INVESTMENT COMMENTARY

3rd Quarter 2017

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it."

-(probably not) Albert Einstein

CAR WASH

I sat down to write a lengthy missive about Donald Trump, the NFL and the controversy over the National Anthem but was interrupted when my oldest son Ben (17) walked into the den and tossed a big pile of cash on my desk, saying, "Can you please deposit this in my investment account, Dad? And don't forget the match." Ben recently started a part-time job at Autobell Car Wash where he is paid an hourly wage plus all the tips he can earn. Based on the stack of bills on my desk, I quickly concluded that either he's selling drugs or he's doing pretty darn well in the tip department.

Dad: "Wow, Ben, that's a lot of money! Did you earn all that in your first three weeks?"

Ben: "Yep. It's $724. You're gonna match it, right?"

Dad: "Seven hundred dollars? Match? Uhh, did I say I would match it?"

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MARKET & ECONOMY

Much like the first half of 2017, the third quarter brought solid returns for investors. All of the major asset classes we track have posted remarkably consistent returns in each of the first three quarters this year.

Volatility has been extraordinarily low. At one point in August, the ten-day rolling volatility of the S&P 500 was the lowest it had been since 1969. The S&P 500, now up 14.2% for 2017, has posted 40 new all-time-high closing values in 2017. The index has fallen by more than 1% on only four days in the first three quarters. Over the past four years, we have averaged over 17 such days through the end of September. Past bull markets have seen similar periods of calm—though not quite to this degree.

Fed takes more steps to normalize policy

At its September meeting, the Federal Reserve announced that it will begin

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Market Index Returns for 2017

Index	1st Quarter	2nd Quarter	3rd Quarter	YTD Totals
S&P 500 (US Large Cap)	6.1%	3.1%	4.5%	14.2%
Russell Midcap (US Mid Cap)	5.2%	2.7%	3.5%	11.7%
Russell 2000 (US Small Cap)	2.5%	2.5%	5.7%	10.9%
MSCI ACWI X-US IMI Net (Foreign Equity)	7.8%	5.9%	6.3%	21.5%
MSCI EM (Foreign Emerging)	11.5%	6.3%	7.9%	27.8%
Barclays Aggregate Bond	0.8%	1.5%	0.9%	3.1%
Barclays Muni Bond	1.6%	2.0%	1.1%	4.7%

Past performance is not an indication of future performance.

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Market & Economy *(Continued from page 1)*

unwinding its $4.5 trillion balance sheet in October. As it laid out in its June meeting, the Fed will not be selling bonds but instead simply will not reinvest a portion of the bonds that mature each month. Specifically, starting in October, the Fed will allow $10 billion of bonds to mature without reinvestment. This amount will gradually increase to reach $50 billion per month over the next year. At a time when other central banks are expected to continue growing their balance sheets, the US is the first to actually begin tightening monetary policy.

Unwinding means scaling back a policy that has helped support bond prices since Quantitative Easing began in 2008. The Fed has already pushed short-term interest rates higher with four federal-funds rate increases dating back to 2015, with another likely to happen later this year. Unwinding the balance sheet may begin to push longer-term interest rates higher, though at a muted pace.

The Fed is able to make these moves because the US economy has been heading in the right direction for some time, as you can see in the chart of four leading economic indicators since the market bottom in March 2009. We have even seen manufacturing start to pick up in the past year, after declining in 2015. We are likely to see a negative impact from the recent hurricanes, however.

Impact of hurricane season is personal and financial

One of the worst hurricane seasons in history has affected millions of lives and inflicted billions of dollars of damage. While stories of heartbreak poured out in the aftermath of the storms, the country's reaction showed the strength and resilience of our nation as people from all over the country rushed to help those in need.

Hurricanes Harvey, Irma, and Maria, which all hit in quick succession, may have caused as much as $290 billion in destruction based on one estimate from Accuweather. Hurricane Katrina, the costliest US natural disaster on record, caused as much as $108 billion in damages, according to Moody's.

