Investment Commentary

1st Quarter 2016

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"Jackson and I cut, split and stacked this load of firewood today to celebrate my 77th birthday."

-Frank Bragg

CHOPPING WOOD

My father sent me a text message on the occasion of his seventy-seventh birthday. He attached a picture of his dog, Jackson, sitting beside a large stack of perfectly-split red oak firewood. Dad's old weathered ax leaned against the stack of wood. His text merely said, "Jackson and I cut, split and stacked this load of firewood today to celebrate my 77th birthday." Not included in the text but certainly implied was the question, "What did *you* do today, son?" I read his message while positioned comfortably in my leather chair at my desk in my climate-controlled office. His message had the desired effect; I couldn't help but feel like a lazy, spoiled, privileged and unworthy child, relaxing in comfort while my seventy-seven year old father was out on a cold February day cutting down a tree and splitting wood by hand. I'm sure he'll read this with great pleasure. Sigh. Perhaps you have endured similar "motivation" from your father or mother from time to time.

Like most folks his age (and heck, my age!), Frank Bragg has battled his share of health hurdles. Whether sore knees, injured shoulders, loss of hand strength, limited vision or other ailments, he has dealt with the inconvenience and figured out a way to keep plugging along. "Plugging along" probably understates the man's pace; he routinely wears me out when we work together on the farm. He doesn't like to talk about getting older but I can tell that he is decidedly not a fan. A few years back he broke his arm when a

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MARKET & ECONOMY

Global markets started the year with a wild ride. Just looking at quarter-end returns doesn't tell the whole story. The S&P 500 started the year in the red, falling nearly 6% in the first five trading days in January. The slide continued and by February 11th, the market was off by more than 11% as the "Three C's"—China, Commodities, and Central Banks—spooked global markets. Then a funny thing happened: the sky didn't fall and the world didn't instantly plunge into a recession. The stock market rebounded sharply with a 14.4% return over the final six weeks of the quarter to finish in the black with a 1.5% gain. Of note, as the market declined, both growth and value stocks fell but value proved more resilient. The S&P 500 Value Index recovered its losses and was back in the black by March 7th and ended the quarter ahead of the S&P 500 Growth Index by about one percent.

The Three C's

China—Worries about slowing growth in China dominated early headlines in January. An attempt by the government to stabilize the Chinese market with new regulations had the opposite effect, causing stock prices to tumble. Like other global markets, the Chinese market began to stabilize in February when the People's Bank of China announced another reduction in interest rates. This comes on the heels of an earlier cut in November. We expect Chinese market volatility and surprise economic announcements to continue

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Market & Economy *(Continued from page 1)*

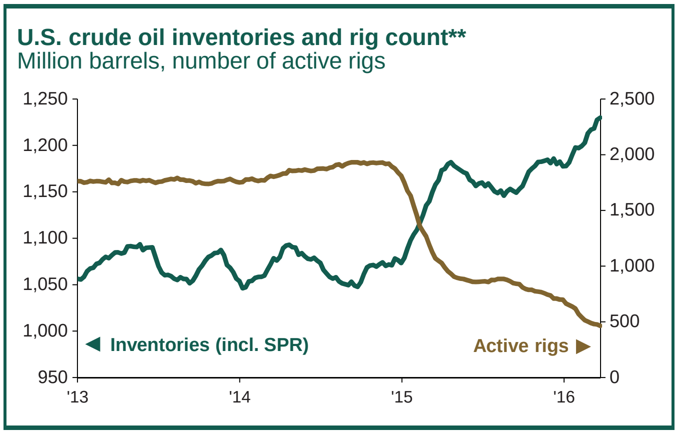
Market Index Returns for Periods Ending March 31, 2016

Index	1stQtr	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	1.4	2.2	11.8	11.5	7.0
S&P 400 US (US Mid Cap)	3.8	-3.3	9.5	9.4	7.8
Russell 2000 (US Small Cap)	-1.5	-9.7	6.8	7.1	5.3
MSCI ACWI X-US IMI Net (Foreign Equity)	-0.2	-8.4	0.8	0.5	2.1
MSCI EM (Foreign Emerging)	5.7	-12.0	-4.5	-4.1	3.0
Barclays Aggregate Bond	3.0	1.7	2.5	3.8	4.9
Barclays Muni Bond	1.7	3.9	3.6	5.6	4.9

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

as China transitions from a manufacturing economy driven by government investment to a service economy driven by consumer spending.

