INVESTMENT COMMENTARY

3rd Quarter 2019

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"Muscles aching to work, minds aching to create —this is man."

-John Steinbeck, *The Grapes of Wrath*

DROUGHT

by Phillips M. Bragg, CFP®, AEP®

"It's pitiful," I mutter. Dad and I survey the pond beside his barn on the farm where my family lives; it is down three feet from full pond. A mere puddle. Clouds of dust from the gravel road drift across the pasture and settle on the grass and the trees, turning their leaves from green to a chalky gray. It is a depressing sight. Dad looks at me a long time and says, "Droughts happen, Phillips. Don't make it worse by fretting about it." Sigh. Still being taught. He then gives me a useful lesson on weather patterns, average rainfall and the frequency of droughts in Mecklenburg County. He concludes by pointing out that with both the weather and anything else in life, lacking a historical perspective can make everything seem like a crisis.

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MARKET & ECONOMY

by Matthew S. DeVries, CFA

After surging to new all-time highs in July, the S&P 500 fell in August on rising recession fears only to recover most of the losses in September. If you are keeping score at home, that marks the fourth time since early 2018 the market has sold off more than 5% after reaching new highs.

Despite the volatility, the market was able to recover enough to eke out a small gain in the third quarter. Through September, the S&P 500 is now up 20.6% year to date. International stocks have not been quite as strong but are still posting returns above their ten-year averages.

Fixed income has been the real story of 2019. Whether bolstered by two Fed rate cuts or investors looking for "safer" investments, bond prices have risen as interest rates keep falling. The

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Market Index Returns as of September 30, 2019

Index	3rd Quarter	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	1.7%	20.6%	4.3%	13.4%	10.8%	13.2%
Russell Midcap (US Mid Cap)	0.5%	21.9%	3.2%	10.7%	9.1%	13.1%
Russell 2000 (US Small Cap)	-2.4%	14.2%	-8.9%	8.2%	8.2%	11.2%
MSCI ACWI X-US IMI Net (Foreign Equity)	-1.7%	11.4%	-1.8%	6.1%	3.1%	4.7%
MSCI EM (Foreign Emerging)	-4.3%	5.9%	-2.0%	6.0%	2.3%	3.4%
Barclays Aggregate Bond	2.3%	8.5%	10.3%	2.9%	3.4%	3.8%
Barclays Muni Bond	1.6%	6.7%	8.6%	3.2%	3.7%	4.2%

Past performance is not an indication of future performance.

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Market & Economy *(Continued from page 1)*

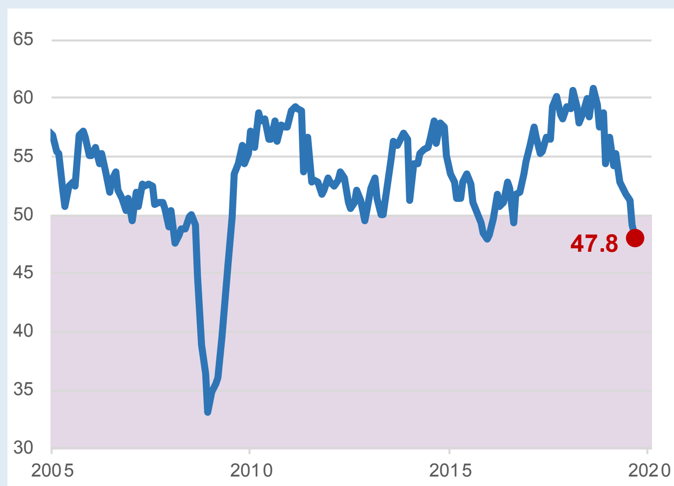
Barclays US Aggregate Bond Index, at an 8.5% return YTD, is having its best year since 2002. While investors are quite happy with recent bond returns, today's high bond prices mean current bond buyers are spending more to get less return in the future.

Recession angst fades

In mid-August, recession talk was everywhere, but a stock market recovery helped ease many of those concerns. It also helped that the news media moved on to a juicier story, the current impeachment inquiry. In terms of recession risks, not much has changed, however. With a strong labor market, consumers continue to support economic growth in the US.

