INVESTMENT COMMENTARY

3rd Quarter 2013

Bragg Building
1031 South Caldwell Street, Charlotte

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MUSCADINES & BEN BERNANKE

Last Sunday afternoon I took three of my children and several of their cousins on a long walk on the farm where we live in Huntersville. I really hadn't planned to take a walk but somehow I found myself in charge of six kids with orders to keep them occupied for three hours. From experience I've learned that nothing entertains like a good walk on the farm. I just amble along and Mother Nature provides plenty to keep the kids occupied. We started out across the pasture but it was hot so we eased onto a trail in the woods and enjoyed the shade. We stopped off at the rope swing built by brother Phillips and the kids shrieked and giggled as they took turns sailing out over a huge ravine before returning safely to solid ground. We then moseyed down the trail to a large rock formation that beckons scrambling children (and adults). The older kids tried to convince little Charlie (six) that a family of dragons lived in the cave under the rocks. Charlie didn't miss a beat. He claimed he already knew about the dragons, boldly declaring, "I've already seen them twice today." That boy keeps us on our toes. We finally ended up wading in Ramah Creek which winds its way through the farm. As usually happens, the creek wading eventually evolved into a splash fight and when somebody got dunked completely under water, I knew it was time to wrap it up.

As we made our way toward home, we found ourselves in my parent's yard–if you can call it a yard. (Dad's philosophy

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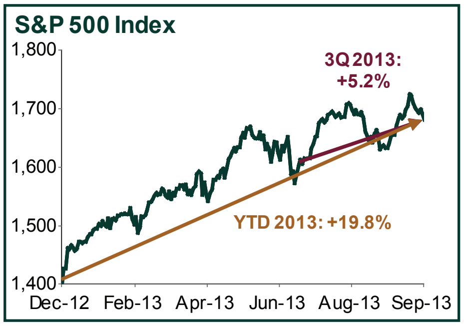
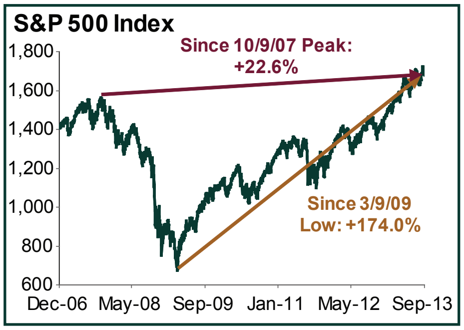
THE SHUTDOWN AND THE CEILING

We think the resolution of the federal government shutdown will be rolled into the battle over raising the federal debt ceiling. We think the two issues will be resolved by October 17th since this is the date when the government will supposedly run out of money to pay its bills. We don't think the government will let the deadline pass and default on its obligations. This has never happened and it likely would create great turmoil in worldwide financial markets. Our dysfunctional government funding process is rooted





Charts reflect index levels (price change only). All returns and annotations reflect total return, including dividends. Charts compiled by JP Morgan. Source: Russell Investment Group, Standard & Poor's, and FactSet

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The Shutdown and the Ceiling *(Continued from page 1)*

Market Index Returns for Periods ending September 30, 2013

Index	3rd Qtr 2013	YTD 2013	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	5.2%	19.8%	19.3%	16.3%	10%	7.2%
S&P 400 US (US Mid Cap)	7.5	23.2	27.7	17.5	13.1	10.4
Russell 2000 (US Small Cap)	10.2	27.7	30.1	18.3	11.2	9.1
MSCI EAFE (Foreign Equity)	11.6	16.1	23.8	8.5	6.4	7.5
Barclays Aggregate Bond	0.6	-1.9	-1.7	2.9	5.4	4.7
Barclays Muni Bond	-0.2	-2.9	-2.2	3.2	6.0	4.5

Three, five and ten-year returns are annualized

in four years of failure by Congress to approve a budget. Instead government operations have been funded by a series of temporary agreements called “continuing resolutions,” the most recent of which expired on September 30th. Over the next week or so, the Republicans again will attempt to tie some of their key priorities to the passage of the next continuing resolution. President Obama meanwhile has said repeatedly that he will not negotiate on the debt ceiling and will only sign a clean bill that contains no other items. By the time you read this, a lot will likely have happened and market volatility will have accompanied it. We’ve been here before. The last protracted battle over the debt ceiling occurred in August of 2011 and the market did not respond favorably to the period of uncertainty in the short term. Once a resolution was reached however the market surged ahead. The market has generally not been kind to investors who try to “sidestep” these deadline-driven periods of volatility and our advice is to stick to your long-term investment plan.

