INVESTMENT COMMENTARY

3rd Quarter 2016

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"A small number of Black Swans explain almost everything in our world..."
-Nassim Nicolas Taleb

BROWN COWS & BLACK SWANS

My niece, Martha Kate (15) was crestfallen when the veterinarian announced that Suzie, Martha Kate's cow, had lost her calf and was no longer pregnant. My brother John and his wife Catherine had finally given in to Martha Kate's begging and pleading and given her a milk cow for Christmas last year. The local farmer who sold John the cow offered a special "buy-one, get-one-free" deal. Yes, Suzie was pregnant when she arrived on the farm. Martha Kate was beside herself with excitement as she began preparing for the arrival of the baby calf. But then, a month prior to Suzie's approximate due date the veterinarian delivered the bad news of the loss of the calf after a *thorough* examination of Suzie's insides. It was a sad day on the farm. More on this later.

In 82 AD, Roman satirist Juvenal originated the notable Latin expression, *"rara avis in terris nigroque simillima cygno,"* or "a bird as rare upon the earth as a black swan." In the first century, a black swan was impossible to fathom. Swans were white! At least that was the case until the seventeenth century when Dutch explorers first documented sightings of black swans in Australia. Since then, the term "black swan" has been used as a metaphor to describe the occurrence of highly improbable events. Examples from history might include inventions such as the wheel, the printing press, the steam engine, the telegraph and the internet. Events might include the births of Jesus and Muhammad, the Protestant Reformation, the American Revolution, World War I, the rise of Hitler, the fall of the Berlin Wall

(Continued on page 3)

MARKET & ECONOMY

The third quarter brought much less volatility than we saw in the first two quarters of the year, but that is likely to change as we enter the final month before the US election. Nearly all asset classes outside of commodities posted gains for the quarter. The S&P 500 rose 3.9% for the quarter and is now up 7.8% for 2016. Bond yields remained relatively unchanged during the quarter as the Federal Reserve ended up making no changes at their July and September meetings. So far this year, the Barclays Aggregate Bond Index is up a whopping 5.8%.

An Election like No Other

Election season has taken much of the focus away from the Fed, the economy and corporate earnings. At this point, many polls show Hillary Clinton with an edge in the race for the White House but as fast as things are changing, and after so many surprises this election cycle, it is way too early to declare a victor. Due to the still-tight contest, we suspect that events such as last week's debate are moving markets as investors try to predict the outcome.

We may see more volatility in coming weeks now that the election is less than a month away but that is nothing new. Recent research from Vanguard found that volatility around an election is typically short-term in nature and that volatility typically fades once the election has passed.

While the platforms of both presidential candidates promise significant changes in the areas of tax policy, trade agreements, foreign

(Continued on page 2)

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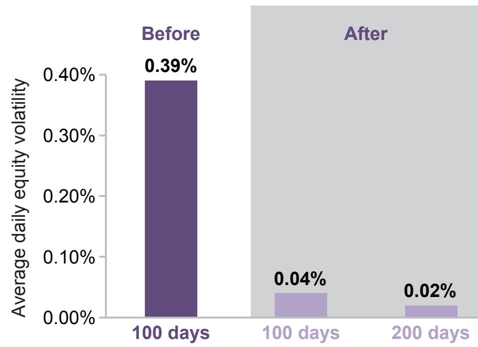
Market & Economy *(Continued from page 1)*

policy, entitlement spending and more, it is important to note that there is usually a wide gap between the winning candidate's promised proposals and the enactment of those proposals. Most policy changes such as tax reform need to be approved by Congress. The president does have the power to affect trade agreements such as NAFTA but modifications wouldn't be easy or quick as existing treaties are written into US law and would likely bring counter-measures from affected nations. It is worth noting that the US hasn't withdrawn from a trade agreement since 1866.

Stock market volatility tends to wane shortly after U.S. presidential elections



Source: Vanguard calculations based on data from Thomson Reuters Datastream, 2016

While most economic data over the past few years have been consistently positive, this election has brought to light the angst felt by many Americans who haven't enjoyed the full effects of the economic recovery. While the unemployment rate has fallen to a relatively low 5%, much of the improvement has happened at the extremes. As you can see in the chart put together by Russell Investments, most of the employment growth has occurred in either high-paying jobs or low-paying jobs. Employment growth in mid-level jobs has lagged in comparison. This may be one reason the Fed has continued to delay rate hikes while the economy has shown slow but consistent growth.

