INVESTMENT COMMENTARY

2nd Quarter 2016

Bragg Building
1031 South Caldwell Street, Charlotte

"Our clients hire us to do the worrying so they don't have to."

-Frank Bragg

FIRST AID KIT

I just spent a fortune on a first aid kit! Next week I leave town for two weeks with 40 teenagers and 10 brave adults from Boy Scout Troop 58 in Davidson, North Carolina, to go to Philmont Scout Ranch in New Mexico. Philmont Scout Ranch is the Boy Scouts of America's largest national High Adventure Base and the world's largest youth camp. The ranch covers 137,000 acres—about 214 square miles—of rugged mountain wilderness in the Sangre de Cristo range of the Rocky Mountains in northern New Mexico. Philmont offers 315 miles of trails over rough terrain and elevations that range from 6,500 to 12,440 feet. More than a million Scouts and their volunteer leaders have made the trek to Philmont since Oklahoma oilman Waite Phillips gave the ranch to the BSA in 1938. This summer, approximately 22,000 Scouts and leaders will hit the trail for a 12-day backpacking trek. Each day, 350 arrive, 350 leave and 3,500 will sleep in the backcountry.

Our troop will be divided into five crews, each with eight Scouts and two adult leaders. Each crew will be on its own in the backcountry, backpacking 75 miles over 12 days. You guessed it, I'm an adult leader. Eight other Braggs will be in attendance, including two of my sons, my brother John with three of his children, and two sons of my brother, Phillips, who volunteered to stay home and mind the store at Bragg Financial Advisors. Phillips may avoid sleeping on the hard ground for twelve straight days but he'll endure a lifetime of abuse from those of us who braved the adventure.

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MARKET & ECONOMY

Much like in the first quarter, the stock market sold off sharply in the second quarter, only to end up with positive returns. It was the United Kingdom's vote to exit the European Union, referred to as "Brexit," that shook the markets. The market reacted severely in the two trading days following the June 23rd vote. The S&P 500 fell 5.3% but then staged a nearly-as-impressive recovery over the last three days of June to end up 2.46% for the quarter and 3.84% for the year. The S&P 500 has now posted gains in the last three quarters in a row. Despite worries about rising interest rates in early 2016, bonds have remained strong as the 10-year US Treasury yield has fallen by a third to 1.49% during the first six months of the year.

The three C's (China, Commodities and Central Banks) that drove volatility early in the year all quieted down in the second quarter. China is still muddling through its economic transformation and while Chinese stocks haven't recovered, prices have stabilized since January's decline. Commodity prices posted much better returns in the second quarter, led by oil. West Texas intermediate crude oil posted a 26% gain during the second quarter. Central bank worries have also abated somewhat as it now looks like the Federal Reserve may only raise rates once in 2016, if at all. The three C's have all taken a back seat to Brexit, which has completely dominated financial news recently.

IMPLICATIONS OF BREXIT

Leading up to the June 23rd vote, British sources were citing as much as

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Market & Economy *(Continued from page 1)*

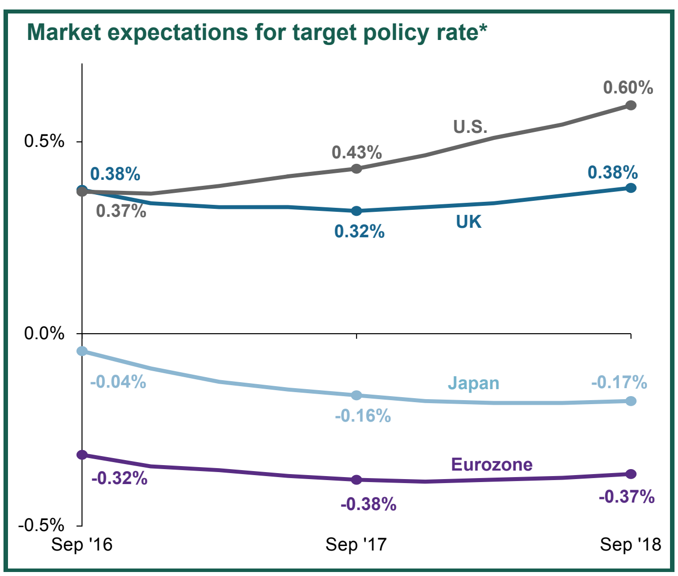
Market Index Returns for Periods Ending June 30, 2016

