INVESTMENT COMMENTARY

2nd Quarter 2017

Bragg Building
1031 South Caldwell Street, Charlotte

"Son, you need a reality check."
-Frank Bragg

BEDPANS AND BULL MARKETS

I called home from college in the spring of 1989 to let my parents know that I had decided to go down to Wrightsville Beach that summer to find a job. I figured I could bus tables in a restaurant in the evenings, catch the late-night parties and hang out on the beach all day. Of course I didn't use that precise wording when telling my parents of my plans but I thought I made a pretty good case for myself. At the time I was just finishing up my freshman year and frankly, things were going pretty darn well. I had done fine academically but more importantly (to me anyway) I had never had more fun. You likely remember it well; for the first time in life you enjoyed total freedom from adult supervision. I cherished the independence, my new friends, the parties, ACC football, road trips, and of course, all those babes at Wake Forest! Life was good. A summer at the beach would be the perfect way to keep the party going.

(Continued on page 3)

MARKET & ECONOMY

The second quarter of 2017 looked much like the first. All of the major asset classes we follow were up again. In the US, large-cap stocks are nearing double-digit gains for 2017 with the S&P 500 now up 9.34% for the year. Small-cap stocks continue to lag as the Russell 2000 is up 4.99% year-to-date. This relative underperformance by small caps isn't too surprising considering the strong run small cap stocks had in the second half last year.

The big five technology companies are a major contributor to the S&P 500's gain this year. Depending on the day, Apple, Alphabet (Google), Microsoft, Amazon, and Facebook are the five largest companies in the index by market cap and the average return of these five companies exceeds 23% in 2017. Though accounting for only 1% of the total number of companies in the S&P 500, these companies account for nearly a third of the total return of the index this year.

(Continued on page 2)

Market Index Returns for Periods Ending June 30, 2017

Index	2nd Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	3.1%	9.3%	17.9%	9.6%	14.6%	7.2%
Russell Midcap (US Mid Cap)	2.7%	8.0%	16.5%	7.7%	14.7%	7.7%
Russell 2000 (US Small Cap)	2.5%	5.0%	24.6%	7.4%	13.7%	6.9%
MSCI ACWI X-US IMI Net (Foreign Equity)	5.9%	14.3%	20.4%	1.1%	7.6%	1.4%
MSCI EM (Foreign Emerging)	6.3%	18.4%	23.8%	1.1%	4.0%	1.9%
Barclays Aggregate Bond	1.5%	2.3%	-0.3%	2.5%	2.2%	4.5%
Barclays Muni Bond	2.0%	3.6%	-0.5%	3.3%	3.3%	4.6%

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

BRAGG Financial Advisors | 50 Years of Service

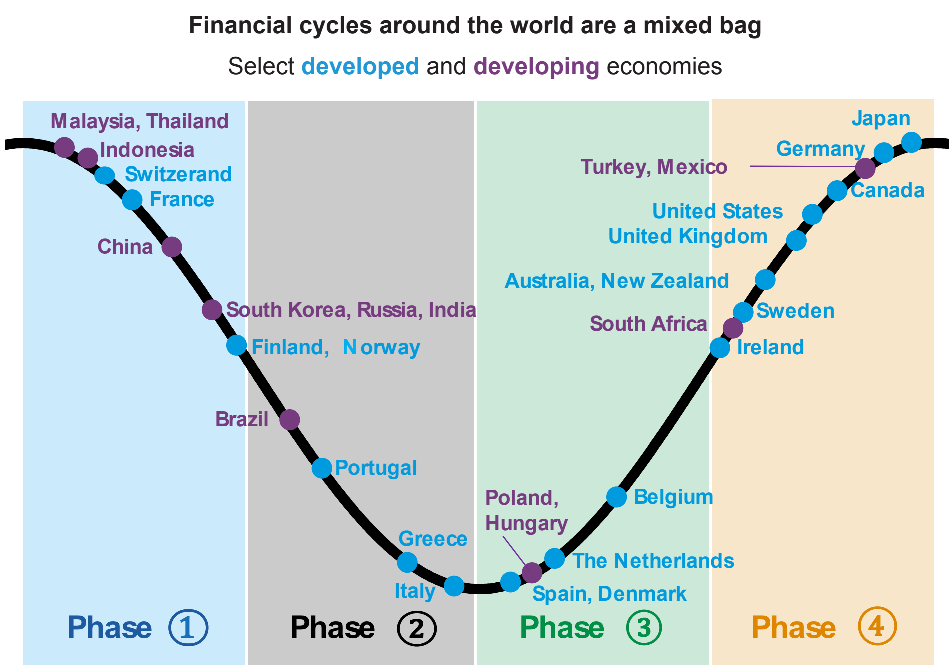
1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203
(704) 377-0261 • Fax (704) 334-9754

