Investment Commentary

2nd Quarter 2019

Bragg Building
1031 South Caldwell Street, Charlotte

TOYOTA TACOMA

What's the deal with teenage boys and four-wheel drive trucks? Surely a future genetic study will identify a specific gene in many young men that indicates an insatiable desire to drive a jacked-up 4x4 into a big mud hole. My 17-year old son, Carlton, while seemingly on the right track with his academic pursuits, extra-curricular activities and general direction in life, somehow became obsessed with acquiring one of the aforementioned vehicles. He would say, "Come on Dad, I am seventeen years old. We live on a farm. I need a truck! I can buy an old junker and fix it up." To be fair, Carlton has always had an interest in tinkering with anything with an engine, especially if it might go fast. You might recall an earlier Bragg Commentary that featured his rebuilding his uncle's broken-down riding mower. According to Frank Bragg, Carlton is the only one of his fifteen grandchildren who has been "certified" to operate Frank's 85-horsepower John Deere tractor, also known as "Big John." Despite these interests, Carlton's mother and I made it clear that he should put the 4x4 truck out of his mind and focus on more important things like his AP Chemistry

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MARKET & ECONOMY

For investors, the volatility of the last 18 months has been especially frustrating. Like Sisyphus endlessly pushing his boulder to the top of the hill, only to watch it tumble down again, we have seen the stock market reach a new peak three times, only to drop back sharply. Yet, looking at just the first six months of 2019, this has been a good year overall for stocks and indeed all asset classes, even bonds.

Large company stocks, as measured by the S&P 500, are up 18.5% for the first half of the year, albeit rising off a relative low at the end of 2018. Small cap stocks have also performed well, with the Russell 2000 up 17% year-to-date. May's sell-off of 6.6% was not nearly as sharp as the 20% fourth quarter plunge in 2018, or the 10% drop earlier in that year. The drop-off in May reflected concerns over trade tensions with China; when those eased in June the market recovered to score all-time highs, just above levels seen in January 2018, September 2018 and early May 2019.

Bonds have also done well in the first half of 2019. The Federal Reserve is now expected to lower short-term

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Market Index Returns as of June 30, 2019

Index	2nd Quarter	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	4.3%	18.5%	10.4%	14.2%	10.7%	14.7%
Russell Midcap (US Mid Cap)	4.1%	21.4%	7.8%	12.2%	8.6%	15.2%
Russell 2000 (US Small Cap)	2.1%	17.0%	-3.3%	12.3%	7.1%	13.5%
MSCI ACWI X-US IMI Net (Foreign Equity)	2.7%	13.3%	0.3%	9.2%	2.3%	6.8%
MSCI EM (Foreign Emerging)	0.6%	10.6%	1.2%	10.7%	2.5%	5.8%
Barclays Aggregate Bond	3.1%	6.1%	7.9%	2.3%	3.0%	3.9%
Barclays Muni Bond	2.1%	5.1%	6.7%	2.6%	3.6%	4.7%

Past performance is not an indication of future performance.

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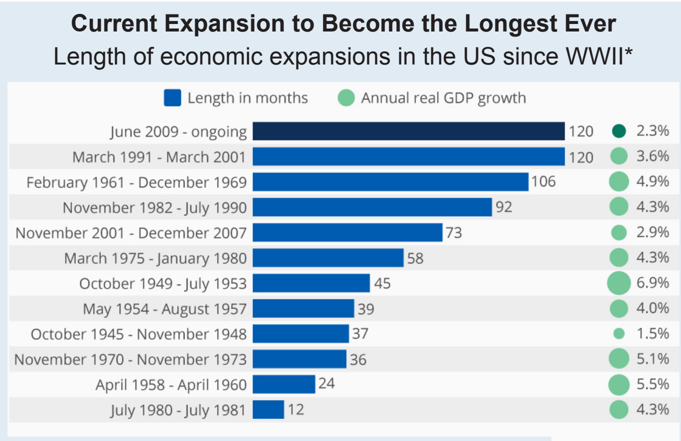
Market & Economy *(Continued from page 1)*

interest rates in 2019, reversing course after a series of quarter-point increases which began in late 2015 and which took the Fed Funds target rate from approximately zero to the current target range of 2.25% to 2.50%. At the end of June the Barclays US Aggregate Bond Index was up 6.11% for the year. If that return holds through year end, it would rank as the best year for the major bond index since 2011.

Ten-year anniversaries

The current bull market was ten years old in March, and we are now also celebrating the tenth anniversary since the end of the last recession. As of this month, this current expansion is tied with 1991-2001 for the title of the longest enjoyed by the US in the last 75 years (see chart below). However, even though the current expansion will soon be the longest in recent history, the expansion lags behind most others in terms of the rate of growth, with just 2.3% annual GDP growth. This slower rate of growth may explain why we haven't seen the types of excessive risk taking by investors typically seen at the end of a bull market.

