INVESTMENT COMMENTARY

3rd Quarter 2018

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WITH CICERO, LOOKING BACK

"To be ignorant of what occurred before you were born is to remain always a child."

Marcus Tullius Cicero, Roman orator and statesman, 106BC–43BC

I included Cicero's quote in a letter to my oldest son, Ben, as he prepared to leave home for his first year of college this fall. If you know me, you'll know I'm not one to regularly quote the Ancients in everyday conversation, but I did major in history in college and have always loved this quote. Indeed the older I get, the more I like it. It especially rings true today as our world changes at an ever-increasing pace and as the word "*unprecedented*" is used more and more frequently to describe what is said or done by those in the public spotlight, whether individuals or institutions.

My purpose in quoting Cicero in the letter to my son was simply to encourage him to keep an open mind about his course of study, to explore a variety of subject areas before settling on a specific major. Okay, maybe I was gently steering him toward the liberal arts, especially history. That was my wife's interpretation anyway. "Let the

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MARKET COMMENTARY

The old adage "Sell in May and go away!" was not good advice this year. From May through September, large company stocks as measured by the S&P 500 posted a return of 11%, bringing the YTD return up to 10.6%. Small company stocks have also had a good year. The Russell 2000 Index of small caps was up 11.5% year-to-date through the end of the third quarter. Foreign stocks have continued to trail the US; the MSCI ACWI Foreign Stock index is down 3.3% for the first three quarters of the year.

The performance disparity between US and foreign stocks is significant and reflects a number of factors. First, the US economy has been performing better than those in much of the rest of the world. Second, a rising dollar resulted in unfavorable currency conversions for owners of foreign stocks. And finally, much of the gain of US indices (the Dow Jones industrials, the S&P 500) has been driven by the performance of a few very large companies such as Microsoft, Boeing, Amazon, Apple, and Google, which have large weightings in the commonly-used indices and which have had outsized returns this year. After this divergence

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Market Index Returns as of September 30, 2018

Index	3rd Quarter	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	7.7%	10.6%	17.9%	17.3%	14.0%	12.0%
Russell Midcap (US Mid Cap)	5.0%	7.5%	14.0%	14.5%	11.7%	12.3%
Russell 2000 (US Small Cap)	3.6%	11.5%	15.2%	17.1%	11.1%	11.1%
MSCI ACWI X-US IMI Net (Foreign Equity)	0.4%	-3.3%	1.8%	10.1%	4.4%	5.6%
MSCI EM (Foreign Emerging)	-1.1%	-7.7%	-0.8%	12.4%	3.6%	5.4%
Barclays Aggregate Bond	0.0%	-1.6%	-1.2%	1.3%	2.2%	3.8%
Barclays Muni Bond	-0.2%	-0.4%	0.4%	2.2%	3.5%	4.8%

Past performance is not an indication of future performance.

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of performance, foreign stocks now look cheaper than US stocks on a valuation basis (price to earnings, price to cash flow, etc.).

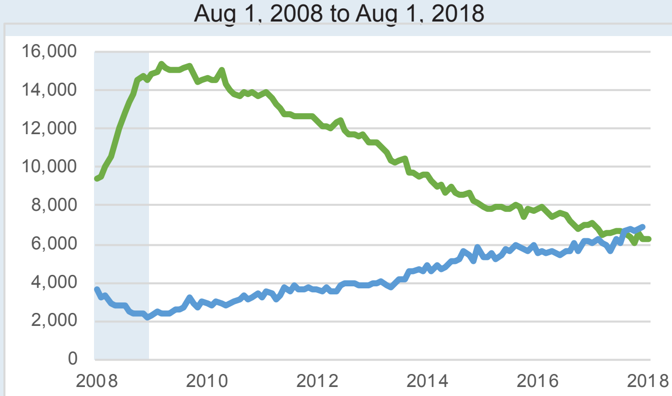
Labor market shows strength in the US economy

Back in February of this year, the US Bureau of Labor Statistics reported that January hourly wages grew at a higher-than-expected 2.9%. This report immediately sparked inflation worries and sent US stocks down 6% in just two days. A similar BLS report of 2.9% wage growth for August saw no such reaction because so far, rising inflation just hasn't materialized. History has demonstrated that this Goldilocks scenario won't last forever.