Commodities—Oil has been the most volatile commodity in recent years. West Texas Intermediate crude oil prices fell as much as 29.72% during the first quarter but then reversed course dramatically to end the quarter with slight gains. Crude oil production has remained steady in the US even as producers have reduced the number of rigs in operation and laid off thousands of employees. Inventories have risen sharply as shown in the chart at right. This phenomenon combined with talk among OPEC nations about maintaining current production levels means oil prices aren't likely to post significant gains in the near future.



Source: J.P. Morgan Asset Management; EIA; Baker Hughes.

***U.S. crude oil inventories include the Strategic Petroleum Reserve (SPR). Active rig count includes both natural gas and oil rigs.*

Central Banks—Entering the year, there was much hand-wringing about the Fed beginning to tighten monetary policy while foreign central banks continue or even accelerate their own easing policies. Japan's Prime Minister Shinzo Abe recently said he was considering a new economic stimulus package while the European Central Bank made cuts to push rates negative and increased its bond buying program. When the Fed raised rates in December for the first time since 2006, it made clear its desire to normalize policy and move away from near-zero interest rates. Coming into the new year, it looked like the Fed would raise rates four times in 2016 and possibly another four times in 2017.

With the fall in commodities and general global weakness, the Fed decided economic conditions weren't robust enough to raise rates in either January or March (the Fed did not meet in February). Looking ahead, it appears it isn't likely to raise rates until at least June, meaning we may be looking at two rate increases in 2016 instead of four. The market has responded positively to this expectation. The effects were clearest in the returns of stocks of utilities, probably the most interest-rate-sensitive sector. The S&P 500 Utilities Index rose 15.6% in the first quarter. The Fed's dovish position on rates also contributed to the rebound in commodities prices as it pushed the US dollar lower.

The labor market in the US continued to improve, adding 628,000 new jobs during the quarter. It may sound counterintuitive but the fact that the unemployment rate ticked higher to 5.0% from 4.9% in March is good news because it means more people are confident enough to rejoin the labor force, as shown in the chart on the next page. The civilian workforce has grown by 1,453,000 people since December, according to the Department of Labor. It is a small tick up from the participation rate trend but a step in the right direction nonetheless.

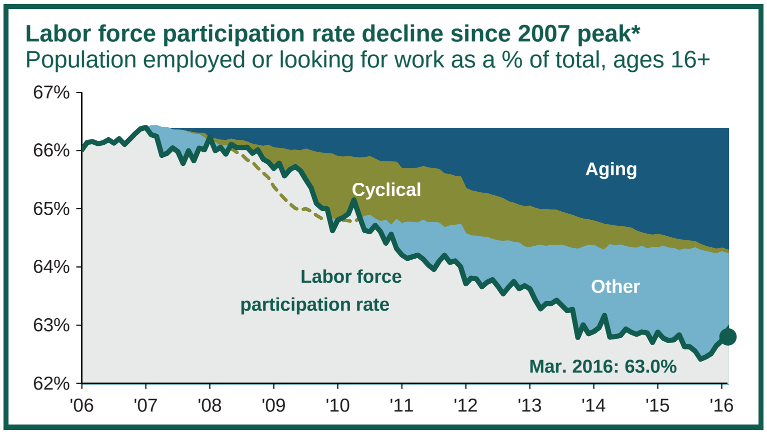
Looking Ahead

Europe—The big story in Europe right now is the possible "Brexit" vote coming in June, when British citizens will vote on whether to remain in the European Union. A vote to exit would mean trade agreements and financial regulations would need to be renegotiated, creating a good deal of uncertainty for both the British and EU economies. Polls are currently showing voters are leaning towards staying in the EU.

Market & Economy *(Continued from page 2)*

Presidential Election—So far, the upcoming presidential election hasn't seemed to have had much impact on the market. While all of the candidates tend to talk about how bad the economy is, the US economy continues to grow slowly and has been the strongest among global developed economies. The market will likely begin to take more notice after the conventions, at which point there will be more scrutiny of the specifics of each candidate's platform.

