INVESTMENT COMMENTARY

1st Quarter 2017

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"Living out on the farm, we could barely make it home on five gallons of gas!"
-Frank Bragg

REAGAN, TRUMP AND THE CHEVY VEGA

My father's response to the oil embargo of 1973-74 was to trade in our gas-guzzling station wagon for a more fuel-efficient mode of transportation. Prior to the trade, the Bragg family of six traveled in a Chevrolet Townsman 9-seater station wagon that sported a 350 cubic-inch V8 engine, weighed 4,300 lbs. and boasted gas mileage of 11 mpg. As Dad described it, "Our car was longer than a city block! When they started rationing gas, we had to wait in line for half an hour and then you'd only get five gallons. Living out on the farm, we could barely make it *home* on five gallons of gas!" Dad traded this behemoth for a 1973 Chevrolet Vega. This was the Vega "Kammback," a two-door station wagon with a hatchback third door. In comparison to our prior wagon, the Vega was powered by a measly four cylinder 140 cubic-inch engine, weighed only 2,300 lbs., and claimed fuel efficiency of 22 mpg.

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MARKET & ECONOMY

Markets higher in Q1 as investors eye Washington

There was no shortage of news during the first quarter but markets were unusually quiet. In fact, it was the least volatile quarter for the S&P 500 since 1967, according to *Barron's*. Most major benchmarks were up for the quarter. Large-cap stocks led the way in the US with the S&P 500 rising 6.07%. Small-cap stocks lagged some with the Russell 2000 up 2.47% for the quarter, which is probably reasonable considering the big year small caps had in 2016. Bonds were able to hold onto small gains despite a rate increase by the Federal Reserve.

At the start of the year, one of the most talked about and popular trades among Wall Street analysts was to bet that the dollar would continue to strengthen against other currencies. The opposite happened over the first

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Market Index Returns for Periods Ending March 31, 2017

Index	1st Quarter	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	6.1%	17.2%	10.4%	13.3%	7.5%
Russell Midcap (US Mid Cap)	5.2%	17.0%	8.5%	13.1%	7.9%
Russell 2000 (US Small Cap)	2.5%	26.2%	7.2%	12.4%	7.1%
MSCI ACWI X-US IMI Net (Foreign Equity)	8.0%	13.0%	0.8%	4.7%	1.6%
MSCI EM (Foreign Emerging)	11.5%	17.2%	1.2%	0.8%	2.7%
Barclays Aggregate Bond	0.8%	0.4%	2.7%	2.3%	4.3%
Barclays Muni Bond	1.6%	0.2%	3.6%	3.2%	4.3%

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

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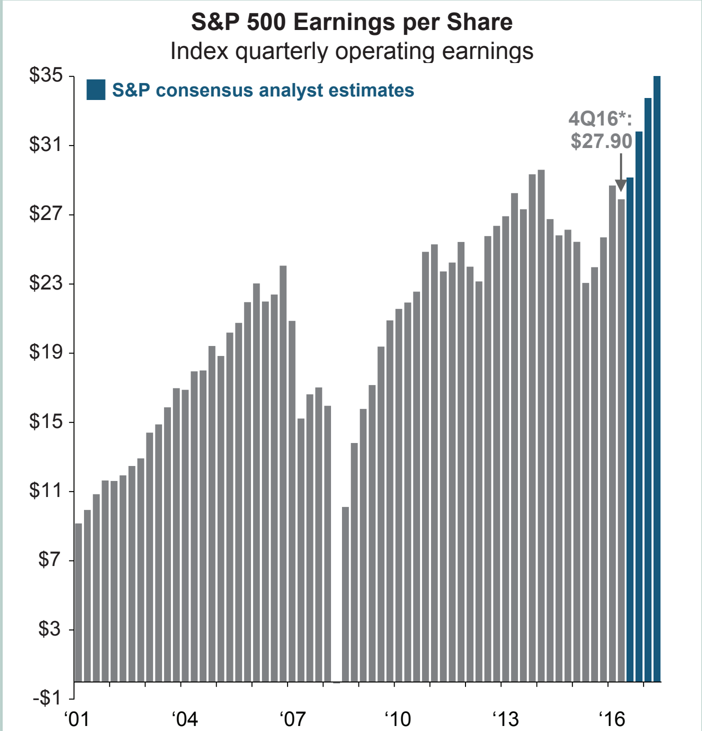
three months of 2017 with the dollar falling 2% relative to other global currencies. While the traders on the losing end of that wager may still be proved right, the weakening dollar propelled foreign stocks to nice gains in the first quarter. Emerging markets had their best quarter in five years as the MSCI Emerging Markets index rose over 11%.

