INVESTMENT COMMENTARY

4th Quarter 2016

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INSIDE THIS ISSUE

"I hate to ruin a man's fishing trip but those guys are giving us a ride across this lake."
-Ben Naylor

JACKSON LAKE

Back in 1991, two friends, Ben Naylor and Jeff Elias, and I decided to backpack the length of the western shore of Jackson Lake at the base of the Teton mountain range in Wyoming. If you've visited Grand Teton National Park, you know this to be a beautiful area; the Tetons rise dramatically from the crystal-clear waters of Jackson Lake and soar thousands of feet into the air. Who needs the Swiss Alps? If you haven't been, put it on your list. There is no established trail along the western shore of Jackson Lake but from the maps we studied (pre-Google, of course), it appeared that we could simply hike along the lake shore and even make camp on the soft white sand. As the crow flies, it appeared to be about 25 miles; spread over two-and-a-half days, the trek would surely be no contest for three strapping, 22-year-old, experienced backpackers. After all, we had recently climbed to the summit of the Grand Teton itself. That the Grand would be towering above us for the duration of this mild jaunt added to the appeal. Heck, we even brought fishing poles. Freshly caught cutthroat trout beside a warm campfire and sleeping under the stars? What could go wrong?

A lot! And it did! After leaving our vehicle at a Park Service gate around noon, we spent the first half day of our trip wandering through the forest simply trying to *find* Jackson Lake. A smartphone with GPS device would have come in handy. Instead, we followed one wildlife trail after another

(Continued on page 3)

MARKET & ECONOMY

2016 was a productive year for investors, with most major asset classes finishing in the black. Stocks had a good run with the S&P 500 posting an 11.96% gain, while bonds held onto small increases with the Barclays US Aggregate Bond Index up 2.65%. However, that doesn't quite tell the whole story. The year had its share of twists and turns. Looking at the CBOE's S&P 500 Volatility Index, we had three sharp spikes in volatility during 2016: one to start the year, one at the end of June, and one leading up to the US presidential election. As you can see in the accompanying chart of the S&P 500, those spikes in volatility were short-lived in 2016.

Here's a quick look at what happened in 2016 and some thoughts on 2017.

The Three C's Bring a Rough Start

2016 brought one of the worst beginnings to a year ever for stocks. The three C's (China, commodities, and central banks) raised recession fears, and the S&P 500 fell more than 11% during the first six weeks of the year. Stocks began to rebound in mid-February as oil prices moved higher from their 13-year lows and the US Federal Reserve signaled delays in raising interest rates. Bonds were the stronger asset class in the first half as uneasy investors pushed prices up and yields lower. The US economy was as unsteady as stocks early on with GDP growth of just 0.8% and 1.4% in the first and second quarters respectively.

(Continued on page 2)