Fed Would Rather Wait and Be Wrong than Raise Rates Too Soon

In a July speech at Jackson Hole, Fed Chairwoman Janet Yellen said, "The case for tightening has strengthened," and by early August, it appeared a September rate hike was all inevitable. The Fed, however, is "data dependent" and after a handful of lukewarm economic reports the committee voted in September to leave rates unchanged. On the Fed's willingness to wait longer, Yellen said, "We can more effectively respond to surprisingly strong inflation pressures in the future by raising rates than to a weakening labor market and falling inflation by cutting rates." In our view, the trajectory indicates that rates are likely to rise only gradually. Of note, while US monetary policy has been dovish, it remains in stark contrast to that of central banks and policy makers in the UK, the EU and Japan, who are aggressively pursuing monetary easing and fiscal stimulus to prop up their slow-growing economies.

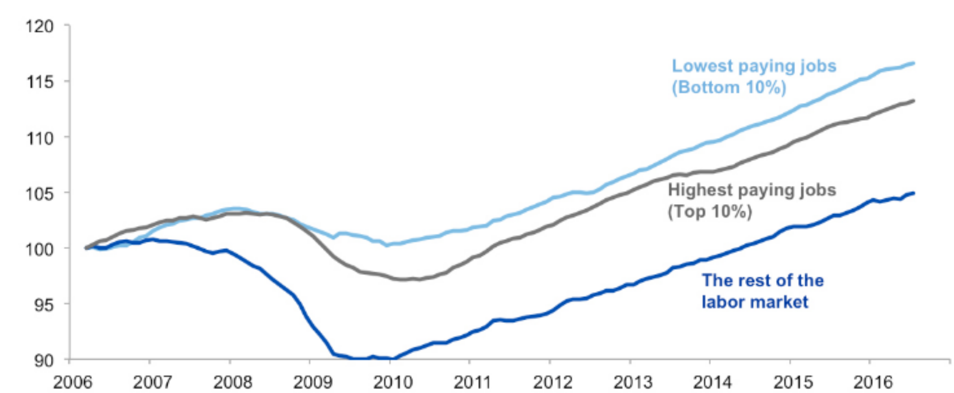
Q3 Earnings Expected to Fall but Revenue Will Show Gains

As we always say, company fundamentals drive returns (and not elections). On this front, earnings have been a disappointment over the past year and a half but there is reason for optimism on the horizon. The current estimate for third quarter earnings for S&P 500 companies is a decline of 2.1% according to FactSet, reflecting a significant drop from early-year estimates. The main culprit continues to be the energy sector which is expected to post a year-over-year decline of 67%.

Excluding energy, however, earnings are projected to grow 1.2% for the rest of the S&P 500 and in the fourth quarter, overall earnings are expected to grow. Also, revenue is expected to grow 2.6% in the third quarter and at least that much in the fourth quarter--the first quarterly growth since the fourth quarter of 2014.

Looking deeper, it is hard to argue that US consumers overall aren't doing better even though there are very clear pockets of economic struggles. The unemployment rate has fallen to 5%, weekly unemployment claims are at their lowest point since the financial crisis of eight years ago and there were over 1.6 million new jobs created in the first 9 months of the year. Also, consumer confidence, as measured by the Conference Board, is at its highest level since the financial crisis. Confident consumers with jobs tend to spend more and this spending drives GDP.

Bulk of employment growth concentrated at the two extremes of the pay spectrum
Private sector employment index by pay category, March 2006=10C

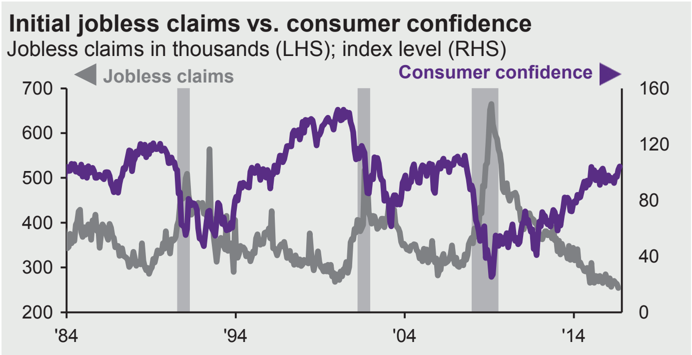


Source: Russell Investments analysis based on detailed employment and wage data across 89 sectors from the Bureau of Labor Statistics. The latest observation is for July 2016.