Nevertheless, one area of weakness, in part related to the ongoing trade war, has been manufacturing, both in the US and around the globe. The US purchasing managers' index (PMI) from the Institute for Supply Management fell to 47.8% in September, the lowest reading since June 2009. Any reading below 50% signals manufacturing output is falling. This is significant but not necessary a reason to sound the alarm as manufacturing now accounts for less than 12% of US GDP according to the World Bank.

Purchasing Managers' Index



Source: Institute for Supply Management. 1/1/2005 through 9/1/2019.

Central banks cut the tension

Citing low inflation, tightening credit, and trade concerns, the Fed lowered the Fed Funds rate twice in the third quarter after raising rates four times in 2018. The fact that the Fed cut rates with unemployment near 50-year lows would have been almost unimaginable a decade ago. Since the financial crisis, the Fed has repeatedly demonstrated a willingness to help keep the economy moving forward and stock prices moving higher—whether by keeping interest rates low, outright purchasing of bonds, or even providing liquidity in the repo market as Phillips discusses in his commentary.

The Fed is not alone. Central banks around the world have been cutting rates this year. The European Central Bank not only cut rates in September but also announced plans to purchase €20 billion in bonds monthly to maintain prices and keep rates low.

Trade weighs on global economy

There is a limit, however, to what the Fed and other central banks can do. Effects of the trade war are showing. China is no longer the top trading partner for the US. Mexico and Canada have both accounted for a greater portion of total trade with the US than China in 2019, as trade with China has fallen 14% versus the first seven months in 2018.

Top US Trading Partners January-July 2019 vs. 2018

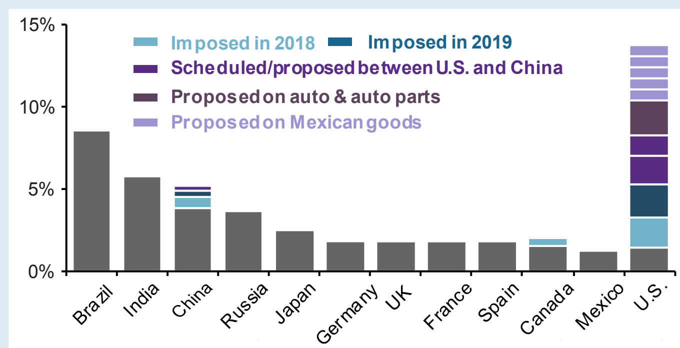
Country	Total Trade 2019 Imports + Exports	% of Total Trade 2019	Total Trade 2018 Imports + Exports	% of Total Trade 2018
Mexico	$361.1 Billion	15.0%	$351.5 Billion	14.6%
Canada	$357. Billion	14.8%	$362.2 Billion	15.0%
China	$321.3 Billion	13.3%	$371.1 Billion	15.4%

Source: US Census Bureau

With more tariffs planned, this is a trend that is likely to accelerate.

Global Tariffs

Tariff rate, applied, weighted mean, all products



Source: FactSet, J.P. Morgan Asset Management, MF, USITC, World Bank

Outside of the US/China rift, developed economies around the world are struggling more than the US. Germany's manufacturing-led economy is barely above water. German GDP is now expected to grow by 0.5% in 2019 and 1.1% in 2020, down from 0.8% and 1.8% estimates back in April, according to the German Institute for Economic Research.

And while there have been several twists and turns in Great Britain over Brexit, little has changed. Parliament is scrambling to assemble a deal before the current October 31st deadline but it appears, as of this writing at least, that no

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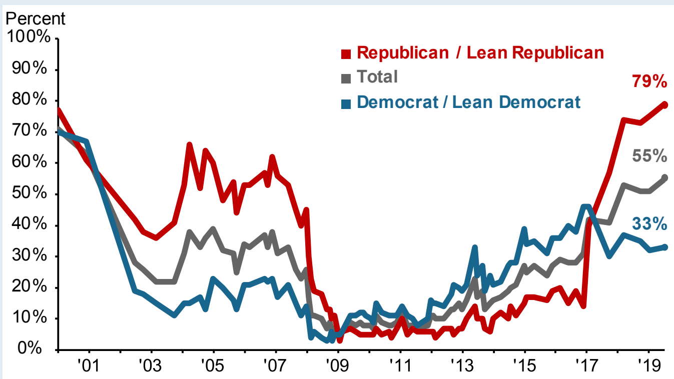
plan will be reached and the exit date will again be delayed. A delay could open the door for a snap election giving voters a chance to weigh in on how the country should proceed.

