Investment Commentary

2nd Quarter 2018

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BIG FISH

I've got a few friends who love to send me pictures of the huge fish they just caught. Not a weekend passes without one of these guys lighting up my phone with photos of some oversized trout, bass or even exotic sportfish he's snared. The pictures are usually accompanied by a catchy message: "Blues are runnin' at Hatteras!" Or, "Cleanin' up down here in Costa Rica!" Even worse, several of our retired clients like to send pics of the monsters they caught on a Monday morning or Wednesday afternoon when I'm hard at work. "Landin' some lunkers in Alaska!" Or, "Bonefish bite is on in the Bahamas!" While I'd like to think their motive in sending me these mementos is pure—that they're thoughtfully including me in their fine adventure—the cynical side of me suspects their true aim is slightly less admirable. Since some of these fisherman friends of mine will read this letter, I hesitate to say they're obnoxiously shoving their trophy catch in my face to make me jealous. But they are. Adding to the insult, some of my pals know that I am not a great fisherman myself. It's true. I enjoy the sport and actually spend a fair amount of time with rod in hand.

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MARKET COMMENTARY

The S&P 500 Index was up 3.4% in the second quarter, bringing the year-to-date return to 2.7%. Recall that returns in the first quarter were slightly negative and that the first quarter was marked by a dramatic surge out of the chute followed by a sharp correction of 10% that started at the end of January. A return to the January high for the S&P 500 remained elusive during the second quarter as the market reacted to headlines on trade and interest rates. However, small cap stocks were particularly strong in the second quarter as the Russell 2000 was able to break through to new all-time highs with a 7.8% return. Volatility was more contained through the spring than in the first quarter but still elevated relative to the unusually calm markets we saw last year.

Foreign stocks did not fare as well. Emerging market stocks in particular struggled, as the MSCI Emerging Markets Index lost 8%. Some of the negative performance of foreign equity can be explained by the strengthening US dollar. With the US Federal Reserve being the only major central bank tightening monetary policy and

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Market Index Returns as of June 30, 2018

Index	2nd Quarter	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	3.4%	2.7%	14.4%	11.9%	13.4%	10.2%
Russell Midcap (US Mid Cap)	2.8%	2.4%	12.3%	9.6%	12.2%	10.2%
Russell 2000 (US Small Cap)	7.8%	7.7%	17.6%	11.0%	12.5%	10.6%
MSCI ACWI X-US IMI Net (Foreign Equity)	-2.6%	-3.7%	7.8%	5.5%	6.4%	3.0%
MSCI EM (Foreign Emerging)	-8.0%	-6.7%	8.2%	5.6%	5.0%	2.3%
Barclays Aggregate Bond	-0.2%	-1.6%	-0.4%	1.7%	2.3%	3.7%
Barclays Muni Bond	0.9%	-0.3%	1.6%	2.9%	3.5%	4.4%

Past performance is not an indication of future performance.

Market and Economy *(Continued from page 1)*

with economic growth slowing among most major non-US economies, the US Dollar Index (DXY) rose 5% in the second quarter relative to other global currencies.

Italy puts EU on edge

Political developments in Italy raised stress levels around the European Union in June when the populist Five Star Movement and anti-EU League parties formed a new government coalition—the 64th government since 1945. Five Star wants to create a monthly income for all Italians while the League wants to cut income taxes. Both parties want to lower the pension eligibility age. Together, these changes could add an estimated $200 billion to the already large annual budget deficit.

If Greece threatened the stability of the EU in 2011, Italy poses an even larger threat. Italy is the third-largest economy in the EU and ninth-largest in the world. Any stumble there could induce the European Central Bank to postpone plans to curtail its quantitative easing program early next year.