The US Federal Reserve has worked to stay ahead of inflation. The Fed once again raised the Federal Funds rate target range by 0.25% last month, to 2.00%-2.25%. The Fed Funds rate is the interest rate at which banks can lend excess cash balances to other banks overnight. When the Fed raises the Fed Funds rate, as it has eight times over the last three years, interest rates rise on short-term bonds, making it more costly to borrow money. The Fed's goal is to moderate the rate of economic growth in order to keep inflation in check. The Fed has communicated that the current target range of 2.00%-2.25% for the Fed Funds rate is a "neutral stance," neither stimulating nor hindering economic growth.

Unemployment Rates

Aug 1, 2008 to Aug 1, 2018



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

- Unemployment Level: **July 2018 6,280**
- Job Openings - Total Nonfarm: **July 2018 6,939**

With US unemployment holding below 4%, there are now 659,000 more job openings in the US than unemployed workers—a record level since the Labor Department started tracking openings. With fewer workers available for a growing number of jobs, wages will likely continue to rise more quickly than we have seen over the past decade. After all, wage growth of 2.9% is still only about 1% in real terms when you adjust for inflation. As wages move higher, the Fed will likely continue to push interest rates up, at least through 2019.

Politics remain in focus

The "trade war" with China continues to dominate headlines. So far the US has imposed tariffs on $253 billion in Chinese imports, which accounts for about half of the $504 billion in products the US bought from China in 2017. China, on the other hand, has imposed retaliatory tariffs on about $100 billion in US exports, which covers a much higher percentage of the $129 billion in goods China imported from the US in 2017. Pockets of disruption are showing here in the US. For example, President Trump already enacted a plan to provide farmers up to $12 billion in relief to mitigate damage from Chinese tariffs. While tensions with China are intensifying, the US has made progress in trade negotiations with South Korea, Mexico, Canada, and Europe.

While the trade dispute with China is far from over, it's unlikely to escalate further prior to the mid-term elections. According to many polling organizations, Democrats are projected to win a majority in the House of Representatives while Republicans are projected to retain the Senate. This is not unusual; according to PolitiFact, the party of the sitting president has lost, on average, 32 seats in the House and 2 seats in the Senate in mid-term elections since 1862. A split Congress would likely ensure that policies like tax reform and deregulation, enacted by the current Republican-led Congress, would stay in place. Gridlock in Washington has historically been good news for the stock market.

Economic momentum likely to continue in the near term

This bull market has persisted long enough that the historic collapse of Lehman Brothers, now 10 years in the past, seems like but a distant memory. Bull markets don't, however, die of old age. It's usually a recession that finally ends the run and the run will end at some point. The economy seems to have enough momentum to continue to expand, at least in the near term. US GDP grew 4.2% in the second quarter and is expected to have grown more than 3% again in the third quarter. Some are suggesting that the entire decade of the 2010s will pass without a recession—something that's never happened in a calendar decade in the history of our great country. The slow but steady growth we have seen since the financial crisis has sustained economic expansion while also preventing the economy from overheating. It appears that we are now closer to the turning point however, with headwinds more apparent (higher interest rates, wage pressures, surging oil prices) and with pockets of weakness (softening auto sales and a sluggish housing market in parts of the country).

With valuations still above historical norms, stocks may not perform at the level we've grown accustomed to over the last few years. Rising yields on savings and a strong labor market will be good for American households but rising interest rates, energy prices and labor costs are likely to put pressure on corporate profit margins. Likewise, friction in international trade may increasingly impact the bottom line for multi-national corporations. Since 2009, the US stock market has run ahead of the US economy, but we should

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be prepared for a time when Main Street finally does better than Wall Street.

Our recent portfolio actions are intended to position clients for what may come. Benton quoted Cicero in his article. I'll jump on the bandwagon and conclude with another Cicero classic that is relevant to our work:

"Before beginning, plan carefully."