Index	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	3.8	4.0	11.7	12.1	7.4
S&P 400 US (US Mid Cap)	7.9	1.3	10.5	10.6	8.6
Russell 2000 (US Small Cap)	2.2	-6.7	7.1	8.4	6.2
MSCI ACWI X-US IMI Net (Foreign Equity)	-1.0	-9.6	1.7	0.4	2.2
MSCI EM (Foreign Emerging)	6.4	-12.1	-1.6	-3.8	3.5
Barclays Aggregate Bond	5.3	6.0	4.1	3.8	5.1
Barclays Muni Bond	4.3	7.7	5.6	5.3	5.1

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

a 90% probability that UK citizens would vote to remain in the EU. Experts and politicians alike were surprised by the vote. UK Prime Minister David Cameron immediately announced he would resign his post and step down in October.

Looking ahead, exiting the EU is not something that happens overnight. The process doesn't even start until the UK invokes the never-used "Article 50" of the Lisbon Treaty. The vote itself is not legally binding and must be approved by the UK parliament. Outgoing Prime Minister Cameron has said he will leave the decision to trigger Article 50 to the new prime minister, so we are at least a few months away from formalization of the exit. Two leaders of the movement to leave the EU, Boris Johnson and Michal Gove, have both said Article 50 does not need to be invoked immediately and may even be delayed for several years.



Source: Bloomberg, J.P. Morgan Asset Management.

**Target policy rates for Japan are estimated using EuroYen 3m futures contracts less a risk premium of 6bps. Government bond index is the BofAML Global Government Bond Index, which includes investment-grade sovereign debt denominated in the issuer's own domestic currency. The index includes all Euro members, the U.S., Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.*

Once invoked, however, it will still be two years before the UK officially leaves the EU. Following the immediate shock of the vote, it is clear that Brexit is only just beginning and there won't be any immediate changes for trade in the EU and the UK.

But in the near term, the UK and the remaining European Union countries are left with considerable political uncertainty. With Cameron set to step down, there are questions about who will be the next prime minister. The new PM will then begin the lengthy negotiations with the EU to determine what an exit will look like.

Both the EU and the UK are highly dependent on each other as trade partners but EU officials have made it clear there will be no special treatment for the UK, in large part to deter similar referendums in other EU countries. According to German Chancellor Angela Merkel, "There must be and there will be a palpable difference between those countries who want to be members of the European family and those who don't."

Across Europe, there are questions about other potential referendums. Scottish citizens voted overwhelmingly to stay in the EU and First Minister Nicola Sturgeon has talked about the possibility of another independence referendum. Since the June 23rd vote, there have been calls for referendums to determine EU membership in France, Italy, Holland, and Denmark. Should these countries leave, it would be more destabilizing than the UK leaving because each of these countries use the Euro as their currency. The UK never adopted the Euro, preferring to maintain the pound sterling as its currency.

Central banks around the world, including the Bank of England, European Central Bank, Bank of Japan, and the US Federal Reserve have all voiced their willingness to stimulate growth and provide liquidity to the global economy through further monetary policy. As you can see, central bank rates around the world are now expected to stay about the same or fall over the next two years. The US Federal Reserve is the only central bank expected to significantly raise rates over that time but only by 0.23%--far different from the 1.00% per year increase the Fed was projecting coming into 2016.

FOCUS IS STILL ON THE FED IN THE US

It is difficult to predict what kind of impact, if any, Brexit will have on our economy. While growth prospects in Europe may be diminished, our trading status with the

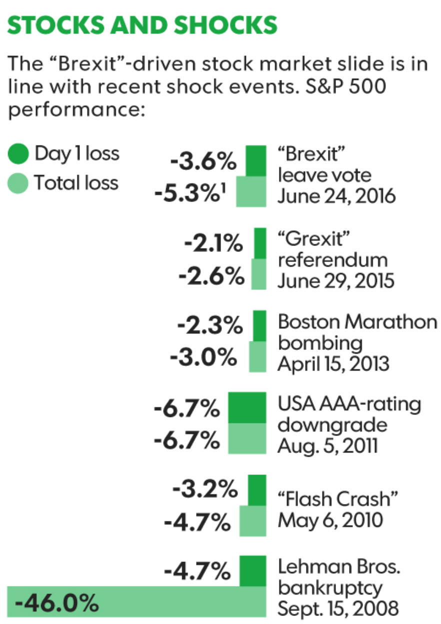
Market & Economy *(Continued from page 2)*

EU and the UK isn't likely to be significantly affected. Only 13% of US GDP comes from foreign trade; it's the actions of the Federal Reserve Bank that are more likely to have a significant impact on our economy.