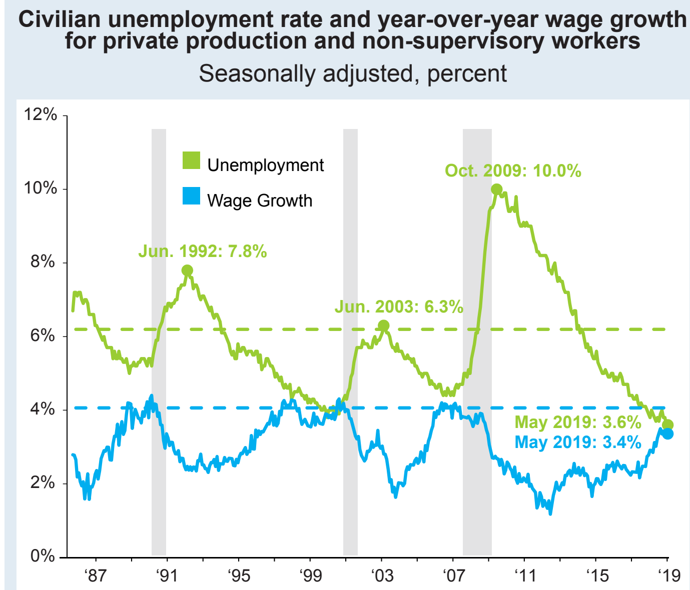


Source: National Bureau of Economic Research, BEA
**The NBER broadly defines an expansion as a period, usually lasting several years, during which economic activity rises substantially, spreading across the entire economy.*

Several factors support continuing economic growth. Most estimates for 2019 GDP growth range from 2% to 3%, in line with annual growth over the past decade. US unemployment has continued falling and is currently at a very low 3.6%, boosting consumer optimism. Despite the lowest unemployment rate since 1969, wage growth has remained subdued. There are pockets of the labor market that are seeing pay increases but overall, managers aren't yet being forced to pay more to hire workers. We typically see wages rise over 4% year-over-year as the economy overheats late in the market cycle. June's robust job creation figure of 224,000 further signals economic health.

Furthermore, trade issues that sparked May's selloff have calmed for now, with a temporary trade truce in place with China as talks continue. The US is postponing tariffs on an additional $300 billion in Chinese imports.

Moreover, the Federal Reserve, which helped propel stocks higher in June by signaling a possible future rate cut, seems to be standing ready to support the economy with further rate cuts if it deems it necessary. Though it's hard to understand why the Fed would lower rates if the economy were not in immediate danger of recession, one guess is that the Fed governors saw the market's negative reaction to its December rate hike as a misstep they do not want to repeat.



Source: BLS, FactSet, JP Morgan Asset Management

Factors to watch

On the other hand, periods of economic expansion do not go on forever, and there are several factors to keep an eye on. Trade issues are not going away any time soon. It is hard to envision a permanent trade deal while China competes to overtake the US as the premier global superpower. While China relies on the US to buy its goods, there is a limit to how heavy-handed the US can be in its negotiations.

Meanwhile, manufacturing is slowing around the globe. The Purchasing Managers Index (PMI), which indicates manufacturing trends for national economies, is showing that manufacturing outputs for most major economies are now in, or approaching, the contraction zone (see chart on page 3).

In Europe, Brexit remains an ongoing puzzle with no happy resolution in sight. British officials appear to be increasingly likely not to reach a deal before the UK's official exit from the European Union. Failure to reach a deal would mean border checks would be introduced, transport of people and goods would be disrupted, and EU tariffs would be introduced. The deadline for the official Brexit is now scheduled for October.

Meanwhile, here in the US, the micro-economics of individual companies are beginning to reveal internal pressures on margins. Top line revenue growth appears scarce for many companies due to the weaker global economy and the uncertainty created by the trade war. 2019 earnings

