INVESTMENT COMMENTARY

1st Quarter 2018

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INSIDE THIS ISSUE

LESSONS FROM 25 YEARS

I was sitting at my desk in the Davis Street branch office of NationsBank (now Bank of America) in Burlington, North Carolina, in January of 1993 when my father called and offered me a position at Bragg Financial Advisors. He said he needed help handling the growth of his company and was willing to match my current salary of $24,000 if I was willing to come. Making the decision to join the family business was of course a difficult one. But if you know Frank Bragg, you know that he can be persuasive. He had already lured over my older brother, John, two years earlier; Dad and John put the pressure on me and by May of that year, I was the fifth employee at Bragg. Twenty-five years, two recessions, two major bear markets and a good number of gray hairs later, perhaps it makes sense to reflect a bit on some of the lessons I've learned thus far in this business.

There will always be something to worry about. The Dow was at 3,435 when I joined Bragg in 1993. It closed at 24,103 for the quarter just ended. On price alone the Dow returned just under 7.5% annualized for the 25-year period. Assuming the reinvestment of dividends, the annualized return was 10.3%, a very nice showing,

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MARKET COMMENTARY

On the heels of one of the least volatile years for the stock market in the last century, 2018 is proving to be something very different. A very strong 5.7% gain for the S&P 500 Index in January was entirely wiped out just three trading days into February. Since that point, we have seen significant swings up and down. After falling nearly 10% in February, the NASDAQ was able to rally enough to make new all-time highs in March before again pulling back.

In the end, stock market losses were moderate considering the wild swings of the first quarter. The decline of 0.8% for the S&P 500 in the first quarter is just the second down quarter since the 4th quarter of 2012. Even with the recent volatility, the index is still up over 100% since then. February's drop also broke a 15-month streak of monthly gains for the S&P 500.

Most major asset classes moved slightly lower during the quarter. Of note, after a bang-up 2017 and a great start to the first quarter, foreign stocks ended up with the largest decline among equity asset classes. The MSCI All-Country World Index (excluding the US) fell 1.1%. But bonds were the biggest disappointment with the Barclays

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Market Index Returns as of March 31, 2018

Index	1st Quarter	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	-0.8%	14.0%	10.8%	13.3%	9.5%
Russell Midcap (US Mid Cap)	-0.5%	12.2%	8.0%	12.1%	10.2%
Russell 2000 (US Small Cap)	-0.1%	11.8%	8.4%	11.5%	9.8%
MSCI ACWI X-US IMI Net (Foreign Equity)	-1.1%	17.1%	6.8%	6.2%	3.1%
MSCI EM (Foreign Emerging)	1.4%	24.9%	8.8%	5.0%	3.0%
Barclays Aggregate Bond	-1.5%	1.2%	1.2%	1.8%	3.6%
Barclays Muni Bond	-1.1%	2.7%	2.3%	2.7%	4.4%

Past performance is not an indication of future performance.

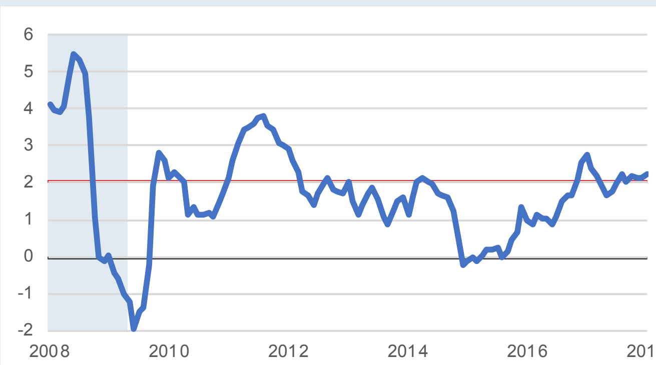
Market and Economy *(Continued from page 1)*

Aggregate Bond Index down almost 1.5% for the quarter as interest rates inched higher.

Strong report brings inflation concerns. The stock market has been on quite a run since President Trump's election victory. His economic policy promises—regulation reform, tax reform, and infrastructure spending—boosted investor confidence and drove stocks ever higher throughout 2017 and to an all-time high in late January of this year. Then some better-than-expected economic reports halted the climb and sent stocks lower in early February as investors worried about an overheating economy and the potential for higher interest rates.