On several occasions over the last two years the Fed has said it was going to raise rates, and then has failed to do so. As a result, we've seen counter-intuitive market turmoil: the market has gone up on disappointing economic reports and has slipped on good news, as investors anticipate the effect of the economic news on the Fed's decisions. This phenomenon reappeared in the middle of June as the market fell just as some economic reports came in better than expected, suggesting the Fed may raise rates soon. However, the Brexit vote quickly pushed estimates of the next rate hike out as far as 2018, according to some estimates. The Fed's Open Market Committee decided in April and again in June to delay raising rates, so the current period of historically low rates may well continue. Meanwhile, the US economy has been performing solidly. The Atlanta Federal Reserve Bank is estimating a 2.6% growth rate for GDP in the second quarter, well above the 1.1% rate seen in the first quarter.

LOOKING AHEAD

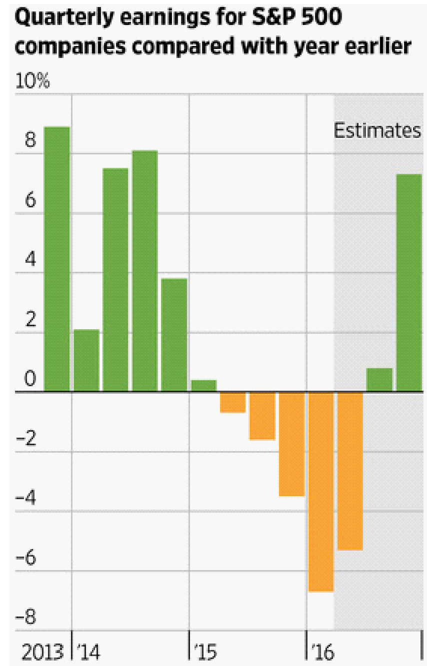
As the chart to the right shows, market shocks have been fairly common in recent years. The last four shocks prior to Brexit were all short-lived. It just goes to show that immediate reactions to news aren't always great predictors of which direction the market is headed.



1-2 day loss ending 6/27/16
Source: S&P Capital IQ. Frank Pompa. Compiled by USA Today.

Undeniably, the landmark vote in the UK to leave the European Union creates a lot of uncertainty. Who will be the new UK prime minister to lead the exit negotiations? Will the EU make an example of the UK to the detriment of both sides? Will we look back at this vote as the beginning of the end for the European Union? Will central banks around the world push interest rates even lower? Does this really matter for global growth?

We won't have answers to all of these questions for quite a while. We do know that the UK is still a part of the EU for a least a couple years. Over that time, however, we are likely to see additional spikes in volatility that have been more and more common in recent years even as the market has kept rising.



Source: The Wall Street Journal

Ultimately, headline news tends to cause short-term market movements, but long-term market returns are driven by company earnings. Here the indications are hopeful. Earnings for S&P 500 companies have fallen for the last five quarters, even as the stock market has risen 5.3%. But earnings are projected to begin growing again in the third quarter and further accelerate in the fourth quarter as shown in the nearby chart. And in the end, earnings growth should trump even Brexit for its impact on investment returns.

Matthew S. DeVries, CFA® ■

First Aid Kit *(Continued from page 1)*

Preparing for the trip has been quite a commitment. In addition to assembling the required gear and completing training courses in wilderness survival and first aid, we've taken four so-called "prep-trips." These included a 20-mile day hike in the Uwharrie Mountains east of Charlotte and a two-night, 22-mile backpacking trip in the Shining Rock Wilderness in western North Carolina. One of my roles as a crew leader was to assemble the first aid kit for my 10-person crew. REI sells a basic kit for $40 but I was told to supplement that kit with numerous other items that we might need. It's amazing what can go wrong out there on the trail! In addition to the typical bandages, tape and wraps, I have a splint for broken bones, an irrigation syringe for cleaning cuts, wound closure strips, a CPR face shield, tweezers, trauma shears, vinyl gloves, thermometers, moleskin for blisters, Afrin for nosebleeds, Pepto Bismol for indigestion, Imodium for diarrhea, Benadryl for allergies, ibuprofen for pain, Orajel for mouth sores, EpiPens, inhalers, trauma pads, second skin for burns, a cravat to

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First Aid Kit *(Continued from page 3)*

make a sling and even stool softener! I think I now have a complete kit but I'm broke! Hopefully we'll have a safe trip and our first aid kit will remain buried in my 45-pound backpack. But should we need it, I'll be prepared.