Market & Economy *(Continued from page 1)*

We have enjoyed bountiful returns investing in US stocks over the eight-plus years since the market hit its lows during the financial crisis. Depending on the metric you look at, US stocks are either fairly valued or overvalued today. That isn't to say we are headed for a correction but in our view it does mean that US stocks aren't likely to offer the same upside we've enjoyed over the last eight years.

International stocks have enjoyed a significant rebound so far in 2017, with the MSCI All Country World Index excluding US stocks (MSCI ACWI X-US) up 14.30%. Reasons for the strong returns in foreign stocks include a falling US dollar, continued stimulus from foreign central bankers, and the sweeping victory of newly-elected French President Emmanuel Macron over anti-EU candidate Marine Le Pen.

Capital Group, the manager of the American Funds, provided the chart below which illustrates their best estimation of where different countries are in the financial cycle. The chart shows how economies normally (but don't always) move through the market cycle starting in phase one with early decline, moving on to full recession, then recovery, and finally into phase four where the expansion slows. The chart makes the case that the recent run by foreign stocks may have room to continue as most foreign economies aren't nearly as far along in the market cycle as the US. The MSCI ACWI X-US trailed the S&P 500 by 70% from the beginning of 2008 through the end of 2016 but it is very possible we are seeing a turning point in 2017. While we would caution against trying to selectively bet on specific countries shown in the chart, we will always advocate for maintaining a globally diversified portfolio.



Source: Capital Group, Investment Insights: Financial Cycles and Asset Prices

Source: Board of Governors of the Federal Reserve System (US)

What happens at the end of the bond bull market?

Interest rates on treasury bonds have steadily fallen since 1981 as you can see in the chart above. This has generated good returns for bonds but has made it increasingly hard for investors to earn meaningful income from bond investments. With quantitative easing and a record-low Federal Funds Rate, the Federal Reserve helped push interest rates to new lows in the past decade. When the Fed began signaling it was time to initiate rate increases, we began hearing more and more about the coming end of the three-and-a-half-decade bull market for bonds. If we truly are at the end, however, it doesn't mean rates will shoot higher and bond prices will start falling.

Case in point, the Fed has now raised the Fed Funds rate three times since last December and something unexpected has happened—the 10-year Treasury yield has actually *fallen*. What determines where interest rates will go? The answer is old-school economics—supply and demand.

Even though the US government has issued debt at record levels since 2008, there has been no shortage of buyers. The Federal Reserve has led the way as the largest single buyer of US Treasuries. During the three Quantitative Easing Programs from 2008 to 2014, the Fed went out and bought as much as $85 billion worth of bonds each month with money it didn't have. Over this time, the Fed added nearly $2 trillion worth of Treasuries to its balance sheet.