The effect was seen quickly. In the week after Harvey made landfall, US weekly jobless claims spiked 26% to 298,000 people filing for unemployment benefits, up from 236,000 the week before. We saw similar increases in claims after Katrina and Sandy, but after both of those storms, jobless claims returned to pre-storm levels within two months. There is a long road ahead for rebuilding in Texas, Florida, and Puerto Rico. The money spent to rebuild will add to US GDP, but the loss in economic activity will be a drag on GDP growth for the second half of 2017.

The debt ceiling was just given a short-term extension until December 15th to ensure the funding of hurricane relief efforts. That could become an important date to mark on the calendar if disagreement over other policies leads to another standoff over the debt ceiling. We are hoping we don't see a repeat of the debt-ceiling crises of 2011 and 2013.

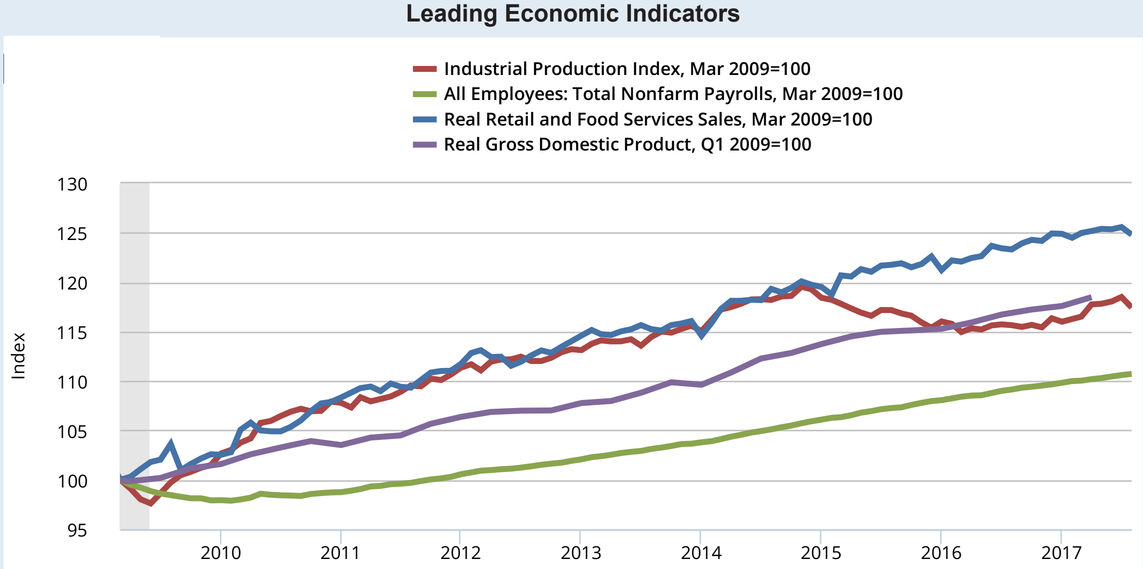
Tax reform is on deck

Recent reports from Congress show that we may be nearing some of the tax reform promised by President Trump. Here are some of the proposed changes:

- Simplify and reduce the number of tax brackets from seven to three or four
- Double the standard deduction to $12,000 for single filers and $24,000 for married couples
- Increase the child tax credit
- Eliminate some tax deductions
- Repeal the Alternative Minimum Tax
- Eliminate the deduction for state and local taxes
- Eliminate estate taxes
- Cut the corporate tax rate from 35% to 20%

Overall, taxes would likely fall initially for most Americans but without details that are yet to be hammered out, it is impossible to gauge what changes people at different income levels will see. The last bullet point is more straightforward.