US Economy—The US economy continues to grow at the slow pace we have seen throughout the entire recovery. First quarter GDP growth hasn't been released but is likely to come in stronger than in recent years because we didn't see the same type of crippling winter storms that we saw in 2014 and 2015. While businesses are still hesitant to make investments in growth, the situation for the American consumer continues to gradually improve as highlighted by job growth and wage gains.



*Source: BLS, FactSet, J.P. Morgan Asset Management. *Aging effect on the labor force participation rate is the estimated number of people who are no longer employed or looking for work because they are retired. Cyclical effect is the estimated number of people who lose their jobs and stop looking for work or do not look for work because of the economic conditions. Other represents the drop in labor force participation from the prior expansion peak that cannot be explained by age or cyclical effects. Estimates for reason of decline in labor force participation rate are made by J.P. Morgan Asset Management.*

Corporate Earnings—First quarter earnings are projected to be weaker than in recent quarters, with the energy sector being the biggest detractor. These projections are likely already priced into the market as analysts have been lowering estimates over the past few months. Historically, lower estimates have led to more upside surprises, which has been good for stocks. The fact that the US dollar index fell 4.7% relative to foreign currencies in the first quarter will help make US products more competitive globally going forward. This may already be showing up in the numbers. The Institute of Supply Management Manufacturing Index (ISM) moved back up to 51.8 in March—the first reading showing expansion in manufacturing since last July.

Lessons—Market action in the first quarter offers investors a learning opportunity. Recall that six weeks into the quarter, stocks were down 11% and interest rates were higher. Headlines such as "Stocks have worst ever start to a new year!" and "Higher rates spell trouble for bond investors!" and "Some economists predicting recession!" were the norm. It looked like the perfect time to hunker down in cash. Just six weeks later, the stock market was back in the black for the year, interest rates had fallen back below the levels they ended the prior year and economic headlines had turned mostly positive. We are reminded of the value of maintaining a disciplined long-term investment plan and of the benefits of rebalancing the portfolio amid the volatility.

Matthew S. DeVries, CFA® ■

Chopping Wood *(Continued from page 1)*

cedar tree snapped back on him while he was clearing trails on the tractor. I got a real kick out of watching his reaction when friends would see him in a cast and shoulder sling and ask, "Oh Frank, did you have a fall?" It infuriated him. When I recall that Dad's mother lived to 93 and his father lived to 101, I figure I have a lot more years of receiving his motivational text messages. I'm counting on it.

Dad's resilience is similar to the resilience of the US economy. In the face of global weakness, carnage in the energy industry, weak corporate investment, flat corporate earnings, a strong dollar, the drumbeat of negativity from presidential candidates and threats from terrorism, the US economy continues to create jobs and expand. On Friday April 1, the labor department reported that US employers added 215,000 jobs in the month of March, the 73rd consecutive month of positive job creation. Hiring was fairly broad-based across economic sectors, with only mining and manufacturing showing declines. Wage gains, which have been scarce since the recession, saw a slight uptick during the month and for the twelve months ending in March, wages increased by 2.3% after inflation. Finally, the labor-force participation rate inched up slightly to 63% after hitting a 39-year low of 62.4% last September. More on this in the next section.

Not everything is rosy. As we have discussed before, the pace of economic growth during this expansion has been far below the pace of growth during past expansions. Many of the jobs created have been part-time or lower-paying positions and as mentioned above, many discouraged workers have dropped out of the labor force. But despite the negatives, the US economy is working its magic. This is nothing new. During my lifetime (48 years), real GDP (US economic