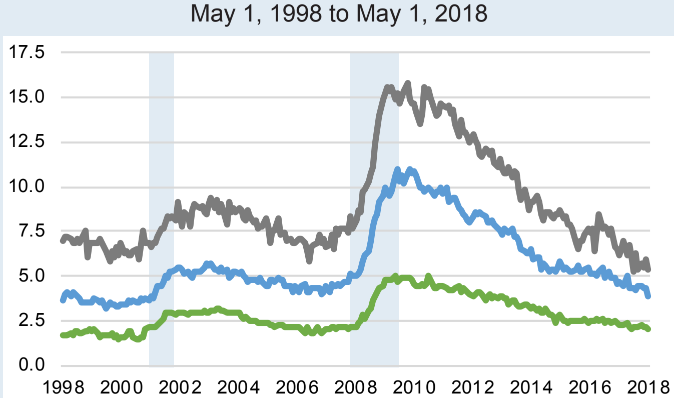
Borrowing costs are rising

"The economy is doing very well," declared Chairman Jerome Powell following the June Federal Reserve meeting. Accordingly, the Fed raised the Fed Funds rate another quarter of a percent for the second time in 2018 and seventh time since December 2015, bringing the overnight rate up to 1.75% - 2.00%. These moves have pushed interest rates higher but the current rate level is still relatively low as the Fed's neutral rate is around 3%. As of the June meeting, the majority of Fed committee members were expecting a total of four rate hikes in 2018—a sign the Fed expects continued economic growth and isn't putting too much stock into predictions of a full-blown trade war.

One of the reasons cited for the recent rate hike is that some businesses are reporting trouble finding qualified job seekers. The unemployment rate stands at 3.8% as of May's reading—the lowest rate since 1969—and is still trending

Unemployment Rates

May 1, 1998 to May 1, 2018



Shaded areas indicate US recessions. Source: US Bureau of Labor Statistics

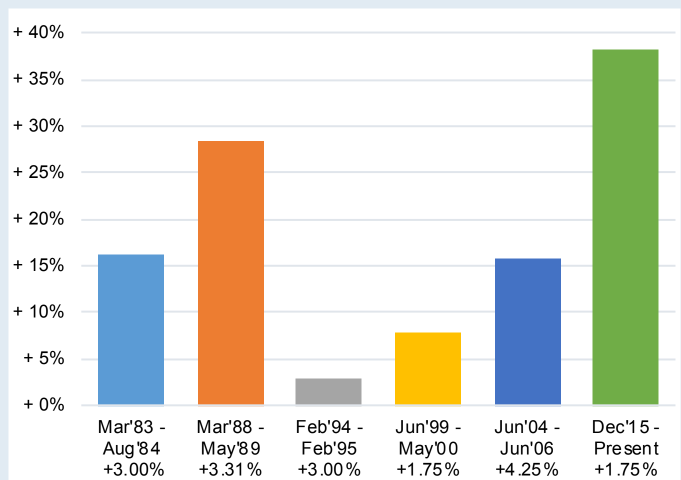
- Less than a High School Diploma, 25 years and over
- High School Graduates, No College, 25 years and over
- College Graduates, Bachelor's Degree, 25 years and over

lower across all areas of the labor market. Any further improvement in the labor market may result in wage pressures and a pick-up in inflation, which could signal that the economy is beginning to overheat as it usually does late in the economic cycle. This may prompt the Fed to raise rates at a faster pace and even overshoot the 3% neutral rate.

As the Fed has steadily raised rates, the difference between short- and longer-term Treasury yields has narrowed. Historically, when the three-month Treasury yield has risen above the yield of ten-year Treasury (referred to as a yield curve inversion), it has been a reliable warning sign of an impending recession. When the curve has inverted, a recession has generally started within two years. We aren't there yet but it is something we are watching closely.

In the interim, the Fed will likely keep pushing interest rates higher as long as the economy and the stock market continue to do well. That raises borrowing costs for everyone but doesn't necessarily mean stock prices will fall as a result. In fact, the stock market generally rises during periods when the Fed is hiking rates, as you can see in the accompanying chart. It shows market returns during periods when the Fed raised rates by more than 1% over the past 35 years.

S&P 500 Cumulative Returns During Periods When Fed Raised Rates by More than 1%



Dates of rising rates and total amount Fed Funds rate rose

Tariff rhetoric ratchets up

While tariffs on hundreds of billions of dollars' worth of imports have been discussed by the Trump administration, thus far, tariffs on just $34 billion in Chinese imports have been enacted since the March steel tariffs. As retaliation, China enacted their own tariffs, in this case on $34 billion worth of US exports. While a large number, it equates to less than 0.2% of our GDP.