Calmer Markets in Europe but Important Elections Loom

Following the surprising Brexit vote in June, the Bank of England quickly moved to support the economy by cutting interest rates and stepping up purchases of government and

Market & Economy *(Continued from page 2)*



Source: Thomson Reuters Datastream, J.P. Morgan Asset Management. Light grey columns indicate recession.

corporate bonds. Stock markets across Europe, including the UK's FTSE 100, moved higher during the third quarter as the shock from Brexit wore off. It will still take some time to see the effects of Brexit as the UK Parliament has yet to formally file to leave the European Union. Valuations in Europe look less expensive than in the US as market returns have been tempered by fears of political risk as growing anti-globalization movements threaten to impact elections over the next year. Also weighing on the European financial system is a potential fine of $14 billion that the US government is considering imposing on Deutsche Bank, Germany's largest bank.

Elusive Economic Growth

Most central bankers would admit we are seeing diminishing returns after eight years of monetary policy measures. Something else is needed to kick-start growth and the presidential election is unlikely to be the catalyst. Two important things to watch for are productivity and fiscal policy.

At nearly 70%, the largest component of GDP is personal consumption. On that front, the numbers look fairly good given that job creation has brought the unemployment rate down to the point that we're starting to see wage gains. Productivity, on the other hand, has not rebounded as it typically does in economic recoveries. Some predict that automation or increased connectivity of everyday objects (i.e. the "Internet of Things") will begin to move the needle but productivity growth has historically been difficult to forecast.

Over the past eight years, central banks have provided unprecedented stimulus through monetary policy as lawmakers of developed nations have been reticent to use fiscal policy (government spending) in the face of strong support for austerity. This may change in the in the US in the near future as both Donald Trump and Hillary Clinton have talked about upgrading our infrastructure. If Congress approves new spending on highways, the power grid and other essentials, it could have long-term effects. We think this is something to watch.

Elections Don't Change the Need to Invest

It would appear that we are nearing a major inflection point with the election looming. Just a few months ago, it seemed the same way in the UK with the Brexit vote and yet British citizens continued to get up each morning, go to work and spend money and the UK stock market calmed down and even moved higher. In our opinion, regardless of the election results, our experience in the US isn't likely to be much different. We'll continue to see the usual gyrations but that shouldn't change long-term investment plans. As always, our advice is to stay the course with the knowledge that companies will adapt to a changing world and find ways to prosper.

Matthew S. DeVries, CFA® ■

Brown Cows & Black Swans *(Continued from page 1)*

and the 9/11 terrorist attacks. Each of these inventions or events were improbable and yet each had a major impact on civilization.

Author, professor and former Wall Street trader Nassim Nicolas Taleb further developed black swan theory in his 2007 bestseller, *The Black Swan: The Impact of the Highly Improbable*. Taleb makes the case that there are three conditions of a black swan event. First, the event is highly improbable. Second, the event has tremendous impact, and third, that despite the low probability of the event happening, humans tend to concoct explanations for the event after the fact with the benefit of hindsight. In Taleb's words:

"A small number of Black Swans explain almost everything in our world, from the success of ideas and religions, to the dynamics of historical events, to elements of our own personal lives. Ever since we left the Pleistocene, some ten millennia ago, the effect of these Black Swans has been increasing. It started accelerating during the industrial revolution, as the world grew more complex. Meanwhile, ordinary events, the ones we study and discuss and try to predict from reading the newspapers, have become increasingly inconsequential. Black Swan logic makes what you don't know more relevant than what you do know.