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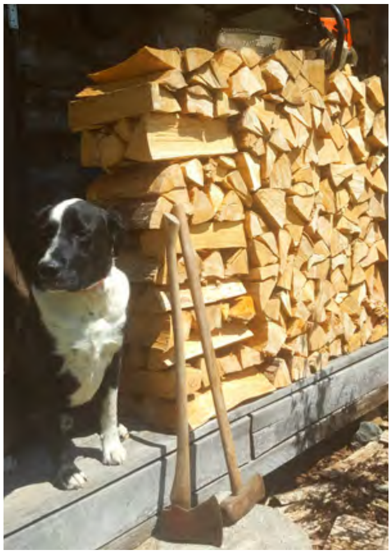
Chopping Wood *(Continued from page 3)*

output adjusted for inflation) increased from $4.5 trillion to $16.5 trillion. On a per capita basis (considering population growth) real GDP increased from $22,000 to $51,000. Remarkably, over the last twenty years, which included the bursting of the technology bubble and the financial crisis, real GDP per capita increased from $38,000 to $51,000, an increase of $13,000 *per person* or 34%. Had the increase been distributed equally (it wasn't, but I think you'll see my point), a family of four would have seen household income increase by $52,000 over the twenty-year period ($13,000 multiplied by four). Again, these figures are adjusted for inflation. Even during the Great Recession, the economy proved amazingly resilient. Economic output only declined by 3.4% from its peak of $14.9 trillion in 2007 to its low of $14.4 trillion in 2009 before resuming its upward march to $16.5 trillion in 2015. I don't know about you, but when I think about the dark days of late 2008 and early 2009, I find it astounding that our economic output shrank by only 3.4% during this period. It seemed so much worse! (You can easily find all of this data and much more for free at the website of the St. Louis Federal Reserve Bank).


Jackson hard at work

I think you'll agree that the economic figures are interesting if not amazing. The US economy is a powerful force! And remarkably, economic growth happens by evolution. Rather than being the result of some grand plan, economic growth and prosperity evolve through the collective actions of individual market participants. In his 1776 book, *The Wealth of Nations*, Scottish economist Adam Smith described the "Invisible Hand" of a free market system in which an individual acting to maximize his own gain must exchange what he owns or produces with others who sufficiently value what he has to offer. In this way, by division of labor and a free market, the public interest is advanced. Said another way, when we each act in our own self-interest, society as a whole is better off. It is not the central planning of the government or the interest rate policy of the Federal Reserve Bank that create prosperity. History has shown that planned economies (the USSR, Cuba, North Korea, Venezuela and China to name a few) and excessive government regulation have the effect of stifling or destroying the wealth-creating magic of the free market. While obviously there is a place for government policies and regulations to protect the populace and promote the public good, the free market remains the powerful engine that has reliably driven our economy for centuries.

We'll need some free-market magic in the years ahead. We've written on numerous occasions about the challenges we face with the Federal budget. According to the non-partisan Congressional Budget Office (CBO), by the year 2019, entitlements, defense and interest on the Federal debt will consume all tax revenue collected. Any spending beyond those items will require the United States to add to its growing pile of debt (now almost $20 trillion). Within ten years, our annual deficits are projected to balloon to $1.3 trillion (almost 5% of projected GDP) from the current level of $400 billion (2.5% of current GDP). The CBO projections assume the economy avoids recession and continues to grow at its current pace, that unemployment remains low, that inflation is benign and that interest rates remain low. There are a lot of feel-good assumptions there. Lob in an expensive war, spiking interest rates, unexpected inflation or one of Donald Rumsfeld's "unknown unknowns" and we may find ourselves with a big hole in the fence.

The path is obviously not sustainable and there will be some tough choices in our future. Depending on the political party, our current candidates (Hillary, Bernie, The Donald, Cruz, Kasich?) are promising higher taxes and more spending or lower taxes and less spending. None of the math works. Reality calls for a combination of higher taxes and lower spending and none of the candidates seem to suggest this path...why make everyone mad, I guess? We'll write more about politics (carefully) in July and October when things have really heated up.

In the interim and in the long term, we'll remain optimistic that the economy will have the resilience to grow through the challenges coming our way, creating the prosperity to move us forward. 240 years of history make a strong case that one shouldn't bet against America. In the unlikely event that we're wrong and our best days are behind us, you can find me on the farm chopping wood with my dad. Maybe you can grow some vegetables. We can trade with one another and have our own little economy.

On behalf of everyone at Bragg Financial, thank you for choosing us for your financial planning and investing. Enjoy your spring!

Sincerely,

Benton S. Bragg

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