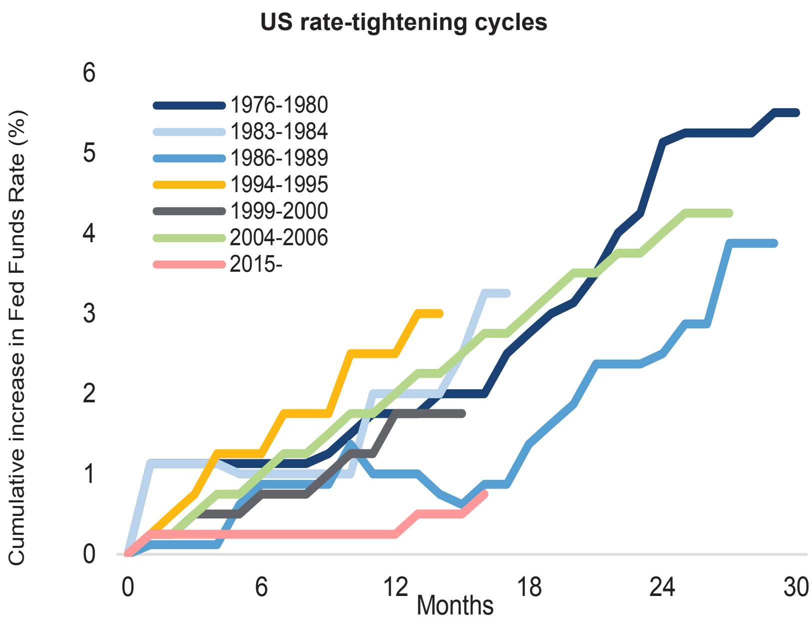
In addition to the Fed, government agencies from all over the world have been major buyers. Since 2008, foreign

Market & Economy *(Continued from page 2)*

governments' Treasury holdings nearly doubled from $3.1 trillion to $6.1 trillion in April. This has primarily been driven by our trade deficit. We buy more things from China than we sell to them. The People's Bank of China facilitates the trade imbalance by printing new Chinese Yuan to exchange for all of the US dollars flowing into the country. They have been more than happy to do so to help keep the Yuan weak and Chinese goods competitive. As a result, the Chinese government has built up over $1 trillion worth of US dollar holdings. For the most part, they have taken these dollars and bought US Treasuries.

From the end of 2008 through April 2017, 55% of the debt created by the US Treasury has ended up in the accounts of the Federal Reserve and foreign governments. The rest has been bought by individuals and institutions. Not to be forgotten, the aging US population plays a big part as well as Baby Boomers reaching retirement age need to shift some of their savings out of stocks into more stable investments like bonds.

What happens from here is hard to say but it's difficult to see a major change coming that will push rates back to where they were 20 years ago. The Fed just announced a plan that may start later this year to let its balance sheet start shrinking by as much as $10 billion per month as bonds mature. Anything above that will be reinvested into more bonds. It will take a long time for that to make much of a dent considering the Fed's total balance sheet is currently sitting at about $4 trillion.



Source: HSBC Global Asset Management

There is definitely room for rates to rise but thus far indications are that this will likely happen slowly. As shown in the chart to the left, this is already the slowest pace the Fed has raised rates at any point dating back to 1976. If rates do rise slowly, bonds can still provide a positive return. In sum, given the continued slow-to-moderate pace of global growth, the absence of significant inflationary pressures, and the slow pace of central bank tightening, we think we are unlikely to see a major spike in rates that would prove damaging to bond portfolios. Regardless of what happens, the downside risk of bonds is far less than the downside risk of stocks. Bonds will continue to improve portfolio diversification while offering always-important capital protection.

Matthew S. DeVries, CFA ■

Bedpans and Bull Markets *(Continued from page 1)*

Frank Bragg felt otherwise. There was no discussion. "Nope. Be home the day after your last exam." My summer at the beach never materialized. Those of you who know my father might know that he has strong opinions on raising children. With regard to children making decisions for themselves, Dad has been known to say, "Of course my kids need to learn how to be good decision-makers. But until they reach the age and maturity that they make the same decision I would make, I'll make all their decisions for them." Apparently I was still a child. And thus it was that I found myself working as an orderly at Presbyterian Hospital during the summer after my freshman year of college. As Dad put it, "Son, you need a reality check. Life is not a party. You are not the center of the universe. I'm not spending fifteen thousand dollars a year for you to go live in a self-centered bubble."