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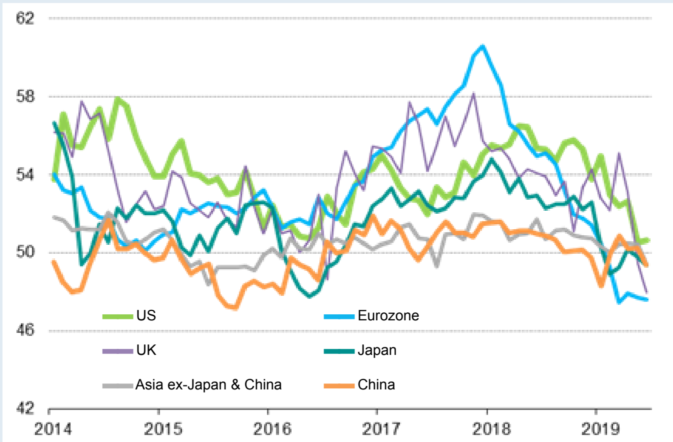
growth will likely be meager compared to the outstanding numbers posted in 2018. Juiced by the 2017 tax cuts, S&P 500 earnings grew by more than 20% in 2018. The comparisons will be trickier in 2019. This brings into question the sustainability of indefinite rosy market expectations. One sign that stock market sentiment is still quite high is the number of high-profile IPOs of Silicon Valley "unicorns" such as Uber, Lyft and Pinterest—companies that have grown to $1 billion+ valuations. A significant earnings recession will let some of the air out of the balloon...hopefully this can be avoided.

Manufacturing PMI

Manufacturing PMI Index, 50 = no change on prior month



Source: IHS Markit, JPMorgan, CIPS, Caixin

Volatility appears set to continue. Treasury bond yields once again inverted in the second quarter, with the ten-year bond paying less interest than the three-month bill—frequently an indication of a coming economic slow-down. We live in a world where a 140-character tweet can send the market up or down by 2%. It's easy to imagine the negative event that could push us lower—military conflict with Iran, trade interruptions with China, a terrorist act. Positive events could also surprise us, with a positive effect.

We are navigating through a challenging time for investing. We've faced uncertainty over the past several years and investors have been rewarded for patience. With the economy on stable footing, we'll continue to use these short-term bouts of volatility as rebalancing opportunities to buy at lower prices or take profits on price jumps. Through these actions, we hope to be well prepared for whatever lies ahead.

Matthew S. DeVries, CFA ■

Toyota Tacoma *(Continued from page 1)*

homework. We told him that like his older brother before him, he would count himself fortunate to drive a practical, safe, high-mileage but well-maintained, previously-owned sedan. (Financial planning note for parents of teens: Car dealers are practically giving away used Accords and Camrys these days as everyone wants an SUV instead).

Carlton was not to be deterred. He spent hours and hours on Craigslist, 4x4.com and even military surplus sites searching for the perfect "rig." I can't count the number of times he interrupted my workday with a text that included a link to some Craigslist listing featuring a "lifted" Chevy truck with massive tires, a 10,000 lb. winch, brush guard, light bar and other so called "mods" (modifications). The price was always right and the comments were what you might expect: "1974 Chevy Blazer...274,000 miles...time to let my baby go. I got $5,000 in her...she runs good, hardly any rust, lotta tread left on tires...might need a little transmission work and a new muffler. Missing title. $2,100 OBO...will consider trade for fishing boat." Reading the Craigslist entries was entertaining but I looked forward to the day when the sedan was purchased and this nonsense would finally end.

Things finally came to a head when school got out in May; we truly needed another car since Carlton and his sister each needed transportation to get to their summer jobs. So I set out one Saturday morning to find the perfect used sedan. I didn't tell Carlton I was going. I planned to just bring home a sedan and put an end to this endless dreaming of going muddin'. I was encouraged when the very first dealership I visited had an assortment of used sedans that fit the bill. But as I walked through the lot, I couldn't help but notice an old Toyota pick-up truck parked at the end of the row of sedans. You really couldn't miss it; parked beside a Honda Accord, its lifted suspension and off-road tires made it stand out. I looked a little closer. It was ten years old and the odometer showed 105,000 miles. I saw that it was four-wheel drive, and yes, it had a manual transmission. It reminded me of the old 4x4 Toyota truck I drove in my youth. Man, I had loved that old truck. Standing there in the parking lot I felt a rush of emotion...nostalgia I guess.

I don't need to tell you what happened next, do I? I'll only say that I don't know who was more shocked when I drove up in that truck—my wife, Alice or my son, Carlton. After hearing sermon after sermon about the merits of a practical, inexpensive sedan, they were simply dumbfounded by my purchase. Demonstrating how well he knows his father, my older son, Ben, described the event as "the strangest day in the history of our family." I really can't explain my behavior. Call it impulsive, emotional and irrational. It was certainly out of character.

