INVESTMENT COMMENTARY

4th Quarter 2015

Bragg Building
1031 South Caldwell Street, Charlotte

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> *"2015 was the best year in history for the average human being. The world is better-educated, richer, better-fed, healthier, freer and more tolerant than ever before."*
>
> -Charles Kenny, *The Atlantic* magazine

POT-BELLIED PIG & PERSPECTIVE

My son's pot-bellied pig died last month. Little Blaze was one of three pigs Carlton (14) convinced us to get him for his birthday three years ago. The pig's death was premature; the normal life expectancy for a pot-bellied pig is between 12 and 15 years. Yes, I have contemplated the fact that I'll be caring for these pigs long after Carlton has left the house. He'll be having fun in college or even raising a family and I'll still be feeding his pigs! Good fodder for future newsletters perhaps. But I digress. Somehow Little Blaze became paralyzed from the waist down. The vet said that it could have been from a traumatic injury (one of our miniature donkeys might have kicked him at feeding time) but it was more likely that he suffered from a disc problem which apparently is fairly common with these pigs due to their long bodies and big bellies.

Regardless of the cause of the paralysis, we took the vet's advice and euthanized Little Blaze after trying steroids and massage therapy for about ten days. The little guy's quality of life was simply not going to be good. As you can imagine, Carlton was not a happy boy in early December ... his eyes would fill with tears whenever we discussed his little buddy. To this point in his life he'd been fortunate; he'd never experienced the loss of a family member, friend or pet. Sadly, Little Blaze was his favorite of the three oinkers. In Carlton's words, "Little Blaze was the friendliest of my three pigs. He always came over to see me at feeding time. He would grunt when I scratched his ears and then he'd roll over for a belly-rub." Carlton and I

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MARKET & ECONOMY

Stocks rebounded in the fourth quarter, erasing most of the damage done in the third quarter. For the full year, stock returns were mixed. As shown in the table on page 3, US large cap stocks were just barely positive for the year while mid cap, small cap and foreign stocks were negative.

While large company stocks as measured by the S&P 500 finished with a positive return, the average stock in the index actually did considerably worse. The S&P 500 index is cap-weighted, meaning that the larger the market value of a company, the greater its representation in the index. According to Bespoke Investment Group, the average stock in the index fell 3.8% in 2015. The largest 50 stocks in the index were up an average of 1.5% while the smallest 50 stocks were down 11.9%. In particular, performance was driven by four large growth companies, Facebook, Amazon, Netflix and Google (FANG for short) which had a combined return of over 60% on a cap-weighted basis. Excluding the FANG stocks, the S&P 500 was down 4.8% in 2015.

Driving home the point that the market has had extremely narrow leadership of late, note the S&P 500 Sectors chart (page 2) showing the price change of the average S&P 500 stock since its 52-week high. We last saw narrow leadership like this back during the tech bubble. This doesn't mean we are headed for a crash but it does remind us to avoid chasing or overweighting last year's best performers.

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Market & Economy *(Continued from page 1)*

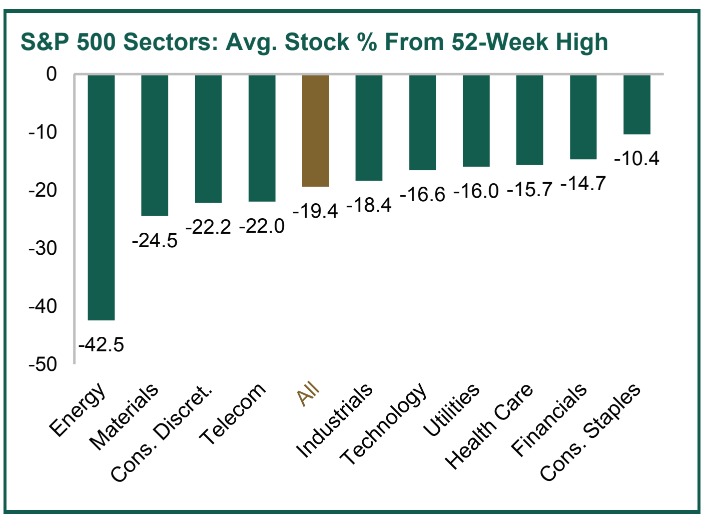
Why the Market Weakness?

Corporate Earnings drive stock prices in the long run and they've been weaker of late. After peaking in the third quarter of 2014, earnings have faced strong headwinds from a stronger dollar and severe weakness in the energy sector. Both of these phenomena are shown in the charts below. These headwinds may persist for some time. The US economy is showing relative strength compared to the Eurozone, Japan and China and this may continue to support the dollar relative to other currencies. Adding additional support to the dollar are higher interest rates in the US relative to those in other large economies. As for the weakness in the energy sector, history has shown that time will heal these wounds and that earnings will rebound at some point. But at this point, the over-supply of oil continues to weigh on oil prices and therefore on energy sector earnings.