Leading Economic Indicators



Source: BEA, BLS, Board of Governors, St. Louis Fed, fred.stlouisfed.org

Market & Economy *(Continued from page 2)*

The US has the highest corporate tax rate among developed countries at 35% and there is actually some agreement on both sides of the aisle in Washington that the high rate discourages investment in the US. A drop to a 20% tax rate could bring a nearly 25% bump in profits overnight to those companies which pay the full tax rate. Not all companies pay the full tax rate. Some, especially large multinational corporations, pay much lower effective rates. On the whole, we would expect a significant positive impact for corporate earnings should this legislation pass.

The projected increase in earnings would likely boost economic activity in the US. Companies may be more likely to hire more employees, invest in new projects to grow revenues, pay down debt, or even return money to shareholders through share repurchases. Increased economic activity means hiring and with unemployment already low, wages may begin to rise more quickly than the sub-3% annual gains seen since the financial crisis. A lower tax rate would also diminish the incentive for tax inversions that have become so common in recent years. In an inversion, a US company acquires a foreign-based company that is located in a lower-tax jurisdiction. The acquiring company then relocates to the lower-tax jurisdiction and enjoys a lower tax bill.

Much has been made about the fact that stocks are trading at higher-than-normal valuations. The S&P 500 has a nearly 20% return since last year's election and as mentioned earlier, the market has hit numerous new all-time highs this year. We expect some of the recent exuberance is due to the anticipated tax legislation but investors are also bullish about corporate earnings. Earnings among S&P 500 companies have already shown promising growth in 2017 and expectations are for third-quarter growth to exceed 4.2%. So far, 43 companies in the S&P 500 have raised their estimates for third-quarter earnings—the most in any quarter since 2010. It should be noted that none has increased its estimate since Hurricane Harvey made landfall. Finally, investors are hopeful that recent strong readings for consumer spending and business investment will result in accelerating economic growth, further juicing earnings. The big question is how much of the promise of tax reform, future earnings growth and accelerating economic growth is already baked into current market prices? Stay tuned.

Matthew S. DeVries, CFA ■

** The basic central government statutory (flat or top marginal) corporate income tax rate.*
Source: OECD, Forbes, Statista

Car Wash *(Continued from page 1)*

Ben: "Yeah! You always told us you would match dollar for dollar whatever we save. 100% return right off the bat, right, Dad? You've said it a hundred times. Compound interest -- eighth wonder of the world -- like a snowball rolling down a hill. Money makes money. Take care of the nickels and dimes and the dollars will take care of themselves? Remember, Dad?"

Dad: "Umm...yeah. Wow. You've listened well. Way to go, Ben."

"Man," I thought. "This is going to be expensive!" It was one thing to match the children's savings when they were making $10 or $20 per month doing chores around the house like mowing grass or feeding the chickens and pigs. Even matching Ben's just-above-minimum-wage earnings when he worked part-time at Harris Teeter wasn't that painful. But if this continued, it would hurt. I might need to pick up some part-time work at Autobell myself! I also marveled at his quoting me. "Nickels and dimes...money makes money...a snowball rolling down a hill." How did he remember all that? Have I overdone it just a smidge with my parental lessons in the saving/investing department?

After some thought I decided to continue the matching until Ben heads out for college. Sadly, he'll be leaving in just 12 months. How much damage can he do to my bank account between now and then? The mere fact that he remembers those lessons on thrift and compound interest softens the blow. Meanwhile, like a cost-cutting corporation, I'll send around a memo that revises the "matching plan" for all of my children born after the year 2000. Maybe 25 cents on the dollar above a certain amount or something. Stingy, I know. But a man's got to have limits; I want to retire someday too!

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Car Wash *(Continued from page 3)*

I'll be the first to say that not all of my children exhibit the same zest for working and saving that Ben does. For one child in particular, it seems chores are to be avoided at all costs, even when the reward is a generous allowance. Many of our clients have made similar observations about their own children. "She's a saver!" or "He has the first dollar he ever earned." Alternatively, "He's not so great with financial decisions," or "We have to help her out financially from time to time." While we might discuss whether these behaviors are a result of nature or nurture, I'll make a strong case that offering our kids a few simple lessons about money can make an enormous difference in their lives.