Politics vs. economics

Looking ahead, the headline flow is likely only getting started. The current impeachment proceedings in the House of Representatives signals that the 2020 election cycle is in full swing. Politics can evoke some pretty strong emotions, which can be troublesome for investors. While no one wants to think they are biased, this chart from JP Morgan shows most people's political leanings shade how they view the broader economy.

Percentage of Republicans and Democrats who rate national economic conditions as excellent or good



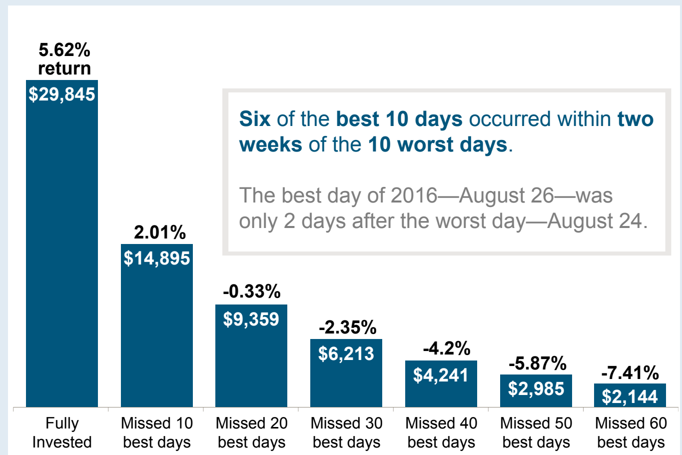
Source: Pew Research Center, J.P. Morgan Asset Management. Pew Research Center, July 2019, "Public's Views of Nation's Economy Remain Positive and Deeply Partisan." Question: Thinking about the nation's economy, How would you rate economic conditions in this country today... as excellent, good, only fair, or poor?

We continue to say the economy is steady if unspectacular. Economists surveyed by the *Wall Street Journal* are projecting 2.2% US GDP growth in 2019 and 1.7% in 2020. While one or two disappointing reports aren't enough to halt the $20 trillion US economy, the stock market tends to shift abruptly based on headlines, as we have seen several times over the past two years.

While we hope the volatility doesn't continue, we know keeping a long-term focus, or a historical perspective as Frank Bragg puts it, is important. Even a short-term mistake can have long-term implications when investing. So in the face of volatile markets and unexpected events, a steady approach will continue to serve us best going forward. ■

Even missing just a few good days can dramatically undermine portfolio returns

Performance of $10,000 investment between Jan. 4, 1999 and Dec. 31, 2018



Source: J.P. Morgan Asset Management analysis using data from Bloomberg. Returns are based on the S&P 500 Total Return Index, an unmanaged, capitalization-weighted index that measures the performance of 500 large capitalization domestic stocks representing all major industries. Indices do not include fees or operating expenses and are not available for actual investment. The hypothetical performance calculations are shown for illustrative purposes only and are not meant to be representative of actual results while investing over the time periods shown. The hypothetical performance calculations for the respective strategies are shown gross of fees. If fees were included, returns would be lower.

Drought *(Continued from page 1)*

According to the September advisory issued by the NC Drought Management Advisory Council (NC DMAC), northern Mecklenburg County is experiencing a drought (notably, Charlotte is not). NC DMAC designates the level of drought as "Moderate," which is defined as having received little to no rain in the last 40 days. We stand at drought level 2 out of 5 with 5 being "Exceptional." The average annual rainfall for Mecklenburg County is 43 inches and due to a wet spring it appears that we are on track to exceed that for the full year, but the last two months have been exceedingly dry. The last "Exceptional" drought we had was twelve years ago; you'll recall it was so dry we felt guilty wetting our toothbrushes before brushing our teeth! That drought was on the eve of the financial crisis. Let's hope that was coincidence and not causation. Like past droughts, this one will end at some point.