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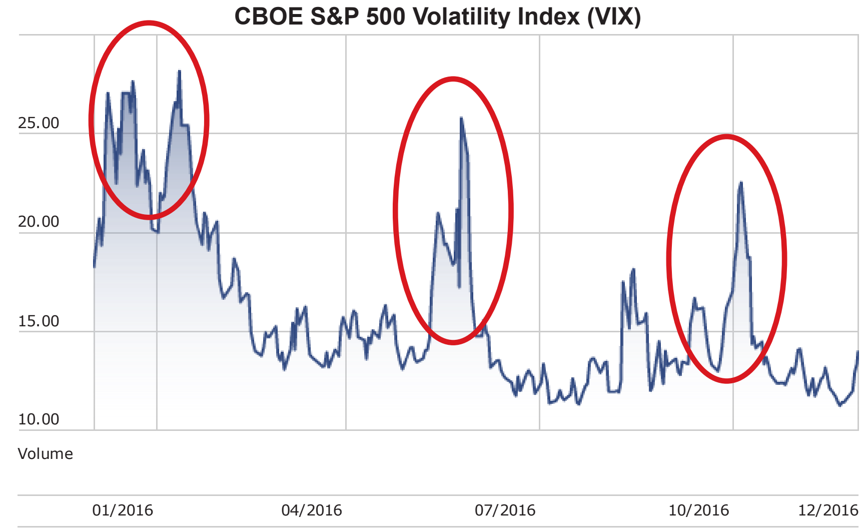
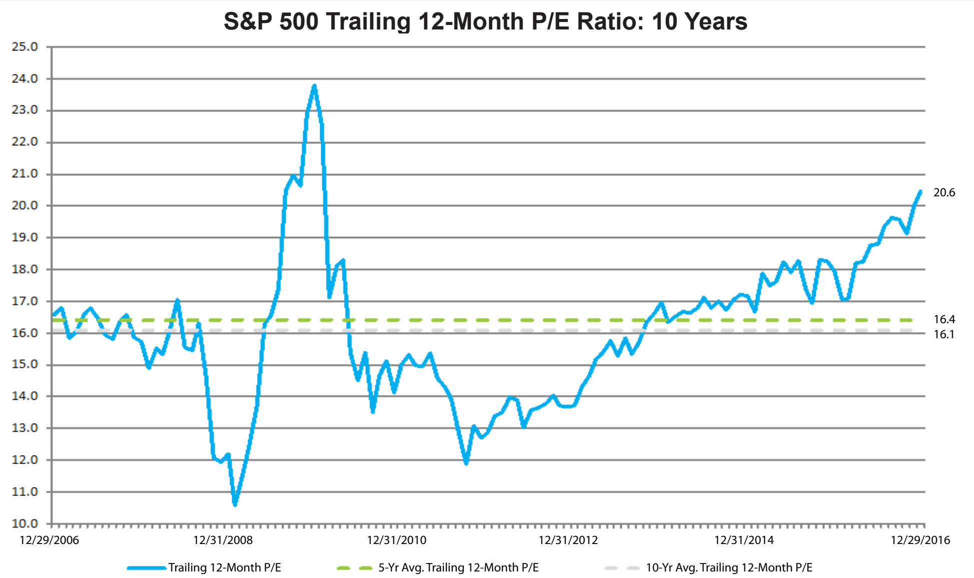
1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203
(704) 377-0261 • Fax (704) 334-9754

Market & Economy *(Continued from page 1)*



Data for 01/01/2016-12/31/2016. Source: Morningstar.com

Data for 01/01/2016-12/31/2016. Source: Morningstar.com



Source: FactSet

Brexit Surprise

Shocking the vast majority of experts, the United Kingdom sprang the first major political surprise of the year when British citizens voted to leave the European Union on June 23. From an investment standpoint, it is generally believed that global economic integration is preferable to isolation and trade barriers and markets responded swiftly to the vote. The S&P 500 fell 5.3% over the next two trading days. However, the drop was short-lived, even in the UK, as it became apparent that Brexit would take time, possibly even years to occur. The Brexit vote and similar moves toward populist candidates in other EU countries remain on investors' worry list as we move into 2017.

The Trump Rally

We, of course, had our own surprise in the US in November when Donald Trump claimed victory over Hillary Clinton in the presidential election. As it became apparent Trump would win, markets began to plummet. Dow index futures were down over 800 points on election night. Markets reversed much more quickly than with Brexit and actually rose the next day, and kept rising through year-end on optimism based on Trump's pro-growth policies. With the inauguration quickly approaching, we will soon see what President Trump and a Republican Congress can accomplish.

Central Banks

Perhaps lost in the fray of all the election headlines is the fact that 2016 was another extraordinary year for central banks. Just when it seemed they had used up all the tools in their toolboxes, central bankers found ways to step on the gas. Both the Bank of Japan and the European Central Bank took the unusual step of pushing interest rates below zero last year as they desperately tried to stimulate growth in their respective economies. The Bank of England cut rates and restarted quantitative easing in August to combat the weakness following the Brexit vote. Even the US Federal Reserve waited until December for the first and only rate hike of 2016 while acknowledging the belief that the US economy was probably strong enough for more increases.