Though we are currently talking trade on three fronts—China, Mexico and Canada (NAFTA), and Europe—we haven't yet devolved into an all-out trade war. As you can

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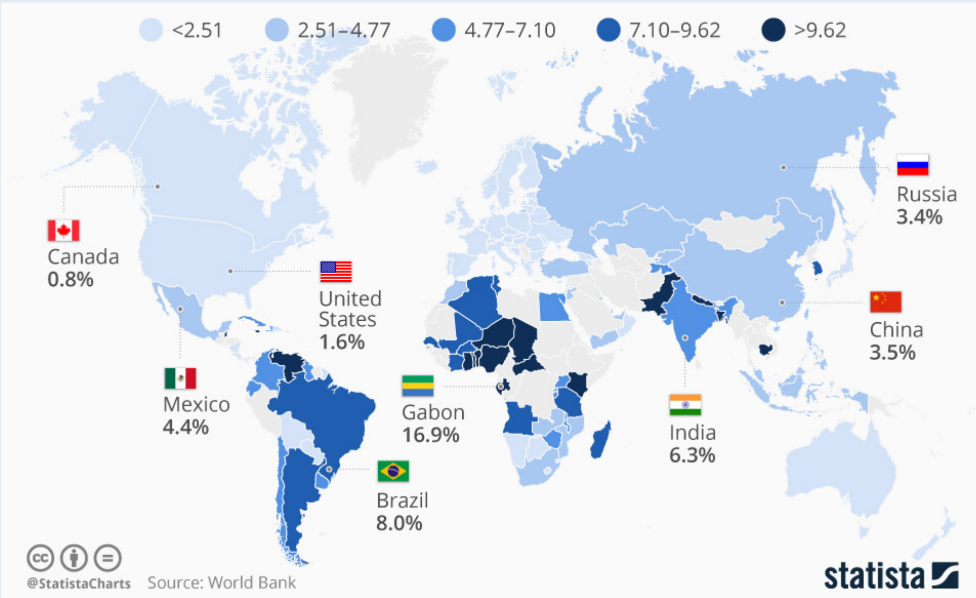
see from the world map of global tariff rates, the US has a long way to go before we are truly considered a protectionist country and trade restrictions have a major impact on our economy.



Source: Statista Charts, World Bank

The back-and-forth rhetoric is having an effect, however, as many businesses are delaying new projects and wage increases due to trade worries. The Atlanta Federal Reserve Bank recently cut their previous GDP growth estimate for the second quarter from 4.8% to 3.8% as a result. The trade situation is likely far from over. We are still hoping for a negotiated resolution because we've learned from history that no one tends to win in a prolonged trade war.

Earnings growth is built into market prices

S&P 500 earnings are expected to grow by 20.5% in 2018 according to FactSet. And yet the S&P 500 Index is up just 2.7% for the year. In what may seem like a contradiction, stock returns are usually lower when earnings growth is high. Conversely, returns are usually higher when earnings growth is low or negative. This is because the stock market is forward looking. Expectations for future earnings are usually already reflected in current market prices.

The stock market detests uncertainty, so we are likely to continue to see bouts of volatility while the trade situation plays out. That's not the worst thing for investors because whenever there is broad consensus that "everything is great," the market tends to be set up for failure. The general mood to start the year was very positive and the market shot higher. But then it only took one better-than-expected wage-growth reading to set off a 10% correction.

A high level of uncertainty (fear) may mean that market participants see an above-average probability of a pending recession or slowing earnings growth but this uncertainty also creates an environment where unexpected good news can potentially move stock prices higher.

Matthew S. DeVries, CFA ■

Big Fish *(Continued from page 1)*

But the fact is, I don't catch many fish. Thus, when these pics come rolling in, well, what can I say, it hurts.

The bright side to my not being a good fisherman is that whenever I take my kids fishing, they have very low expectations. If we catch anything at all (shark, skate, minnow, an old shoe), they are both shocked and delighted. Going fishing with Dad is code for "going to hang out with Dad for the next three hours and catching nothing at all." Fortunately for me, they usually still want to go.

Just last weekend we set out on yet another fishing expedition, this time while down at Litchfield Beach on the occasion of the Annual Beach Week of my wife's extended family. A crowd of us (aunts, uncles, cousins, grandparents) gathered at sunset as the tide came in on the southern tip of the island. Expectations were low. Most of the kids quit fishing after a few casts—past experience indicated that this was a reasonable course of action. Only the youngest of the cousins (my ten-year-old son, Charlie) still had his line in the water. We all chalked up his zeal to youthful naivety. It was then that little Charlie saw his rod double over. We crowded around him and watched as something big started taking line off his reel ziiiihn-ziihn-zzziiiiiiiiiiiiiiiiiiiiiiiih ng!! (Yes, that's the proper spelling). Ten of us immediately began offering Charlie "expert advice," shouting: "Keep it tight! Don't hoss him! Rod tip up! Reel it fast! Wind it, slowly! Back up some! Give him some line! You got him, Chuckie!" Like a seasoned angler, Charlie ignored our instructions, calmly loosened his drag, stepped slowly into the surf and patiently fought his fish. Seven minutes later he landed a 24-inch red drum. Needless to say, this greatly exceeded our expectations. As for me, I quickly snapped some pics and started shooting out text messages to my

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fishing friends. If you didn't get my text, see below for a picture of Charlie and his fish.