Here are the Bragg Top Seven:

Start Early (Form Habits Early)
In our business we've learned over time that on average, people spend what they make. Someone making $75,000 per year will spend $75,000 per year. Someone making $350,000 per year will spend $350,000 per year. Call it consumption creep or whatever you will, it is just reality. Therefore it is critical that a healthy pattern of saving and investing starts at a young age before "alternative habits" are formed. I remember my first paycheck from my first job at NCNB after college in 1990 (for young readers, NCNB was the predecessor to Bank of America). My salary was $21,500 and my first bi-monthly paycheck (gross) was almost $900—a ridiculously large sum of money for me at the time! I remember sitting there just staring at that figure. Wow! Looking back, this was obviously a great opportunity to form good habits and to avoid the temptation to adopt a standard of living requiring a paycheck of that size.

Start Early II (Take Advantage of Compounding)
Suzie Saver saves $5,000 per year starting at age 22. She increases her annual savings by 3% per year. She invests the money and earns an annualized return of 6.5%. At age 65 Suzie has $1.9 million.

Sam Spender does the same thing EXCEPT he waits until age 32 to begin. At age 65 Sam has $879,000.

Save a Lot
Here are three responses we often hear when we ask the question, "Do you contribute to the retirement plan offered by your employer?" 1) "I'm planning to start once I pay off my credit cards and save up for a new car." 2) "I only put in what they will match." and 3) "I always contribute the maximum allowed." Of course I realize that not everyone can contribute the maximum but obviously, the more you save, the sooner you'll reach your goal.

Do Your Own Math
Quoting my brother Phillips from an article he wrote twenty years ago, "It's your paycheck; do your own math and make the numbers work for you. Don't get caught up in what your neighbor spends or has. For all you know, your neighbor inherited a fortune or is drowning in debt." Basing your decisions on the actions of others is not a plan that will work.

Invest Well
Over long periods of time, owning a diversified portfolio of stocks has been a far better investment than alternatives like bonds or cash equivalents. Specifically, since 1926, large company US stocks have enjoyed an annualized return of about 10% while bonds have averaged approximately 5%. Cash equivalents have barely kept pace with inflation which has averaged just under 3% for the same period. These are historical returns and there is no guarantee that we'll see these returns in the future. In fact, when planning for the future, we think it is prudent to assume that future returns will be lower than historical averages. Yes, lower future returns will require saving a lot in order to reach your financial goals. Sorry.

Pay Attention
Pay attention to how your money is invested. Consider that over a 40-year period, a lump sum of $10,000 invested at 4% grows to $48,010 while the same amount invested at 7% grows to $149,745. You don't have to be Warren Buffet to get this right. Whether you do it yourself or pay someone to help you, give your portfolio some attention each year. As demonstrated, it's worth it!

Be Humble and Never Bet the Farm
You can't see the future and neither can anyone else. Don't try to time the market and never make big bets with money you can't afford to lose. Maintain an investment allocation that is appropriate given your need for liquidity and your need for return. Avoid any investment that sounds too good to be true. The only exception to this last rule is compound interest. While it appears to be too good to be true, it's not, and you should embrace it! As Albert Einstein is reported to have said (but probably didn't), "Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it."

At some point Bragg will get around to publishing a book containing many more nuggets like these. These are the CliffsNotes. If you're reading this, you probably didn't need the lesson, but I hope it will serve as affirmation of your good habits. If you have a child or grandchild who does need the lesson, feel free to share. And while you're at it, you might suggest they apply for a job at Autobell.

As always, thank you for choosing Bragg for your portfolio management and planning.

Sincerely,

Benton S. Bragg

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President, Bragg Financial Advisors, Inc.