Market & Economy *(Continued from page 2)*

Market Index Returns for Periods Ending December 31, 2016

Index	4th Quarter	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	3.82	11.96	8.87	14.66	6.95
Russell Midcap (US Mid Cap)	3.21	13.80	7.92	14.72	7.86
Russell 2000 (US Small Cap)	8.83	21.31	6.74	14.46	7.07
MSCI ACWI X-US IMI Net (Foreign Equity)	-1.57	4.41	-1.44	5.35	1.22
MSCI EM (Foreign Emerging)	-4.16	11.19	-2.55	1.28	1.84
Barclays Aggregate Bond	-2.98	2.65	3.03	2.23	4.34
Barclays Muni Bond	-3.62	0.25	4.14	3.28	4.25

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

S&P 500 Sector	4th Quarter	2016
Energy	7.28%	27.36%
Telecom Services	4.78%	23.49%
Financials	21.10%	22.80%
Industrials	7.21%	18.86%
Materials	4.70%	16.69%
Utilities	0.14%	16.29%
Information Technology	1.19%	13.85%
Consumer Discretionary	2.31%	6.03%
Consumer Staples	-2.02%	5.38%
Real Estate	-4.41%	3.39%
Health Care	-4.00%	-2.69%

Corporate Earnings

Corporate earnings, the driver of long-term stock returns, improved in 2016. Earnings for the S&P 500 components had fallen for 5 consecutive quarters on a year-over-year basis through the second quarter on net losses in the energy sector and weak GDP growth. That trend finally reversed in the third quarter, as those same companies posted a 3.1% gain, with a 3.2% gain projected for the fourth quarter per FactSet. FactSet's analysts are even more optimistic for 2017 with a 12% jump in earnings projected for the year. Market valuations remain at elevated levels, but the market is forward-looking and it appears much of next year's earnings gains may have been priced in during the recent rally.

Looking Ahead

2016 demonstrated that stocks and bonds don't always move in the same direction, despite what we have seen in recent years. While an improving economy and Trump optimism helped bolster stock returns, bonds gave up much of their first half returns as it became apparent that the Federal Reserve could no longer delay rate hikes. If this trend continues, diversification will be very important going forward.

In our view, the past year was a particularly humbling reminder that it's difficult to predict the future and reinforces the need to have a plan and stick to it. Many experts much smarter than we are were wrong about Brexit and the US election. As the earlier chart of 2016 S&P 500 performance demonstrates, investors who fled the market following the Brexit vote or preceding Trump's election would have been disappointed with their year-end results.

There is much more investor optimism entering 2017 than we saw in early 2016 but the issues that moved markets last year (China, oil, central banks, Brexit, President Trump) remain very much on the table as we move forward. As such, we still think it is important to maintain an appropriate, long-term allocation to be prepared for whatever lies ahead.

Matthew S. DeVries, CFA® ■

Jackson Lake *(Continued from page 1)*

until they petered out in thickets of deadfall. Finally giving up at dark, we camped in a muddy, nondescript meadow and choked down dry ramen noodles for supper. The next day, we stumbled on in like fashion for several hours until Jeff yelled, "Woo-hoo, the lake!" While we were invigorated by the news of finding the lake, that was when our trouble really started. While the lake was in *view*, we could *not* reach it. Maybe God saw us coming and decided to create the mother of all obstacle courses for us. We found ourselves in a lodgepole pine forest where only ten percent of the trees were standing. The other ninety percent were lying on the ground, lying on top of each other, uprooted, twisted and tied in knots, matted into menacing mounds, stitched into sharp stacks, bent into barbed barricades and heaped to great heights...sorry, got carried away there. With heavy backpacks, progress was extremely slow. We climbed over logs, crawled under half-fallen trees, fell down, rolled around in the brambles, got up and pressed on.

By mid-afternoon the elusive "sandy lake shore" was um... still elusive. And it was getting unbearably hot in our inescapable thicket. But finally it appeared the lake was within a few hundred yards. That's when the mosquitoes showed up. I'd never experienced anything like it and

(Continued on page 4)

Jackson Lake *(Continued from page 1)*

haven't since. They swarmed us! If they weren't on our bodies or in our eyes and ears, we were *inhaling* them. We were! Figuring we'd find relief at the lake, we desperately pushed on. But then we discovered the source of the bugs. The lake shore was a swamp…no white sand in sight! We plunged into the bog. Now, mired in our personal jungle, hot, wet and muddy, with mosquitoes bleeding us dry and with at least fifteen miles to go, we realized we needed a new plan.