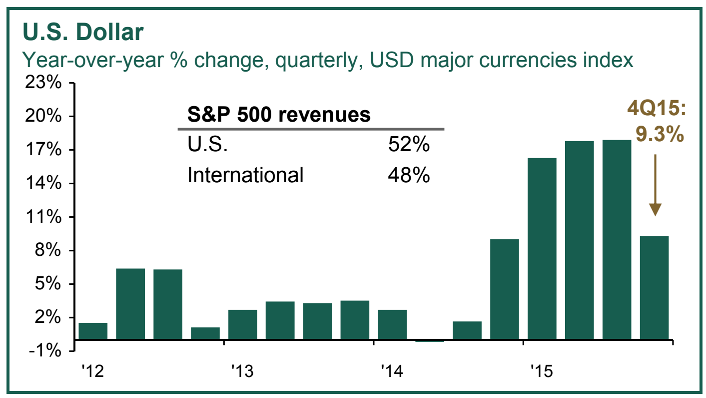
China, the world's second largest economy, continues to see weakness in manufacturing and industrial output and growth in the overall economy is expected to slow further in 2016. As China's demand for oil and other commodities has fallen dramatically over the last two years, investors worry about the impact on overall global growth.

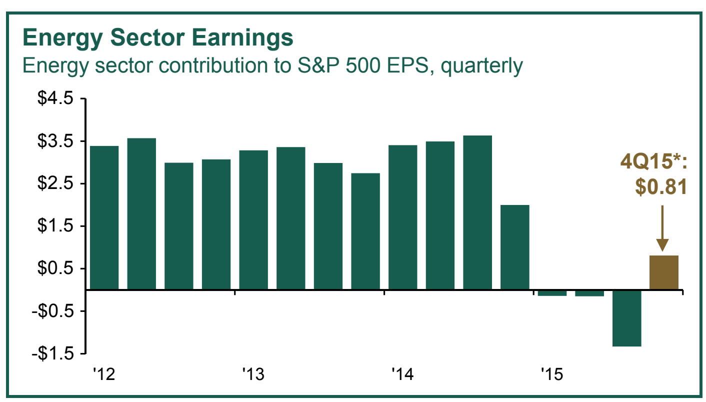
Higher Interest Rates will impact the market and the economy. When the Fed finally raised interest rates in December, it bumped the target range for the Fed Funds rate to 0.25% to 0.50%. The target range had been zero to 0.25%. While not a large increase, the Fed announced plans to gradually increase rates to a more "normal" level in the quarters ahead. In fact, in an effort to reassure investors, the word "gradual" appeared several times during the Fed's statement following the announcement last month. History shows that stocks perform better during periods of gradual rate hikes than during rapid hikes.

Since the interest rate is the cost or "price" of money, it is a critical component in the value of any asset or stream of income. We have a leveraged economy. Most corporations, governments and individuals use some degree of debt to operate. More expensive debt reduces the amount of money available for everything else—earnings in the case of corporations, services in the case of governments, and consumption or savings in the case of individuals. Historically, extremely low interest rates (cheap debt) have encouraged excessive risk-taking and resulted in overheated economies and eventually inflationary pressures. Extremely high interest rates have had the opposite effect. In the US, monetary policy is used as a governor on the economy and the Fed is challenged to find a balance that meets its dual mandate of full employment and stable prices. "Challenged" is a good word. History demonstrates that meeting its dual mandate isn't easy and the task ahead for the current leadership of the Fed will be no exception. In an effort to support the economy during the financial crisis and the ensuing years of economic weakness, the Fed pumped



As of 12/21/2015. The chart above shows how far stocks in the S&P 500 and each sector are trading below their 52-week highs. In the S&P 500 as a whole, the average stock is currently 19.4% below its 52-week high. Four sectors have readings below this level—Telecom (-22%), Consumer Discretionary (-22.2%), Materials (-24.5%) and Energy (-42.5%). Energy is obviously the big standout in the chart, but the Consumer Discretionary sector is probably the most notable. Remember, because of Amazon's huge gains this year, the Consumer Discretionary sector (cap-weighted) is actually up more than 5% year-to-date. But under the surface the sector has been much weaker. Source: Bespoke Investment Group