Speaking of low expectations and big fish, I'll make the case that investors who kept their discipline and stayed in the market over the last few years have caught a "big fish" in the form of good investment returns. And this happened even as expectations for good returns were exceptionally low. Since the low of March 2009, the S&P 500 is up over 300% cumulatively (excluding dividends). As we have discussed in past articles, this has been the most hated bull market in history. At every step of the way over the last nine years of the rally, it seemed the collective feeling of investors was skepticism that the rally could continue. Remarkably, in just the last 24 months, the market has jumped 30%. Two years ago in June of 2016, much of the economic and market news was discouraging at best. The economy was still struggling to achieve a growth rate of 2%. The market was dealing with the fallout of "Brexit" when the UK voted to leave the European Union. The Clinton/ Trump campaign saga was in full swing. Corporate earnings were declining; the 2016 first-quarter earnings drop for companies in the S&P 500 marked the fourth straight quarter of year-over-year declines. Fears of rising interest rates were abundant in 2016 (just as they had been for the three prior years) but at that point in time, rates remained low. The Fed had only raised rates once (December of 2015) and it wouldn't raise rates again until December of 2016. Indeed, it was exactly 24 months ago when the yield on the 10-year Treasury bond hit an all-time low of 1.37% (the yield was 2.85% as of 6/30/2018). Below are selected sections from a *Marketwatch* article by Anora Mahmudova that does a good job capturing the mood in June of 2016:

Charlie Bragg and his Big Fish

> 6/27/2016 *Marketwatch* - U.S. Treasury prices soared and yields plunged to four-year lows as investors continued to seek safe-haven assets in the wake of Britain's vote to leave the European Union last week. The benchmark 10-year Treasury yield hit an intraday low of 1.45% after the S&P 500 downgraded the U.K.'s credit rating to AA, from AAA, saying the event "will lead to a less-predictable, stable, and effective policy framework in the U.K."
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> "Treasury yields are falling because there are other risks out there besides Brexit—a weak global growth picture with equity bear markets in Europe and Japan," said Robert Tipp, chief investment strategist at Prudential Fixed Income. "There will be a knock-on effect on other European countries and this time there are no circuit breakers—rates are already at or below zero and there's no political will for fiscal stimulus. This kind of uncertainty is driving a risk-off mode," Tipp said.
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> Assets perceived as risky, such as equities and oil sold off sharply for a second-straight session on Monday, while gold, viewed as a safe harbor, rose to its highest level in more than two years. The selloff in equities follows Friday's rout, when global equity markets lost more than $2 trillion in value after the U.K. voted in favor of ending its membership in the European Union.

It certainly didn't seem like we were getting ready to make a lot of money in the stock market. And yet we were. Nor would one have imagined that the global economy was on the verge of turning around. And yet it was. As Matt DeVries points out in the Market Commentary, the global economy is growing and many economic measures for the US economy (GDP growth, employment, earnings growth, housing, business investment, etc.) now look more favorable. Despite the good news, stocks seem to have lost their momentum after peaking in January of this year. Many investors are wondering when the bull market will regain its stride. Shouldn't the market continue to rally in this economic environment? Why would we expect anything different?

Returning briefly to my fishing story, you'll recall that I described the low expectations among the members of our fishing expedition at Litchfield Beach. Those expectations were of course based on years of poor luck on similar expeditions in the past. Why would we have expected a different outcome this time? But different it was! In addition to his big drum, Charlie pulled in two flounders in quick succession and another member of our party pulled in a second huge drum. Of note, in the immediate aftermath of Charlie's big haul, I huddled excitedly with my brother-in-law and several of my nephews and began making plans for next year's trip.

One of my nephews said, "Next year we'll bring more rods and more bait and we'll come to this exact spot!" Another added, "Yeah, and let's get out here earlier and let's bring a big cooler for the fish we'll catch!" We all agreed. Can't you just picture our excitement?

There you have it. Fishermen and investors: both human, both emotional and often irrational. Neither can see the future. As always we think it makes sense to own an appropriate portfolio and to keep our expectations in check. We've caught a big fish and now we are rebalancing the portfolio. But as Charlie would advise, we still have our lines in the water.

Thank you for choosing Bragg. Have a great summer.

Benton S. Bragg, CFP®, CFA ■