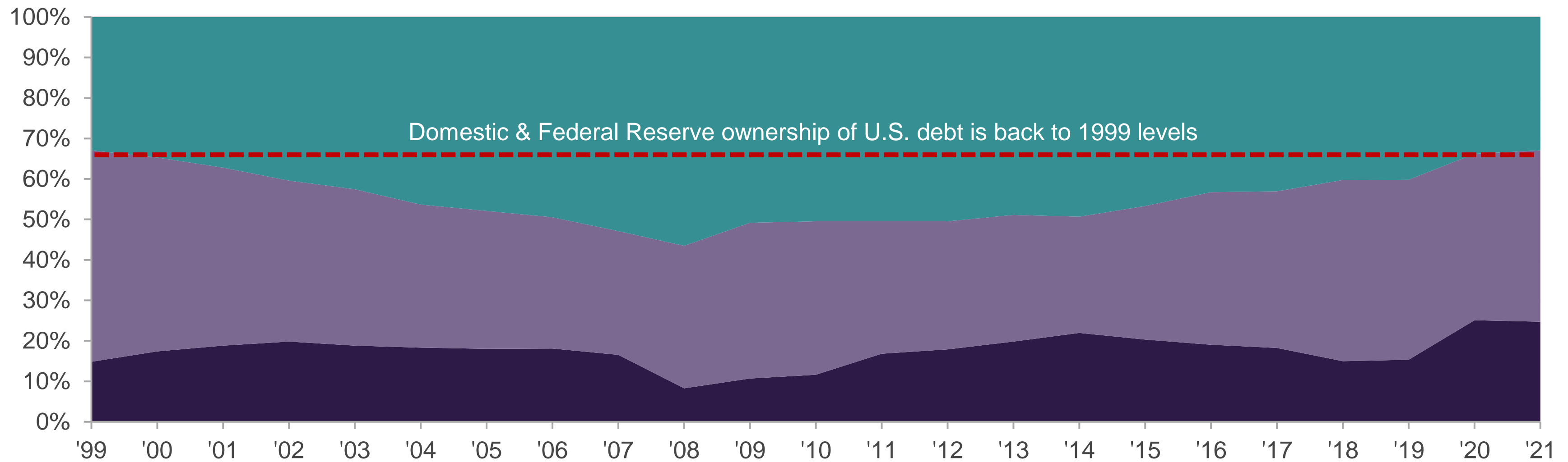
By far, the most valuable U.S. export is USD banknotes. According to Federal Reserve estimates, almost a trillion dollar's worth of paper banknotes are used in overseas countries. There are two main benefits of paper currency held by foreigners. First, in order to accumulate USD, foreigners must sell goods and services, and in return, they receive money in only paper form. Second, the U.S. government does not have to pay interest on paper currency, and annual inflation erodes purchasing power of the banknotes that are floating around.



Data source: Truist IAG, Federal Reserve Economic Data

Who owns most of the U.S. government debt?

Domestic entities and the Federal Reserve own the majority of U.S. government debt, and the level of that ownership has moved back to 1999 levels, increasing alongside higher interest rates.



Data source: Truist IAG, U.S. Treasury

The euro's rocky path since Alan Greenspan's warning on chronic U.S. current account deficits

The EU passed through an existential crisis during the European financial crisis of 2015-16. Greece was forced to restructure its external debt and introduce capital controls. The banking system failed in Cyprus, and many depositors lost their savings. At one point, Greece was at the precipice of an abrupt departure from the EU. Thankfully, Greece did not exit from the EU, but a year later, the U.K., Europe's second-largest economy, did.

Data source: Truist IAG, Bloomberg, exchange rate of 1 euro in USD.

The Japanese yen is 20% cheaper since Alan Greenspan's warning

The transformative leader, Shinzo Abe, managed to implement his three arrows strategy during his second—and much longer—term, but the result was a Japanese yen that was much lower than the USD with little economic growth or productivity gains to show for it. Many realized that Japan's main obstacle is the chronic decline in its population. It is so dramatic that Japan loses one person from its population every minute.

Data source: Truist IAG, Bloomberg; exchange rate of 1 USD in Japanese yen.

Chinese renminbi appreciated because it was undervalued when it was pegged before 2005

Since 2004, China's currency has appreciated against the USD. This is not because it was gaining market share in reserve balances or global trade but because the currency was pegged to the USD for a long time at an undervalued level. This allowed the currency to gain competitive market share against export-oriented economies in Asia and Europe. Once the peg was removed, the currency started to gain.