2013 UPDATE

Rock bottom interest rates, gradually improving labor markets, low inflation, a rebounding housing market and reasonable equity valuations have made 2013 a great year for owners of stocks. As the charts on page 1 show, the S&P 500 was up 5.2% in the third quarter, bringing the year-to-date return to almost 20%. From the low of March 2009 through the end of the third quarter, the S&P was up a whopping 174% including dividends. Aren’t you glad you didn’t fall for the “buy-and-hold-is-dead” pitch making the rounds back in 2009? So far this year, gains were not evenly distributed across all market sectors. As shown in the table to the right, the leaders (Consumer Discretionary, Health Care, Technology and Industrials) led the laggards (Materials, Utilities, Telecom and Energy) by a wide margin. This presents a good opportunity for rebalancing within the equity portfolio.

GDP GROWTH – WHAT’S THE DRAG?

We’ve written a fair amount about the disappointing pace of economic growth since the last recession. Specifically, over the last four years the economy has grown at an annual rate of about 2.2%, trailing the post-war average by about 1.0% and significantly trailing the growth rates we typically see following a deep recession. We’ve also written a lot about the problem of federal government deficit spending and the economic drag created by excessive amounts of debt outstanding. The table at the top of the next page brings these two issues together in an interesting way and offers some encouraging news. The table shows the components of GDP, the respective contribution of each component and finally the growth rate of each component for the last two quarters. During the second quarter, the only component of the economy creating a meaningful drag on growth was federal government spending. (Federal spending is down primarily due to the mandatory spending cuts that went into effect this year.) In contrast, consumer spending was positive, and investment (residential investment, corporate capital investments, etc.) was very strong. The private sector is putting up pretty good numbers. In fact, if you strip out

Year-to-Date Sector Performance

Name	YTD Close Perf (%)
Consumer Discretionary	+36.93
Health Care	+33.51
Information Technology	+26.33
Industrials	+25.61
Consumer Staples	+12.83
Financials	+11.31
Energy	+11.05
Telecommunication Services	+10.95
Utilities	+6.89
Materials	-1.31

Source: StreetSmart Edge

GDP Growth – What's the Drag? *(Continued from page 2)*

government spending, you see that the private sector has actually grown at a rate comparable to the long-term average. This is good news. GDP growth is slow but slow for the right reason . . . the government is beginning the long process of reducing debt and cutting spending while the private sector is showing signs of life.

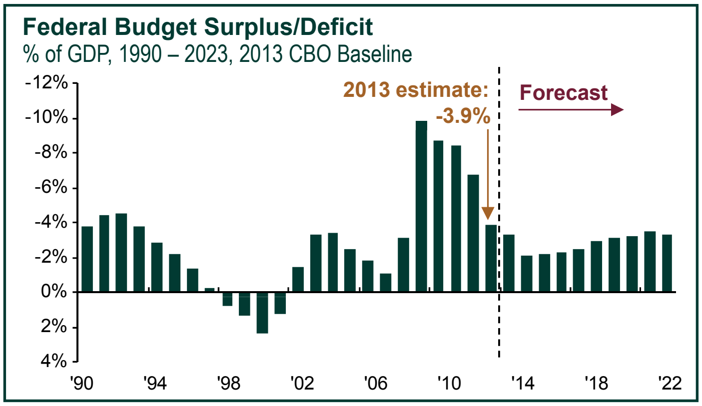
GDP Components – Government the Only Drag

	% of real GDP	1Q13 annualized Q/Q % change	2Q13 annualized Q/Q % change
Consumer spending	68.2%	2.3%	1.8%
Government spending	18.5%	(4.2%)	(0.4%)
• Federal: 7.4%		(8.4%)	(1.6%)
• State/local: 11.1%		(1.3%)	0.4%
Net exports of goods and services	(2.7%)	(0.3)*	(0.1)*
• Exports: 12.7%		(1.3%)	8.0%
• Imports: (15.4%)		0.6%	6.9%
Fixed investment	15.7%	(1.5%)	6.5%
• Nonresidential: 12.6%		(4.6%)	4.7%
• Residential: 3.1%		12.5%	14.2%
Change in private inventories	--	0.9*	0.4*
	Real GDP	1.1%	2.5%