Just imagine how little your understanding of the world on the eve of the events of 1914 would have helped you guess what was to happen next. How about the rise of Hitler and the subsequent war? How about the precipitous demise of the Soviet bloc? How about the rise of Islamic fundamentalism? How about the spread of the Internet? We act as though we are able to predict the future, or, even worse, as if we are able to change the course of history. We produce thirty-year projections of social security deficits

(Continued on page 4)

Brown Cows & Black Swans *(Continued from page 3)*

and oil prices without realizing that we cannot even predict these for next summer."

It's interesting to note that Taleb's book was published in 2007, on the eve of the financial crisis and just as the stock market reached an all-time high. Proving the point of his own book, this brilliant professor, researcher and trader writes *nothing* about the highly improbable but significant events that are right around the corner. At the time of his writing, he has no inkling that the US housing market is on the verge of collapse, that the stock market will fall 55% and that the world will enter the deepest economic downturn since the Great Depression. There is no mention of Lehman Brothers, subprime mortgages, zero-percent interest rates, quantitative easing, the TARP, AIG or Fannie Mae. Indeed, *Black Swan*, the bestseller, was silent about one of the biggest black swans of our lives.

Martha Kate & Dolly

Today we are obsessed with the election. Will it be Clinton or Trump? Taleb would argue that our intense focus on the election will turn out to be wasted energy. The endless polls, predictions, debates and news stories are trivial, day to day, ordinary events that are really inconsequential compared to the black swans that are coming our way. Yikes! Sounds a bit intimidating doesn't it? What IS coming our way? Is it bad – war, disease, financial depression? Or good – rising prosperity, medical advances, technological breakthroughs, lasting peace? And what do I need to do to be prepared? Is my portfolio positioned correctly for the black swans of the future?

Here we turn to our long-time friends about which we often write: liquidity, diversification and discipline. Being prepared for an uncertain future means having adequate liquidity such as a reliable income stream or a robust bond portfolio to make it through difficult periods. Diversification means never bet the farm! For example, we don't want all of our equity exposure in fossil fuels when the black swan breakthrough of a new battery-storage technology dramatically reduces the demand for oil. Now this doesn't mean we abandon energy stocks, nor do we load the boat with investments in solar, wind and bio-mass start-ups. Discipline means we remain humble, we acknowledge that we can't see the future and we rebalance the portfolio to maintain our liquidity and diversification.

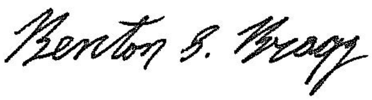
Let's go back to the farm! We had our own black swan occurrence last month. While Martha Kate took the news of the loss of the calf pretty hard, with the passage of time we all went back to our normal routines. A month passed and then we had our black swan event. It was the night before school started back and John's family of six was just sitting down at their supper table for the final family meal of summer when one of the children jumped up and shouted, "Hey, some little brown animal is following Suzie around out there in the pasture!" The whole family bolted for the barnyard where they saw that the "little brown animal" was a new baby calf!

Just like that, the world changed... for the John Bragg family anyway. The chaos and stressfulness of getting four kids into the groove of a new school year (many of you can relate) was immediately complicated and compounded by the chaos and stressfulness of caring for a new baby calf. In consultation with neighbors possessing more experience with bovine care, John and Catherine learned that they needed to move quickly to get the flies off the cows' backs with insect treatment, to partition the paddock to keep the goats and sheep away from the baby calf, to order some *teat wash* (available at discount prices on Amazon), and most important and also intimidating, to immediately begin milking Suzie *twice each day and to continue doing so for the next four months so she wouldn't develop mastitis which could be fatal.* Whew! While it seemed a bit overwhelming at first, they did it all. Yes, they are still milking the cow twice each day. The extended family helped out some but really we just got in the way. As you might imagine, within five minutes of the discovery of the calf, all farm inhabitants (25 of us among three generations) were hanging over the fence trying to get a look. All of the children (and most of the adults too) have enjoyed trying their hand at milking under Martha Kate's steady leadership.

In closing, whether black swans or white swans, we think it makes sense to be optimistic about the future. The human race has a fairly good track record of progress, especially when market forces are allowed to work. Just as my brother's family scrambled around and figured out how to accommodate a new baby calf in the family, we're optimistic that whatever swan shows up next, we'll find a way forward.

Thank you for choosing Bragg for your planning and investing.

Sincerely,



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