The intrepid hikers

Ben set up his tiny one-man tent and all three of us piled into it to get some relief from the blood-sucking bugs while we decided what to do. With no obvious solutions forthcoming, Ben said, "Hey, did you hear voices?" Jeff groaned and said, "Man, I've been hearing voices for the last few hours." Indeed, Jeff seemed a bit delirious. But then there was no mistaking it—we all clearly heard people talking and laughing. We busted out of our shelter and pushed through some pine scrub to see two fishermen in a boat on the lake, not more than fifty yards from where we were. The entire lake was otherwise empty. Not one other boat was in sight and these guys happened to be right there! We couldn't believe it. Maybe God felt bad about the lodgepole pine, mosquito-swamp gauntlet he'd put us through. Ben whispered to us, "I hate to ruin a man's fishing trip but those guys are giving us a ride across this lake." We waved our arms and indicated that we needed help and they motored over to us. Ben is about 6'5" and I knew as soon as he got his big mitt around the bow rail on that boat we were in good shape. Yep. Within an hour we were at Casa Grande Mexican Restaurant in Jackson enjoying a Nacho Supreme Platter and a few cold beverages.

I was reminded of this "memorable" trip as I collected my thoughts to write the commentary this week. As I've watched the market rally over the last seven weeks and as I've read and listened to news stories, I can't help but wonder if investors aren't behaving a bit like Jeff, Ben and me as we planned our trip. We had rosy expectations of a casual stroll around the lake. Maybe investor expectations are a bit rosy these days as well. As Matt DeVries points out in the nearby article, stocks soared to all-time highs following the Trump victory. Bond prices plummeted with expectations that inflation and interest rates will rise dramatically. You've heard much about the Trump plan: lower taxes, reduced regulations, infrastructure spending. And Republicans do control Congress and the White House. But will it be that easy to ramp up the growth rate of our massive economy? Corporate earnings have finally started growing again but will they grow enough to justify the above-average valuations we currently see?

There are a lot of sharp people out there who think so. Here's an example from Ray Dalio, the founder of Bridgewater, the largest hedge fund in the world. In a recent article titled "Reflections on the Trump Presidency, One Month after the Election," he wrote "…it is increasingly obvious that we are about to experience a profound, president-led ideological shift that will have a big impact on both the US and the world. This will not just be a shift in government policy, but also a shift in how government policy is pursued. Trump is a deal maker who negotiates hard, and doesn't mind getting banged around or banging others around. Similarly, the people he chose are bold and hell-bent on playing hardball to make big changes happen in economics and in foreign policy (as well as other areas such as education, environmental policies, etc.)." Also of note he said, "…if this administration can spark a virtuous cycle in which people can make money, the move out of cash (that pays them virtually nothing) to risk-on investments could be huge."

Gets your attention, doesn't it? And perhaps helps explain some of the optimism in the market of late. Maybe Dalio and others expressing similar sentiments are right. Perhaps we're on the verge of a new chapter in our American experience that is different from the recent past. But maybe we're not. Trump's anti-trade, pro-tariff and isolationist rhetoric flies in the face of a pro-growth agenda. Will the economy grow fast enough to generate the increased tax revenue to pay for his proposed massive federal infrastructure spending and tax cuts? According to the Tax Policy Center, Trump's tax plan would increase the federal debt by about $6 trillion over the next ten years even when using optimistic growth assumptions. Can the US prosper even as other economies around the world, developed and emerging, struggle with debt, slow growth, demographic and political challenges, the immigration/refugee crisis, war and terrorism?

We'll have to wait and see, won't we? I guess that's what makes life interesting. Our advice for the portfolio is to maintain discipline, rebalance and keep your long-term perspective. As always we are optimistic about the future. There will be Nacho Supreme Platters and more! But along the way we should be prepared for bugs, bogs and brambles.

On behalf of the whole team at Bragg, thank you for the opportunity to serve you. We wish you the best in 2017.

Sincerely,

Benton S. Bragg

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