- 2.2% ("new normal") = average real GDP since June 2009 recession end
- 3.2% ("old normal") = average private sector real GDP since June 2009 recession end

*As of 2Q13. *Represents contribution to percent change in real GDP. Numbers may not add up to 100% due to rounding. Table compiled by Charles Schwab. Source: Bureau of Economic Analysis and FactSet*

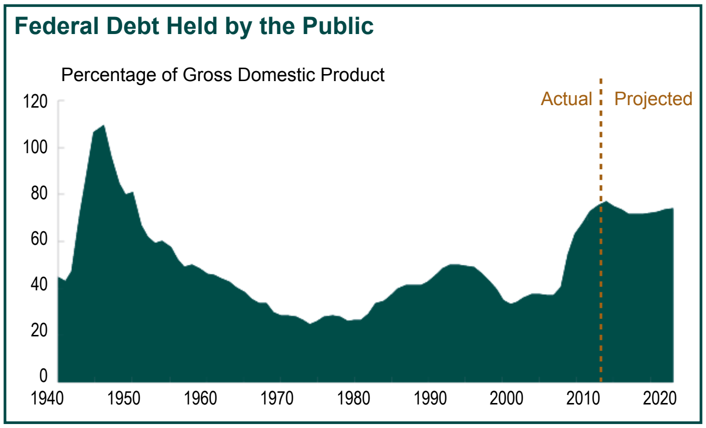
The chart below clearly shows the change in deficit spending. The most recent report of the Congressional Budget Office cites increasing tax revenues and reduced government spending for a revised (lower) estimate of the 2013 budget deficit. From the CBO: "If the current laws that govern federal taxes and spending do not change, the budget deficit will shrink this year to $642 billion, the smallest shortfall since 2008. Relative to the size of the economy, the deficit this year—at 4.0 percent of gross domestic product (GDP)—will be less than half as large as the shortfall in 2009, which was 10.1 percent of GDP."



Source: U.S. Treasury, BEA, OMB, CBO, JP Morgan Asset Management 2013 estimate by JP Morgan Asset Management

Before you get too excited though, notice the chart at right, which does a good job showing the relative amount of debt we have piled up. Even the CBO is concerned. According to their website, "Such high and rising debt later in the coming decade would have serious negative consequences: When interest rates return to higher (more typical) levels, federal spending on interest payments would increase substantially. Moreover, because federal borrowing reduces national saving, over time the capital stock would be smaller and total wages would be lower than they would be if the debt was reduced. In addition, lawmakers would have less flexibility than they would have if debt levels were lower to use tax and spending policy to respond to unexpected challenges. Finally, a large debt increases the risk of a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates." Translation: We have a long way to go!

Whew! If you are still reading, you are to be commended. Keep in mind that we are writing about a thirteen trillion dollar economy and about a future that none of us can see. We see some bright spots out there but be prepared for volatility in the near term.



Source: Congressional Budget Office. May 2013

Muscadines & Ben Bernanke *(Continued from page 1)*

is "Whatever grows is welcome–weeds mown short look as good as fescue.") I think it was Phillips's son Johnny who asked, "Uncle Ben, can we eat some of Papa's muscadines?" I said, "Sure, let's have a few, but we can't stay long because we're already late." The six of them sprinted for the muscadine grape vines and by the time I got there, their mouths were full of this sweet Southern fruit. According to the Frank Bragg database, muscadine (Vitis rotundifolia) is a grapevine species native to the American South that has been widely cultivated since the seventeenth century. There are over 300 muscadine cultivars and the ones we enjoyed Saturday were of the Scuppernong variety. These Scuppernongs were perfectly ripe, sweet and juicy. We paused briefly in our picking and eating to teach Charlie the fine art of eating a muscadine – put the entire grape into your mouth, use your tongue first to crush it and then to separate the skin and seeds from the fruit. Savor and then swallow the fruit, and then remove the seeds and skin from your mouth either discreetly with your hand, or more commonly by spitting them across the yard. My family prefers the more common method . . . spitting contests are half the fun in eating muscadines. Charlie caught on quickly and was soon dashing around under the arbor, "spitting skins" on his cousins.