The Labor Department's jobs report for January showed a 2.9% average hourly earnings gain for private-sector workers—a larger gain than was expected. The S&P 500 fell over 6% in just two days on fears that rising wages may finally start to push inflation above the Federal Reserve's 2% target (fears we've been hearing about since the Fed first started its quantitative easing program back in 2008). Inflation has been hovering just above 2% recently but this report reignited worries that inflation could start to pick up as labor costs rise and consumers with higher incomes ratchet up their spending.

Consumer Price Index for All Urban Consumers
Percent Change From Year Ago



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

So while this jobs report was good news for the average American and does not indicate a recession is looming, it could signal that the end of the bull market is at least edging closer. Inflation typically picks up later in the business cycle as unemployment falls and the pace of wage gains quickens. In a normal economic cycle, tight labor markets and rapidly-rising incomes prompt the Federal Reserve to raise interest rates to help manage rising inflation.

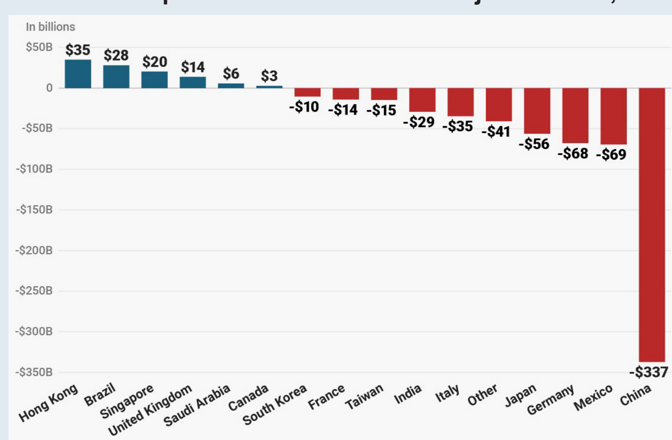
The Fed has a statutory mandate established by Congress: Full employment, stable prices and moderate long-term interest rates. Absent the need to keep interest rates low with US unemployment at a historically low level of 4.1%, the Fed could see a need to begin raising rates more quickly than planned. This would lead to higher borrowing costs and slower economic growth. Some of February's inflation fears were soothed by the February jobs report which showed private-sector average hourly earnings rose just 2.6%. But by then, a new issue had taken center stage.

Tariffs and a trade war could impact global trade. The tariffs on imported solar panels and washing machines announced by President Trump in January didn't garner much of a market reaction. It turned out he was just getting started. In late February, reports came out that the President would announce tariffs on steel and aluminum imports and this news sent the S&P 500 lower by 3.7% in the three days prior to the official announcement on March 1st.

Tariffs of 25% on steel and 10% on aluminum went into effect in late March. Temporary exemptions were granted to Canada and Mexico which may help spur negotiations to revamp NAFTA that have stalled over the past year. While these tariffs may boost steel and aluminum production domestically, they'll also push up input costs for domestic manufacturers or other companies who use these commodities in production. Home building is by far the largest industry that will be affected. We may see higher home prices and fewer new homes being built if these tariffs persist.

Steel has long been a target of protection and the US has had several steel tariffs over the years to promote US steel production, even as recently as 2002 under President George W. Bush. The Bush tariffs were short-lived as the World Trade Organization deemed them illegal and the retaliation from other countries proved very costly for US exporters in other industries. The justification for the new tariffs is different, however, as the Trump administration imposed them on the basis that domestic steel is vital to national security. The WTO has not yet ruled on the matter and it is still unclear what kind of backlash there will be from trading partners or from those US companies that stand to lose as a result of higher costs.

US Trade Surpluses and Deficits with Major Partners, 2017



Note: All balances include trade of both goods and services. Source: United States Census Bureau

The market fell again a few weeks later when President Trump announced another round of tariffs directly

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targeting up to $60 billion in annual imports from China; this move stoked fears of an all-out trade war with China. China's officials responded with their own tariffs on 128 US products, though they only account for about $3 billion worth of US exports.

For the moment, the market appears to have calmed down on reports that the US and China have been having closed-door talks on how to resolve the current dispute. The US trade deficit with China is by far the largest among any countries in the world. Any kind of long-term disruption of the relationship could be costly for both sides. That's not to say that the recent protectionist actions by the Trump administration aren't warranted to some degree. It has been obvious for some time that China has used anti-competitive policies that have benefited Chinese industries at the expense of competitors around the world.

GDP Growth

Year-on-year, %. Arrows indicate the direction of revisions since Nov 2017.