*EPS levels are based on operating earnings per share. *4Q earnings estimates are Standard & Poor's consensus analyst expectations. Past performance is not indicative of future returns. Currencies in the Trade Weighted US Dollar Major Currencies Index are: British pound, Euro, Swedish kroner, Australian dollar, Canadian dollar, Japanese yen and Swiss Franc. US Data are as of December 31, 2015. Source: Compustat, FactSet, Standard & Poor's, JP Morgan Asset Management (top chart also Federal Reserve, S&P 500 individual company 10k filings, S&P Index Alert).*

Market & Economy *(Continued from page 2)*

trillions of dollars into the economy through buying bonds on the open market (Quantitative Easing). The Fed currently has $4.5 trillion on its balance sheet. Historically, aggressive action such as this has ultimately resulted in much higher levels of inflation. In this case we haven't seen inflation—much of the monetary stimulus is sitting on bank balance sheets and has not moved into the economy. But with unemployment down to 5%, policy makers worry that inflationary pressures may build and therefore are hoping to move to a more normal rate environment. The risk is that rates could rise too fast, stalling the economic expansion. You will continue to hear about this in the months ahead.

US consumers are the bright spot in the world economy and this is good news since consumption makes up nearly 70% of US GDP. US automakers sold 17.5 million cars and trucks in 2015, breaking a fifteen-year-old record for annual sales. Household net worth is at an all-time high again and consumers are finally seeing some wage gains due to tightness in the labor market. The housing market continues to slowly improve as do consumer balance sheets. Finally, inflation, interest rates and energy prices remain low, setting the stage for continued strength in consumption.

As always, we think it makes sense to maintain an appropriate long-term allocation and to be prepared for the bumps ahead. Please let us know if you would like to discuss your portfolio. ■

Looking Ahead to 2016

As we said last quarter, the world economy is intertwined and it's currently dealing with a soft patch. The US economy looks healthy relative to the rest of the world but there are signs of life in Europe, the UK and some emerging economies like India. And China, while slowing, is still growing faster than any of the developed economies of the world.

Manufacturing has shown some weakness in the US and around the world. This trend may continue in the months ahead and it may create continued volatility in the market.

Market Index Returns for Periods Ending December 31, 2015

Index	4th Quarter	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	7.04	1.38	15.77	12.57	7.31
S&P 400 US (US Mid Cap)	2.60	-2.18	13.35	10.67	8.18
Russell 2000 (US Small Cap)	3.59	-4.41	12.42	9.19	6.81
MSCI ACWI X-US IMI Net (Foreign Equity)	3.52	-4.60	2.03	1.27	3.16
MSCI EM (Foreign Emerging)	0.66	-14.92	-6.76	-4.81	3.61
Barclays Aggregate Bond	-0.57	0.55	1.41	3.25	4.52
Barclays Muni Bond	1.51	3.30	3.16	5.35	4.72

Three-, five- and ten-year returns are annualized.
Past performance is not an indication of future performance.

Pot-Bellied Pig & Perspective *(Continued from page 1)*

buried Little Blaze on a shady hill in the woods near where I buried my old golden retriever ten years ago. Carlton helped with the grave-digging but his daddy ended up doing most of the work as the soil was rocky and full of roots. It was pitch dark when we finished. I'm not looking forward to the day I have to bury a donkey.

As you might imagine, the passage of time has helped Carlton get over his sadness. He still has his moments—especially when he feeds his surviving pigs, Sweet Tea and Rosebud. I recently asked him if he was still upset about the loss of Little Blaze and he said he was doing much better. I asked him why he thought he was doing better. He seemed a little annoyed with my question but then he said quietly, "I don't know, Dad, I guess Little Blaze is in heaven now and he'd be miserable here. And, um, I guess I have good things to look forward to and I'm happy." Not the most eloquent answer but probably better than I could have managed at his age. He seems to have a good perspective on his pig and on his life. Of course as his father, I hope he maintains that perspective for many years.

Perspective is something we can all use these days. There is a lot going on in the world and it is easy to find yourself worrying about the future. To list a few issues: the Syrian refugee crisis and instability throughout the Middle East; the Islamic State terrorist attacks in Paris and in San Bernardino; strong rhetoric out of Russia and Iran; the military build-up and economic weakness in China; the North Korea hydrogen bomb test; plunging oil prices and the resulting economic instability in emerging economies; negative interest rates and deflationary pressures in Europe; the prospect of additional interest rate increases by the Fed; US presidential-election-year uncertainty and a seemingly divided citizenry. Did I mention the stock market? It's no secret that it has not done well lately. As detailed in the section on the Market and the Economy, 2015 was a grinding year of volatility that included a 12% drop for the S&P 500 in the third quarter, a rebound early in the fourth quarter and a sell-off at year end. On the first trading day of 2016, the Dow was off some 400 points before lunch in reaction to weak manufacturing reports out of both China and the US.