Nancy Snapp was the beloved, long-time head of nursing at Presbyterian Hospital. For thirty years, Bragg Financial handled the retirement plan and other benefits at Presbyterian so Dad knew Nancy quite well. He apparently asked her to give me a job doing something that might *bring me down a notch or two*. As he put it, "Nancy, the boy needs

(Continued on page 4)

Bedpans and Bull Markets *(Continued from page 3)*

some sensitivity training." Nancy had just the thing for me. I went to work on the sixth floor of the hospital where many of the sickest patients received care. Most of these patients were elderly and frail. Many were near the end of their lives. My duties included changing bed linens, changing hospital gowns and emptying bed pans. These patients needed to be bathed, weighed, fed, lifted and transported each day. This I did. All day, every day. For a healthy, confident, nineteen-year-old, big-man-about-campus, my summer job was like a visit to another planet. Here I was sponge-bathing a ninety-five-year-old man when my pals were hanging out on the beach! It was hard. Frank Bragg loved it! And you know what? By the end of that summer I was grateful that he made me do it. Working at Presbyterian exposed me to aspects of life and humanity that I had not known. In addition I was privileged to have co-workers who were the most caring, dedicated, and hard-working individuals you'll find.

Like the over-confident, nineteen-year-old Benton Bragg, investors today need a reality check. The market has been on a roll. US stocks have done well, foreign stocks have too, and even bonds have contributed. Portfolios are flush. Admit it: your portfolio is worth a lot more than you imagined it would be as you worried through the great recession eight or nine years ago. I wish we at Bragg could take credit for this state of affairs, but we can't. To paraphrase famed investor Humphrey B. Neill, never confuse a bull market with brilliance. Sure, we have done what you hired us to do: build the portfolio, remain diversified, rebalance with discipline, keep the costs low and minimize the tax bill. But like you, we've been pleasantly surprised with the market's sustained strength, the remarkable length of this rally and the relatively smooth ride we've enjoyed.

Investors have become a bit complacent. We've even sensed in some of our clients a bit of the swagger of a nineteen-year-old college student. Such is the human condition. The further we get from a period of great pain, fear and uncertainty, the more we discount its significance. We explain away what happened with the benefit of hindsight. We readily accept higher levels of risk and we project the recent past far into the future. In some ways we should be thankful for this human characteristic; as we've written before, without risk-taking, early man likely wouldn't have emerged from the cave after his first brutal fight with the mighty mastodon. But he did emerge and he embraced risk. And just look at the remarkable progress he has made since.

But this risk-taking characteristic also makes us vulnerable to making decisions that lead to loss. Ironically, risk is greatest when there is no perception of risk. We're at our most vulnerable when markets are high, when the headlines are positive, when portfolios are flush, when there is no "fear premium" in the market and when investing is "easy." That's where we find ourselves today. Earlier this week I read a headline from the *New York Times* that read: "Fed Chair Yellen Expects No New Financial Crisis in Our Lifetimes." I found that statement less than reassuring as I recalled then Fed Chair Ben Bernanke's comment on the eve of the financial crisis in 2007: "We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system." Janet Yellen's proclamation is one of many "good-news" headlines we've read lately. In contrast, recall the headlines in 2008 and 2009. Recall your own fears and emotions back then as the market fell 55%, the economy slowed, the banks failed and job losses mounted. Remember your resolve to spend less, to work longer, to save more and to reduce risk in your portfolio. Fear was acutely prevalent. But hindsight makes it clear that we should have "backed up the truck," as my dad likes to say, and loaded up on stocks. That was the time to be bullish.

But no one wanted to be bullish back then. Even our bravest clients who always "bought the dips" were in retreat back then. A fair number of clients asked us to reduce stock exposure even after prices had fallen 30% or 40%. Many more clients asked us not to rebalance. "Hold onto my bonds and cash; don't add to stocks," we heard many times. I'm not being critical—I'm just making the point that we're all human and emotion is a powerful force. Our humanness was on display back then and we must acknowledge that it is on display today as we enjoy brimming portfolios and worry far less about our financial position.

So once again, a reality check from Bragg Financial. Are we suggesting that a market decline is nigh? We are not. We of course can't see the future; the bull might run for months or even years. Likewise, it might not. We *are* suggesting that for the last eight years we've enjoyed a sustained one-direction market with very few declines of any significance. Normal markets are volatile and we should tell ourselves that the good times won't last forever. At Bragg, we are rebalancing portfolios. In general we are trimming stocks and adding to bonds—selling what has done exceedingly well and buying the boring stuff. Put your emotions aside and be glad.

On behalf of the whole team at Bragg, thank you for choosing us for your planning and investing. Have a wonderful summer!

Sincerely,

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