	2017	2018		2019			2017	2018		2019	
World	3.7	3.9	↑	3.9	↑	G20	3.8	4.1	↑	4.0	↑
Australia	2.3	3.0	↑	3.0	↑	Argentina	2.9	3.2	=	3.2	=
Canada	3.0	2.2	↑	2.0	↑	Brazil	1.0	2.2	↑	2.4	↑
Euro area	2.5	2.3	↑	2.1	↑	China	6.9	6.7	↑	6.4	=
Germany	2.5	2.4	↑	2.2	↑	India[1]	6.6	7.2	↑	7.5	↑
France	2.0	2.2	↑	1.9	↑	Indonesia	5.1	5.3	↑	5.4	=
Italy	1.5	1.5	=	1.3	=	Mexico	2.3	2.5	↑	2.8	↑
Japan	1.7	1.5	↑	1.1	↑	Russia	1.5	1.8	↓	1.5	=
Korea	3.1	3.0	=	3.0	=	Saudi Arabia	-0.8	1.6	=	1.7	=
UK	1.7	1.3	↑	1.1	=	South Africa	1.2	1.9	↑	2.1	↑
US	2.3	2.9	↑	2.8	↑	Turkey	6.9	5.3	↑	5.1	↑

Note: GDP in volume. Difference in percentage points based on rounded figures. Dark green for upwards revision of 0.2 percentage points and more. The G20 aggregate does not include EU countries that are not G20 members in own right. 1. Fiscal years starting in April. Source: OECD Interim Economic Outlook

Global economy still has a firm footing. Looking at the fundamentals, the global economy is still on solid footing. The table above, posted in March by the Organization for Economic Co-operation and Development, shows expectations for global growth are not only widespread but have been rising in recent months.

For several years we've estimated that stocks have been, at least, fully valued and that stock prices have run ahead of earnings. Based on what we saw in the first quarter, 2018 may be a year where the fundamentals outperform stocks. This doesn't necessarily mean stocks need to fall. It may just be a back and forth kind of year as earnings hopefully catch up with, and justify, the prices we're seeing.

Historically we've see that it usually takes a recession to put an end to a bull market despite what market prices do in the short term. While the strong projections in the nearby chart of GDP projections could be overly optimistic, there is good evidence to support a continuing expansion. Risks remain of course. Rising inflation which results in higher interest rates, tough talk on trade that escalates into a trade war, or one of those "unknown risks" could put an end to the party. Our advice as always is to remain diversified and to use these bouts of volatility as a good opportunity to rebalance your portfolio.

Matthew S. DeVries, CFA ■

Lessons From 25 Years *(Continued from page 1)*

approximately matching the 100-year average return for the market. On the surface, my career at Bragg so far could be described as benign: *"25-year-old joins investment firm; enjoys 10% annual market returns for his first 25 years with the company."* But that wouldn't be a fitting description, would it? The period has been anything but benign. Frankly I am amazed at the high return considering the wild ride we have endured. The obvious standouts are the two major bear markets: the 48% market decline associated with 9/11 and the tech bubble bursting, and the 58% decline associated with the 2008 housing market collapse and subsequent financial crisis.

My father always says, "Our clients hire us to do the worrying so they don't have to." We certainly did some worrying during those two big declines. But prior to, between, and after those declines, we worried as well. Back in 1997 we worried that the Asian Crisis would result in a worldwide economic meltdown due to "financial contagion." In 1998 we fretted about Russia's debt default and the failure of the massive hedge fund Long Term Capital, which threatened to roil financial markets. In 1999 we were hunkered down, worried about the chaos Y2K might bring and the extreme market valuations in the tech sector. In 2002 we wondered if the market would ever find a bottom. In 2003 we were concerned about the use of chemical weapons on our troops when we went into Iraq. During the financial crisis we worried that the financial system would fail and that the deep recession would become a global depression.

Moving on to more recent history, our worries have included deflation, quantitative easing, the Fed's growing balance sheet, government spending, the Fiscal Cliff, the downgrade of US debt, the H1N1 Pandemic, the European debt crisis, the Greek default, QE II, the Ebola virus, the threat of municipal bond defaults, the end of quantitative easing (the Taper Tantrum), the ZIKA virus, slowing growth and a real estate bubble in China, the potential for a global slowdown, Brexit, a potential Clinton presidency, a potential Trump presidency, the election of Donald Trump, high market valuations, North Korea, even-higher market valuations, and entering 2018, the return of market volatility. Right

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Lessons From 25 Years *(Continued from page 3)*

now we are worried about a potential trade war, signs of inflation and the impact of higher interest rates on asset prices.