Matthew S. DeVries, CFA ■

With Cicero, Looking Back *(Continued from page 1)*

boy make his own choices!" Alice said. She had a good point. I admit that I spent several hours going through his course catalogue. And yes, I made a written list of the 15 to 20 courses I would take were I a freshman in college. And yes, I also listed several courses I would avoid were I in college. And umm, maybe I did share the lists with my son, but just for his information, of course. "Even though your mother and I are footing the bill," we told him, "you are free to take whatever courses you desire as long as you graduate in four years." So imagine my delight in learning that after being enrolled in college for five weeks now, his favorite class is Ancient Greek Philosophers! What a coincidence.

Last month marked the tenth anniversary of the failure of Lehman Brothers, the largest bankruptcy filing in US history. It's hard to believe ten years have passed since the very difficult days of the financial crisis. The S&P 500 touched 677 at its low of March 9, 2009, during the crisis. It closed the third quarter of this year at 2,914, within a whisker of an all-time high. Over that period it is up 331% (price only) and 432% including reinvested dividends. These are cumulative returns. It has been a remarkable run. Where the market goes from here is unknown. The market may be at an all-time high just prior to peaking and entering a significant decline. Alternatively, it may be hitting the first of many all-time highs over the course of the next 12 to 24 months or longer. In this quarter's Market Commentary by Matt DeVries, we delve a bit deeper into the issues affecting the market—trade, interest rates, earnings and the dollar. Here, I'll simply make two points about today's market compared to the market of 2009. First, the market is more expensive today on a valuation basis than it was in 2009 and second, with the passage of time, investors have grown more complacent and accepting of risk.

In the spirit of Cicero's advice to know our history, I thought it would be a valuable exercise to reprint brief excerpts of several Bragg Commentaries that we sent to clients during the financial crisis. Three are from the fall of 2008, exactly ten years ago. The fourth is from February 19, 2009, just a few weeks prior to the market low of March 9, 2009. Enjoy the light reading.

From September 23, 2008, Bragg Commentary

As you know, our financial markets are currently going through a time of great crisis. Last week the government announced that it planned a massive intervention in the private sector to prevent what officials described as the potential collapse of the banking system. Specifically, the Treasury Department announced that it would seek authorization from Congress to use as much as $700 billion of taxpayer money to purchase the bad debt of financial companies to provide liquidity and assure the normal functioning of markets. In addition the Treasury said it would purchase securities held by money market funds in order to provide liquidity for those funds to meet demands for redemptions.

It is our opinion that our financial system will survive this crisis and that our economy will move forward at some point. That is a pretty fundamental assumption...we think you either believe we will get past this and progress or you think our country's economic model will no longer work. We could be wrong but we are solidly in the former camp and this general belief in our economic model drives our long-term investment philosophy. Before abandoning a long-term investment plan due to current market events, we think it makes sense to review your portfolio allocation to make sure it accurately reflects your needs.

Once again, you are hearing that our advice is to maintain a long-term view if you feel that your portfolio allocation is appropriate. We do not know how long it will take to get through the current crisis. Of 15 prior bear markets since 1929, the average peak-to-trough decline was 37% and the average bear market duration was 19 months. The Dow is currently 22% off its peak of October 2007 and we are almost 12 months into the decline. We think it makes sense to prepare for more declines and certainly for more volatility in the weeks and months ahead.

From October 9, 2008, Bragg Commentary

Worldwide stock exchanges plunged again this week after falling over seven percent last week. As of yesterday's close, the S&P 500 is down 36% in price from its peak of last October while foreign markets are down more than 40%. Price declines have not been limited to stocks. Real estate, corporate bonds, municipal bonds and commercial paper have also fallen in value. Worldwide credit markets are not functioning properly. All of us have an uneasy feeling when we see the Dow shed 500, 600, 700 points in one day. It is painful and it is hard to see past this crisis. Why are prices plunging? What is driving this?

The market is still dealing with the fallout from the credit crisis fueled by bad loans made to borrowers who are now defaulting. Market participants, including financial companies themselves, have become extremely worried about having the liquidity (cash) necessary to operate. Banks have stopped lending to borrowers and to one

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another in an effort to preserve their liquidity and this has caused our financial system to freeze up. Market participants are hanging onto their cash. When individuals, corporations and municipalities do not have access to cash, the economy is not able to function.