I'm excited about the trip. According to the many veterans of Philmont I've spoken with, including some of you reading this, it will be very challenging but it will be one of the best experiences of my life. I'm also a bit apprehensive as you might imagine. Assembling the first aid kit got my attention; it drove home the fact that I'll be responsible for the safety of my crew. I'm also mindful of the fact that I'm nearing the end of my fifth decade of life … hopefully the muscles and joints will hold up for the journey. Finally, I'm dealing with the reality that I will be completely out of touch with the office for an extended period of time. I admit that I am guilty of dragging along my device (yes, I still use a Blackberry) on most vacations. At Philmont, there is no cell signal, none. This fact took center stage for me over the last two weeks as the markets went on a rollercoaster ride following the result of the Brexit vote. "This is just great, Benton," I thought. "You'll be deep in the wilderness of New Mexico as the market is unraveling." Now, I know what you're thinking. "Benton, you always preach about being a long-term investor and caution us against trying to make drastic portfolio moves in anticipation of something that might happen. Surely something like the Brexit vote isn't something to worry about?" True, but as my father always says, "Our clients hire us to do the worrying so they don't have to." He's right and if I am completely out of touch, I won't even know if I *should* be worrying. I guess I'll pass the two weeks *wondering* if I should be worried. At this point you're probably a bit worried about me. I'll stop.

Frank Bragg IV at summit of Mt. Baldy, the highest peak at Philmont Scout Ranch at 12,440 feet. Summer 2013. Frank is the grandson of Frank Bragg, Jr., founder of Bragg Financial Advisors. Frank IV returns to Philmont next week.

Speaking of the Brexit (British Exit) vote, in case *you* were without a signal for the last two weeks, I'm referring to the June 23rd referendum when the British citizenry voted 52% to 48% to exit the European Union. The market action before and after the vote was remarkable. Leading up to the vote, markets surged dramatically in anticipation of a vote to "Bremain." Then as the votes rolled in and it became clear that the Brexiteers were the victors, markets plunged. European indices dropped 11%, the British pound sterling fell 10% and US equities fell more than 5%. European bank stocks fell 20% or more. And then, remarkably, markets reversed course and rallied hard, erasing almost the entire decline during the final week of the quarter. The S&P 500 actually had a positive return for the month of June. At Bragg, we knew this was going to happen. I'm just kidding. Of course we did not. But if you were watching CNBC or reading the news online, there were hundreds of "experts" who clearly wanted you to think they did. They and the breathless commentators did their darndest to make you think you needed to do something. "Take action, sell, buy, hedge, trade, unload these stocks and pile into those stocks!" And when the dust settled, the talking heads explained it all, providing a neat and tidy after-the-fact narrative that is so appealing to our hindsight bias. At least we got a break from Trump/Clinton for a few weeks, right?

The Brexit provides a great opportunity to review some fundamentals:

Volatility is normal. Markets rally and markets decline. That is what they do.

No one can see the future. The "authorities on the subject" (highly educated and compelling communicators) are always in abundance whether online, in print or on television. Listening to them can be entertaining and sometimes it can be scary as hell. But remind yourself that they don't know what is going to happen.

Your portfolio should be based on a solid financial plan. Put yourself in a sustainable financial position. As we've discussed before, take care of liquidity first. Be sure your income (salary, pension, dividends, coupons) or your bond/cash position will allow you to make it through extended market declines. Then invest the remainder of your portfolio in long-term "ownership" assets. Own stocks, own real estate and be diversified.

That last point is paramount. I prepared for my Philmont adventure by taking 22 hours of backcountry safety and medical training and assembling a first aid kit to be ready for things that might happen on the trail. Our work at Bragg Financial is no different. As we work with you on your planning or your portfolio we acknowledge that the future is uncertain. Sometimes Brexit happens. The best thing we can do is Be Prepared.

Thank you for choosing Bragg for your financial planning and investing.

Sincerely,

Benton S. Bragg

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