Speaking of inexplicable behavior, market action of late could be described this way. As you are likely aware, the stock market, as measured by the S&P 500, ended the second quarter at an all-time high. The Dow made a new high on July 3rd. One might logically conclude that investors have lofty expectations for continued economic expansion and strong corporate earnings growth. After all, the stock market is forward looking. Meanwhile, bond investors are sending a

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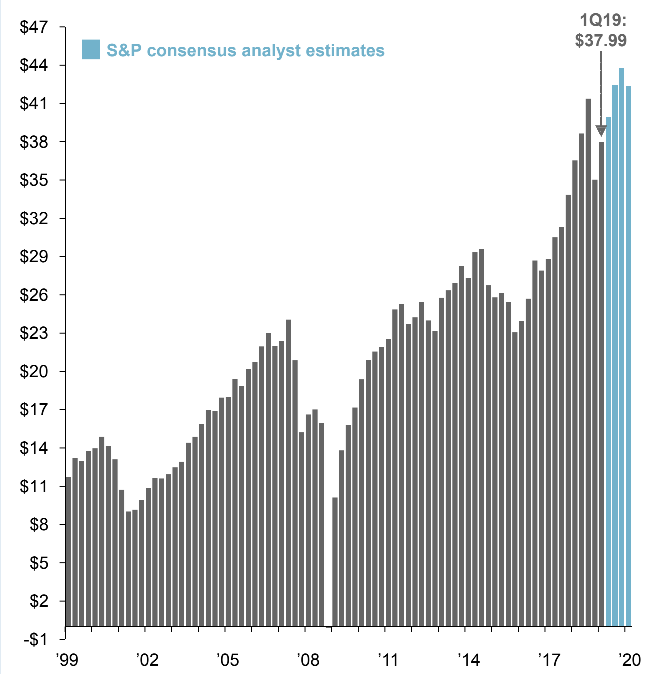
different signal; yields on long-term bonds have fallen dramatically this year. The yield on a ten-year Treasury started the year at 2.7% and ended the second quarter at just 2%. As recently as last November, the ten-year yielded 3.2%. By historical measures, this is a dramatic reversal and the signaling is clear: bond investors expect economic activity to cool in the future. The fact that short-term rates are higher than long-term rates (the yield curve is inverted) points to a recession in our future.

Carlton Bragg and his Toyota Tacoma.

So which market has it right? The stock market or the bond market? Is it off to the races as the stock market would imply or is an economic recession right around the corner as suggested by the drop in bond yields? I think I can explain this seeming contradiction more easily than I can explain my recent purchase of the Toyota 4x4. First, a refresher on bonds and interest rates. Recall that interest rates (yields) simply reflect the "price" of money or the price to borrow money. As with any other good or service, the supply/demand relationship is intact. When the economy is growing and good investment opportunities are abundant, the demand to borrow money increases, the supply of money becomes more limited, and this pushes up the price (interest rate) to borrow. Likewise when the economy is soft and investment opportunities are harder to find, the demand for borrowing declines and the cost to borrow (interest rate) falls. Today's lower interest rates are telling us that bond investors expect a softening economy with fewer good investment opportunities.

S&P 500 Operating Earnings Per Share

Index quarterly operating earnings



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. EPS levels are based on operating earnings per share. Earnings estimates are Standard & Poor's consensus analyst expectations. Past performance is not indicative of future returns.

So is the stock market being overly exuberant? I'll make the case that it is not. The jump in stock prices we've enjoyed this year is simply an adjustment higher as a result of the lower level of interest rates. Recall that the price paid for a stock today represents the discounted present value of the future stream of earnings of the stock. A key component in the discounting of the future stream of earnings is the interest rate. The lower the interest rate used in discounting, the higher the present value of the stock. Stock prices, like the prices of all risk assets, have adjusted to lower interest rates.

And while stocks, as measured by the S&P 500, are at an all-time high, they're only 1% higher than they were nine months ago (September 2018) and only 6% higher than they were almost 18 months ago (January 2018). Corporate earnings peaked in the third quarter of 2018 and according to FactSet, expectations are for earnings to be flat to modestly higher in 2019 (see chart below).

The bottom line is that while earnings are treading water, stock prices have been driven up by lower interest rates. Notably, the current market rally began in late December after Federal Reserve Bank Chairman, Jerome Powell, in what will forever be known as "the Powell Pivot," announced in a speech that the Fed would put future interest rate increases on hold. Just as my son seems to be addicted to 4x4 trucks, the stock market continues to be addicted to low interest rates. This has been the case for some time. It was six years ago when we dedicated an entire commentary to the market's addiction to cheap money.

In summary, we think the bond market and stock market are sending consistent signals. The record-long expansion is showing its age and falling interest rates are propping up the stock market in the face of weak earnings growth. The S&P is up more than 18% through the first half of 2019. While good news on the trade front or other positive economic surprises could extend the rally, we think investors should temper expectations for the second half of the year.

As always, being comfortable with your portfolio allocation is most important. The allocation should reflect your need for liquidity and your comfort with market volatility. If a correction or bear market is in our future, either as a result of a recession or some other event, it will be important to be able to stay the course, four-wheel drive or not.

As always, thank you for trusting Bragg with your planning and investing.

Benton S. Bragg, CFA, CFP®