Another way to raise cash is to sell securities and that is what you are seeing on a massive scale. Financial companies, hedge funds, corporations and individual investors who are desperate for cash are selling securities of all types to raise cash. Some of these redemptions are driven by the need for liquidity but some of these redemptions are driven purely by fear. While we too are anxious, we are extremely hesitant to sell our stocks or our bonds at these prices. We could be wrong, but we think these prices are irrationally low and are driven by emotion. At the same time, we know that prices may go lower still. In fact we should tell ourselves they will. Once again, you are hearing that our advice is to maintain a long-term view if you feel that your portfolio allocation is appropriate.

From October 31, 2008, Bragg Commentary

October account statements will be in your mailbox soon and they will not look good. The stock market as measured by the S&P 500 is down 41% year-to-date through October 27. Most of that decline happened during the month of October; the S&P 500 Index is down a stunning 27% this month. Bonds have also had a rough month, especially corporate and municipal bonds.

In past bear markets, bonds have softened the blow of declining stock prices. From March of 2000 through October of 2002, stocks (S&P 500) declined over 45%. During that same 2 ½ years, bonds gained almost 30%. A typical portfolio holding 60% stocks and 40% bonds would have seen a decline of about 18% back then and the decline would have come gradually over a 30-month period. The same portfolio today is down about 30% over just 12 months and most of the decline occurred during the last three weeks!

We do not know if stocks have bottomed. As measured by the S&P 500, the market is already down 45% (price) since its peak reached on October 9, 2007. The current decline matches the declines of 2000-2002 and 1973-1974. You have to go back to the Great Depression to find a market decline greater than these three.

We again want to say that we think it makes sense to stick with your long-term investment plan. Although market declines like this make us anxious, we are extremely hesitant to sell our stocks or our bonds at these prices. At the same time, we know that prices may go lower still. In fact we should tell ourselves they will.

From February 20, 2009, Bragg Commentary

With the stock market re-testing the lows of last November, we wanted to share our thoughts about the market, the economy and the actions we are currently taking as we manage your portfolio.

Although the market enjoyed a nice bounce from November 20 through the first week in January, the steady drumbeat of worse-than-expected economic reports during the first 6 weeks of 2009 has put a damper on hopes of a turnaround in the economy in the near-term.

The problems with the banks and other financial companies have not been solved. Although the Treasury Department announced a major plan to address the financial crisis on February 9, the plan was short on details. In short, investors simply are not confident that the banking system will survive without substantial additional government support. There is growing pressure for the government to consider nationalizing some of the banks as a way to remove the bad loans from the banks' balance sheets and get credit flowing again. This is a major, major step and one that policy makers have tried desperately to avoid but in our view, the probability that this will happen has increased substantially in the last few weeks.

Meanwhile, as in past recessions, the economic news has been grim. Job losses, foreclosures, defaults, corporate earnings declines, budget shortfalls and the list goes on. As we have discussed before, this recession will certainly equal if not surpass those of '73-'74 and '80-'81 in terms of severity.

We are convinced that this will be a very difficult year. As we have said many times in the past, it always takes far, far longer for the market and the economy to adjust than one would think. The months ahead will likely be similar to the few months that have just passed. Rallies followed by declines. Relief followed by more worry. The market is testing the lows of November and it may reach new lows in the coming months. We won't know when the market has bottomed or when the economy has begun expanding until long after those points have passed. Importantly, we have great confidence that at some point in the coming months, we will see a bottom and that the economy will begin expanding again. (Listen to audio)

I hope the walk down memory lane wasn't too painful. I also hope it was a useful exercise. While we at Bragg are proud of our efforts during those days of great stress, we are likewise mindful of the fact that when we were in the storm, we couldn't see out of it. It is surely evident in our writing. We couldn't see the future. The only thing we could do was maintain our discipline and avoid making emotional decisions with the portfolio. And though the market is hitting new highs as you read this, that's exactly where we are and what we're doing today. We're studying the past, acknowledging that the future is uncertain, maintaining discipline and keeping our emotions at bay. Surely Cicero would approve.

Thank you for sticking with Bragg through the tough times. We greatly appreciate your trust.

Benton S. Bragg, CFP®, CFA ■

P.S. Please go to braggfinancial.com to read the full versions of the 2008/2009 newsletters abbreviated here.