If you grew up in the South, you likely know that it is really hard to stop eating ripe muscadines. The sweetness of the fruit is like an explosion in your mouth; before you even spit out the skin, you find yourself reaching back into the vine for another. This was the case on Saturday. A brief stop on the way home turned into a half hour of bliss that was finally interrupted by the ringing of my cell phone. It was my wife, Alice. "Where *are* you? Those kids are supposed to be *home*. We have *school* tomorrow, they need to *shower* and *you* are supposed to be grilling *burgers*!" And so forth.

Sweet ripe muscadines are not unlike the cheap money provided by Ben Bernanke and the Fed. Our economy and the financial markets are having a hard time adjusting to the idea of higher interest rates. Back in May of this year, Bernanke, chairman of the Federal Reserve, hinted that the Fed would likely begin to taper its bond purchases in the coming months. Markets reacted negatively. Bond prices fell dramatically and stocks took about a six percent swoon – a brief interlude in their meteoric rise of the last four years. Since the financial crisis, the Fed has taken unprecedented action to support the economy, including lowering short-term interest rates to zero and engaging in a massive program of buying Treasury bonds and mortgage-backed securities in the open market (known as quantitative easing) in an effort to keep interest rates low and to encourage lending by member banks.

The latest iteration of quantitative easing known as QE 3 or QE 4 (or to some as QE Infinity) has the Fed buying $85 billion of bonds each month. This is a huge sum of money. Should the Fed continue its current pace of bond buying through the end of 2013, it will have purchased 75% of all government debt issued this year. The Fed has become a financing vehicle for the deficit spending of the federal government. There is no precedent for this. The fear is that this massive increase in liquidity will cause hyper-inflation if it makes its way into the economy. But in fact, very little of this liquidity has entered the economy. Banks aren't lending it out; it remains on bank balance sheets earning less than .25% in interest. As evidence, consider that back in December of 2007, before the financial crisis, banks reported $293 billion in cash assets on their balance sheets, according to the Fed's H.8 report. Six years later, in August of 2013, banks reported $2.4 *trillion* in cash assets, an increase of over $2 trillion. During the same period of time, according to the Fed's H.4.1 report, the Fed's balance sheet increased by $2.1 trillion, primarily as a result of its quantitative easing program.* Almost all of the increase in the Fed's balance sheet is sitting in cash on member banks' balance sheets.

Last month, Ben Bernanke surprised the financial markets, announcing that the Fed would *not* taper its bond purchases after all, at least not until the economy showed more sustained improvement. Investors reacted to the "good" news by pushing stock prices to a new all-time high. Bond markets rallied as well. All along, the Fed has assured investors and politicians that when the economy finally gets its legs, it will begin to remove the stimulus, allowing rates to slowly rise and taking the excess liquidity out of the system. The events of the last few months have shown that this will not be easy. The market and the economy will react negatively to higher interest rates. And yet the artificially low interest rate environment created by the Fed is proving to be like pushing on a string . . . the excess liquidity is sitting idle, demonstrating the limits of this policy.

While a cell phone call from my wife dragged me away from the muscadine vine, getting our markets and our economy off the "sweetness" of cheap money is going to be a bigger challenge. On multiple occasions since the financial crisis we have written that the road ahead is long and bumpy. We'll say it again. The slow-growing economy, the stubbornly high unemployment rate, the impasse in Washington and the conundrum facing the Fed are all tied together. Robust economic growth is the healing salve for what ails us and it looks elusive at this point. Time will pass however and we'll enter a new season of progress. As you read the headlines these days, I hope you'll keep that in mind.

Thank you for choosing Bragg to help you with your planning and investing.

Sincerely,

Benton B. Bragg

Benton Bragg, CFP, CFA
President, Bragg Financial Advisors

*Special thanks to John B. Norris of Oakworth Capital in Birmingham, Alabama for the analysis of the Fed's balance sheet.