Data Source: Truist IAG, Bloomberg, exchange rate of 1 USD in Chinese renminbi.

Bottom line: There is no alternative to the USD

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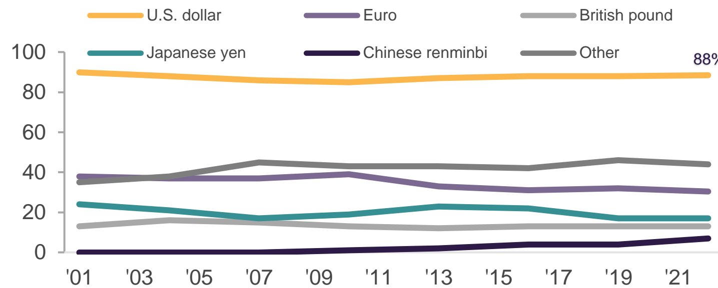

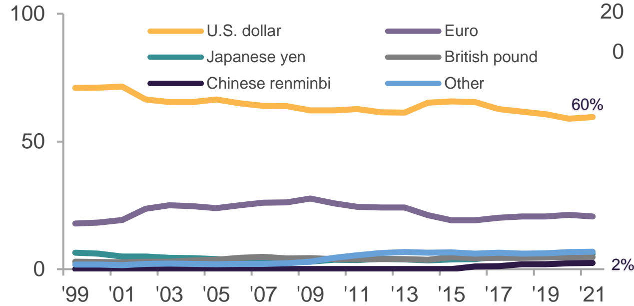

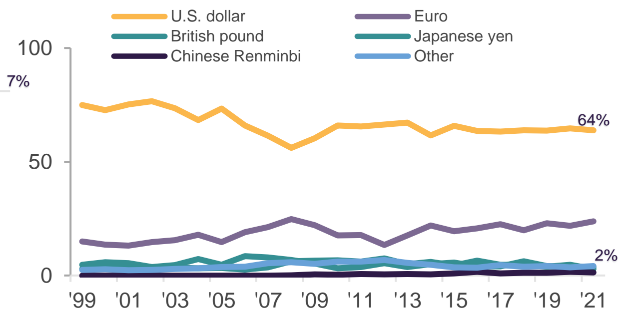

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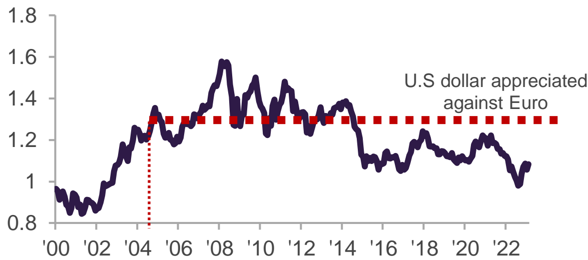

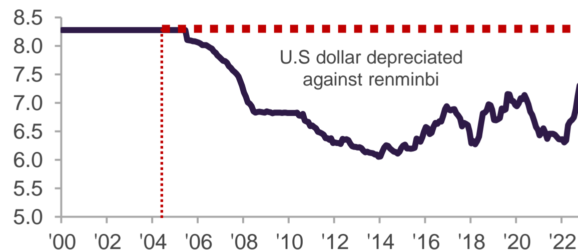

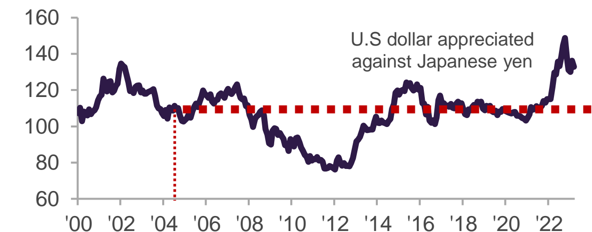

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Data source: Truist IAG, IMF, * BIS Triennial Central Bank Survey of FX and OTC Derivatives Market – last survey was in 2022, survey is done once in three years with a start year of 2001.Years in between survey years interpolated. Percentages add up to 200% because every foreign exchange transaction includes two currencies.

Wealth

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S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

Equity is represented by the MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries*. With 2,757 constituents, the index covers approximately 85% of the global investable equity opportunity set

Fixed Income is represented by the Barclays Aggregate Index. The index measures the performance of the U.S. investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.