Each of the issues I've listed is a big story on its own. Take oil as one example. The impact of the drop in the price of oil from $110 per barrel in mid-2014 to the current level of $37 can't be overstated. It has roiled the oil-exporting

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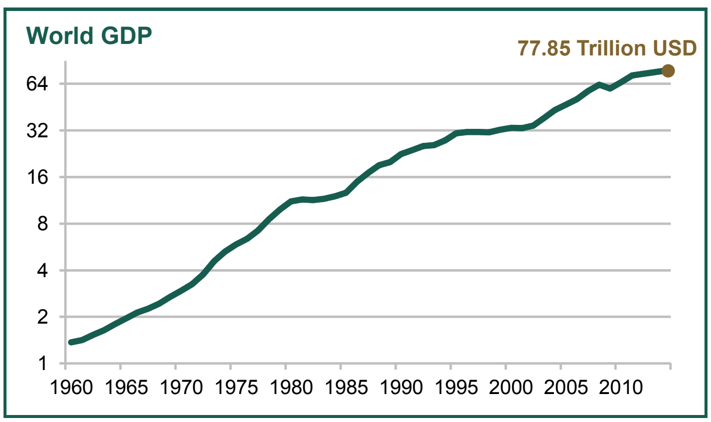
economies of Russia and OPEC member countries including Iran, Iraq, Saudi Arabia, the UAE, Nigeria and Venezuela. It has challenged the viability of alternative energy sources, created massive losses (and some bankruptcies) for traditional drilling and exploration companies and resulted in 30% to 65% declines in the stock prices of the world's largest energy companies. On a more positive note, lower energy prices have put money in the pockets of consumers around the globe, provided an economic boost to oil-importing countries like China, the US, and India and reduced global inflationary pressures.

Carlton and Little Blaze

If oil is a big issue, another is certainly the Fed *finally* raising interest rates. The Fed raised interest rates in December for the first time in almost ten years. For some perspective on how long it's been, consider that when the Fed last raised rates (June 2006), the first iPhone hadn't been introduced yet. The rate increase is significant, not because the increase was large (only one-fourth of one percent) but simply because it signals a change in direction and because interest rates (or the cost of money) are a primary driver in the valuation of financial assets like stocks, bonds and real estate. Investors around the world have been and will continue to be deeply focused on this issue.



Current World GDP: 77.85 Trillion USD (as of Dec 2014); Min: 1.37 Trillion USD (Dec 1960); Max: 77.85 Trillion USD (Dec 2014); World Gross Domestic Product in US current dollars (not inflation-adjusted). Source: World Bank

The list of big issues is long—oil, the Fed, Trump, Clinton, ISIS beheadings, immigrants, China, San Bernardino, Iran, race relations, homegrown terrorists. When we read and hear about these issues through our preferred media outlets, it can be overwhelming and even intimidating at times. And when the stock market goes down like it did in August/September or more recently in December (and yes, this week), it can really get our attention. This is when some perspective is in order. As investors and heck, as just ordinary folk, we've got to remember that life goes on. We live in a physical world but the 24-hour news cycle and today's social media can reduce our existence to a digital domain where bite-sized bits of bedlam come at us at lightning speed. In a world with 7 billion people, 85% of whom carry camera-ready cell phones, today's technology will capture, sort, aggregate and quickly push to a device near you the most outlandish, attention-getting stories of violence, greed, theft, calamity, glory, weather, love and hate. Anything of interest happening anywhere in the world is delivered to you within seconds. It is truly world-shrinking! While it is exciting and entertaining, it can also be unhealthy.

Keeping our perspective means remembering that despite the headlines, the human condition has never been better. According to a recent article by Charles Kenny in *The Atlantic* magazine, "2015 was the best year in history for the average human being" and "the world is better-educated, richer, better-fed, healthier, freer and more tolerant than ever before." According to the World Bank, for the first time ever, less than 10% of the world's population lives in extreme poverty (less than $1.90 per day), down from 37% just twenty-five years ago in 1990.

As owners of shares of companies, we should celebrate and take comfort in the fact that over the last two hundred years, it has been consumer-driven innovation, economic opportunity, free markets and trade that have civilized the world and created the wealth humans enjoy today. Owning shares allows us to invest in people—to invest in human progress. The table from the World Bank (left) shows global economic output from 1960 through 2014. We'll certainly see recessions and market declines in our future but history makes a strong case that amid ISIS beheadings, Russian saber-rattling and a Chinese slowdown, the trend is in our favor.

On behalf of everyone at Bragg Financial I wish you the best in 2016! Thank you for choosing our firm for your planning and investing.

Sincerely,

Benton S. Bragg

Benton S. Bragg, CFP®, CFA®
President, Bragg Financial Advisors, Inc.