Speaking of a lack of liquidity, did you hear about the mini-crisis in the repo market on September 17th? An overnight shortage of cash needed by traders and lenders forced the Federal Reserve Bank to "make it rain" with an emergency infusion of funds. The last time the Fed had to take such action was during the financial crisis in 2008. One role of central banks around the world is to manage the cost and availability of credit by setting short-term interest rates and by intervening in the money markets with purchases or sales of government bonds to keep financial markets running smoothly. While the crisis of last month was short-lived, it was concerning to investors because it was not anticipated by the Fed and it revealed potential structural weaknesses in the financial system. Central bank activity, liquidity, ultra-low interest rates, and even negative interest

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Drought *(Continued from page 3)*

rates (in the EU and Japan) have been at the top of the list of investors' concerns this year.

Paralleling these near-term concerns are longer-term worries about whether we are prepared for the structural changes in store for our economy and labor force as a result of technological innovation. We are hearing that artificial intelligence, automation and robots will affect labor dislocation on scale with the industrial revolution. Will there be enough work and economic activity to ward off recession or even depression if we successfully replace the human at the wheel and at the desk? I asked Alexa, but she was rather evasive. Smart people come down on both sides of this issue. On one side are those who predict a world with limited employment opportunities and the need for a government-guaranteed minimum income for every American. On the other are those who agree that many jobs will be destroyed by technology but that, as in the past, new jobs will be created to absorb the displaced workers. Based on historical perspective, and the fact that the unemployment rate is currently near a 50-year low, we come down on the side of the latter while acknowledging that the accelerating pace of change will create friction as we struggle to re-educate our workforce for the jobs of tomorrow.


Dusty conditions at the Bragg Farm.

This isn't the first time we've dealt with disruption in our capital markets or turmoil and dislocation in our labor force. These are as certain as droughts. Coincidentally, I just re-read John Steinbeck's classic, *The Grapes of Wrath*, which depicts a depression-era farming family displaced by drought and by structural changes in our country's economy. The tractor replaces the mule team and banks foreclose on dried-out farms, marking the end of a way of life for thousands of tenant farmers. In Steinbeck's Pulitzer Prize-winning novel, the Joad family joins tens of thousands of other "Okies" leaving Oklahoma to find a new life in California only to be exploited by a market that is indifferent to human suffering. Steinbeck's opinions on unchecked market forces and the role of government are easily discernible and remind the reader that there's nothing new under the sun in certain debates—only the backdrops change.

The backdrop for the coming year is the 2020 presidential campaign. The same debates profiled by Steinbeck about unfettered market forces and the role of government promise to reach a fever pitch in the coming months. With the 24/7 news cycle, absorbing the day's news will feel like speed-reading *The Grapes of Wrath* before breakfast each day. You are familiar with today's issues—as always some are economic, some geopolitical, some social, some simply personal. History demonstrates that we have had bull markets and favorable economic conditions under both Democratic and Republican control of the White House. Yet prior to every presidential election, we all seem to agree that *never* has the outcome of the race been more consequential than the current one. Here we are again. The argument for this year's race being the most consequential is that the divide between the two parties has never been greater and that the issues on the table will determine the fate of our great nation. One could reasonably find some truth in this argument but if we don't keep our wits about us, the shrill voices, vitriolic accusations, twisted mischaracterizations, half-truths and fake news we'll hear, see and read in the months ahead will have the potential to make this feel like a crisis. Once you decide it is a crisis, you're apt to make bad decisions, including bad investment decisions. We suggest you heed Frank Bragg's advice about maintaining a historical perspective. Steinbeck's story about the Okies doesn't end well but remind yourself that the nation we call America made it through the Great Depression. We'll make it through this election.

I'm not sure that Tom Joad and his family would have been helped by an understanding of monetary policy, liquidity injections into the repo market, artificial intelligence, big data or foreign election interference. The fact is, like the Joads, we humans of today can only digest and react to so much information. Recognizing this, we at Bragg will continue to maintain a disciplined process as we manage portfolios and provide financial guidance. We appreciate your trusting us with studying, investing and advising.

Now, if we could just get a little rain. ■

Note: Phillips wrote his article on Thursday, October 3rd. Two days later at 1am on Saturday morning, Frank Bragg was awakened by the sound of raindrops on the metal roof of his house. He eased out of bed and sat on his screen porch until 3am watching 1.9 inches of rain fall on his pasture.