On September 10, 2001, we were worried about something but it sure wasn't a terrorist attack that would kill almost 3,000 people on our own soil. Which brings us to another important lesson: *Often what impacts the market is not something we were worried about.* I'll spare you another long list of examples—if you are still reading, you've heard enough about worrying. Hopefully the takeaway is that your long-term investment decisions shouldn't be pushed around by the worry of the day. There will always be one.

The market rarely does what you expect it to do and especially not when you expect it to do it. And a corollary: market cycles and trends can last far longer than you might think.

Our investment committee meets for several hours each week to talk about the portfolio we own for clients. There are usually four or five of us in attendance and our combined investment experience is north of 100 years. And yet, here are the questions most often heard in our meetings over the last 25 years: "Can you believe this market? What just happened? What in the world is going on? Why would it go up on that kind of news? This can't end well, can it? Why is it down on that news? How long can this go on?" This last is probably heard the most. "How long can this go on?" Most recently we asked this question about the absolute lack of volatility in the market in 2017. The CBOE Volatility Index (the VIX), a commonly used measure of market fear, recorded some of the lowest levels of volatility since the inception of the Index 28 years ago. According to S&P Dow Jones, of the 56 least volatile days in the history of the Index, 47 of them occurred in 2017. It was also the first year in history in which the S&P 500 Index did not decline from high to low by at least 3% during the year. But the five biggest head-scratchers of the last 25 years for me include 1) the tech-led S&P 500 consecutive annual returns of 38%, 23%, 33%, 29% and 21%, from 1995-1999, 2) the price of oil (which was $20 in 1993) reaching a record high of $140 in June of 2008 and plummeting to just $42 only six months later in January of 2009, 3) the 58% cumulative decline of the market in 2008-2009, 4) the collapse of several of the largest, most respected financial corporations in the world during the financial crisis and finally, 5) the yield on the 10-year Treasury bond dropping from 6% in May of 1993 to a record-low of 1.4% in July of 2016.

Yesterday's winner is tomorrow's loser. By the time you hear about other investors making a lot of money in a certain sector (energy, real estate, commodities, healthcare) or an asset class (small cap, emerging markets, junk bonds, gold) or a security with certain characteristics (dividend stocks, master limited partnerships, preferred stocks), it's too late—all the easy money has been made. Said another way, "If it's in the headlines, it's in the stock price." Don't chase.

Ignore your fear and greed. Own the right portfolio today. Rather than dithering about, waiting for the right time to buy/sell, you should immediately own the portfolio that is appropriate given your need for return and your need for liquidity. Of those two, liquidity is the biggest driver. Having enough liquidity (bonds/cash or income from employment or other sources) provides staying power and eliminates the need to sell into a falling market. This became a hard and fast rule for us back in 2001-2002 as the tech bubble deflated. As we licked our wounds following the market decline, we decided that we should be more assertive with our clients who were making bad portfolio choices based on emotions. In this case the emotion was greed. Many investors chased tech stocks to their demise. Record numbers of Americans became day-traders in the late stages of the tech bubble when it was "easy" to make a lot of money. Some of our clients jumped on the bandwagon and regretted it. We saw this again during the housing bubble. Far too many people used debt to buy residential real estate for investment purposes at or near the peak. In most cases this ended badly as property values fell by 30%-50% even as mortgage balances held their value or even increased as interest accumulated. Greed's evil cousin of course is fear; if fear drives you out of the market at a very low price it can wreck a lifetime of investment returns. When the bear market comes (and it will), we will always focus on the financial plan. If we've done our job correctly and used the right stock/bond allocation (provided for the need for liquidity), there should be no reason to sell stocks at rock-bottom prices.

Stock ownership has been a good investment because humans make progress. This is especially true of humans who live in nations with high levels of individual freedom, private property protections, free markets and limited government. The increase in the global standard of living over the last one hundred years has been nothing short of astounding. And the pace of progress is only increasing. With the past as prelude, I tell my children that there has never been a more exciting time to live. The "good old days" are now! And stock ownership—owning shares of companies run by hard-working people—allows us to harness human ingenuity and to participate financially in humanity's ability to make it bigger, stronger, faster, more efficient, more environmentally-friendly and safer. The next 25 years are sure to be different from the last 25 but it is certain that they too will be a wild ride. Many new lessons will be learned as we move forward.

A final lesson learned: As exciting and rewarding as this industry can be, true wealth is measured in my relationships with clients, co-workers and the fine people of our community. I am grateful.

On behalf of the whole team at Bragg, thank you for trusting us with this important work.

Benton S. Bragg, CFP®, CFA ■