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Commodities are represented by the Bloomberg Commodity Index which is a composition of futures contracts on physical commodities. It currently includes a diversified mix of commodities in five sectors including energy, agriculture, industrial metals, precious metals and livestock. The weightings of the commodities are calculated in accordance with rules that ensure that the relative proportion of each of the underlying individual commodities reflects its global economic significance and market liquidity.

Cash is represented by the ICE BofAML U.S. Treasury Bill 3 Month Index which is a subset of the ICE BofAML 0-1 Year U.S. Treasury Index including all securities with a remaining term to final maturity less than 3 months.

U.S. Large Cap Equity is represented by the S&P 500 Index which is an unmanaged index comprised of 500 widely-held securities considered to be representative of the stock market in general.

U.S. Mid Cap is represented by the S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

U.S. Small Cap Core Equity is represented by the S&P 600 Small Cap Index which is a measure of the performance of the small-cap segment of the U.S. equity universe

International Developed Markets is represented by the MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the U.S. and Canada. With 921 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Emerging Markets is represented by the MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Value is represented by the S&P 500 Value Index which is a subset of stocks in the S&P 500 that have the properties of value stocks.

Growth is represented by the S&P 500 Growth Index which is a subset of stocks in the S&P 500 that have the properties of growth stocks.

U.S. Government Bonds are represented by the Bloomberg U.S. Government Index which is an unmanaged index comprised of all publicly issued, non-convertible domestic debt of the U.S. government or any agency thereof, or any quasi-federal corporation and of corporate debt guaranteed by the U.S. government

U.S. Mortgage-Backed Securities are represented by the U.S. Mortgage-Backed Securities (MBS) Index which covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

U.S. Investment Grade Corporate Bonds are represented by the Bloomberg U.S. Corporate Investment Grade Index which is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding.

The S&P U.S. REIT index measures the investable universe of publicly traded real estate investment trusts domiciled in the United States

U.S. High Yield Corp is represented by the ICE BofAML U.S. High Yield Index tracks the performance of below investment grade, but not in default, USD denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.

Floating Rate Bank Loans are represented by the Credit Suisse Leveraged Loan Index. The index represents tradable, senior-secured, U.S.-dollar-denominated non-investment-grade loans.

Global Equity is represented by the MSCI All World Country (ACWI) Index which is defined as a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI Index consists of 48 country indices comprising 24 developed markets countries and 24 emerging markets countries.

Emerging Markets Equity is represented by the MSCI EM Index which is defined as a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets countries

Intermediate Term Municipal Bonds are represented by the Bloomberg Municipal Bond Blend 1-15 Year (1-17 Yr) is an unmanaged index of municipal bonds with a minimum credit rating of at least Baa, issued as part of a deal of at least $50 million, that have a maturity value of at least $5 million and a maturity range of 12 to 17 years.

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U.S. Core Taxable Bonds are represented by the Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, USD-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

Slide 50 – EU Corporate is represented by the Bloomberg Euro-Aggregate Corporates Index which is a benchmark that measures the corporate component of the Euro Aggregate Index and includes investment grade, euro-denominated, fixed-rate securities.

U.S. Government Bonds are represented by the Bloomberg U.S. Government Index which is an unmanaged index comprised of all publicly issued, non-convertible domestic debt of the U.S. government or any agency thereof, or any quasi-federal corporation and of corporate debt guaranteed by the U.S. government.

U.S. IG Corporate Bonds are represented by the Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S.D denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

U.S. High Yield Corporate Bonds are represented by the ICE BofAML U.S. HY Master Index which is an index that tracks USD denominated debt below investment grade corporate debt publicly issued in the U.S. domestic market.

S&P 500 Information Technology Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the information technology sector based on GICS® classification.

S&P 500 Financials Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the financials sector based on GICS® classification.

S&P 500 Energy Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the energy sector based on GICS® classification.

S&P 500 Materials Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the materials sector based on GICS® classification. S&P

500 Industrials Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the industrials sector based on GICS® classification.

S&P 500 Consumer Discretionary Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the consumer discretionary sector based on GICS® classification.

S&P 500 Communication Services Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the communication services sector based on GICS® classification.

S&P 500 Utilities Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the utilities sector based on GICS® classification.

S&P 500 Consumer Staples Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the consumer staples sector based on GICS® classification.

S&P 500 Health Care Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the health care sector based on GICS® classification.

S&P 500 Real Estate Index – a capitalization-weighted index that is composed of those companies included in the S&P 500 that are classified as members of the real estate sector based on GICS® classification.

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