Fed set on returning to "normal"

The Federal Reserve took another step toward more normal monetary policy by raising the Fed Funds rate another quarter of a percent in March. Since December of 2015, the Fed has now raised rates three times for a cumulative increase of three quarters of one percent. The upper limit target for Fed Funds is now 1%. Supporting the Fed's decision is the rise in inflation we have seen recently, as seen in the chart below showing headline CPI. As of right now, it looks like we likely will see another two or three rate hikes before the end of the year.

Predictably, short-term interest rates have moved higher since December as a result of the Fed's rate hikes. As the Fed continues to pull back from stimulative monetary policy, short-term borrowers—particularly people with credit card balances—will be the first to feel the effects.

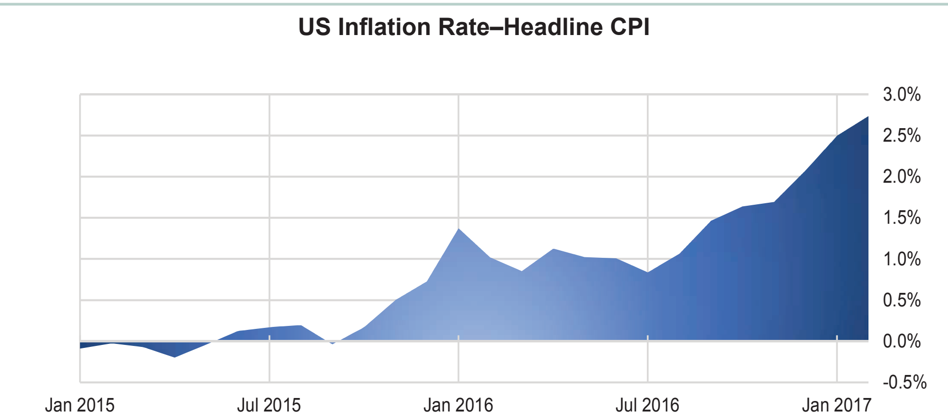
Long-term rates, on the other hand, haven't budged. From the beginning of December to the end of March, the Fed Funds rate rose 0.50% but 10-year and 30-year treasury yields have actually fallen slightly, by 0.02% and 0.04% respectively. This is troubling to the Fed. An upwardly-sloped yield curve (the longer the maturity, the higher the yield) is often a sign of a healthy economy, while an inverted yield curve (where short yields are higher than long yields) often signals recession risk. One option on the table for the Fed to potentially drive longer-maturity yields higher is to start selling some of the nearly $4.5 trillion worth of bonds from its balance sheet. These are the bonds the Fed accumulated during the three Quantitative Easing programs from 2008-14. Fed governors should offer more details over the coming months.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management;
*EPS levels are based on operating earnings per share. Earnings estimates are Standard & Poor's consensus analyst expectations. Past performance is not indicative of future returns. Currencies in the Trade Weighted U.S. Dollar Major Currencies Index are: British pound, euro, Swedish krona, Australian dollar, Canadian dollar, Japanese yen and Swiss franc. *4Q16 earnings are calculated using actual earnings for 98.2% of S&P 500 market cap and earnings estimates for the remaining companies.*

"This is an historic moment from which there can be no turning back"

The quote above is from British Prime Minister Theresa May shortly after triggering Article 50 which officially begins the process of the UK's exit from the European Union. The UK, in effect, is about to become a free agent and the two-year countdown has begun. In that time, the UK must negotiate new trade deals with the EU and other nations around the world. Of all the news that came out this quarter, this will likely have the largest effect on the global economy as the UK is the fifth largest economy in the world by GDP, according to the World Bank.



Source: US Bureau of Labor Statistics

In the end, the final trade deals probably won't harm the global economy but it is hard to imagine the process going smoothly. No country has ever left the EU and remaining EU members are sure to want to set a precedent to discourage other countries from following the UK's example. Part of the bumpiness in the process will likely be a result of human behavior resulting from uncertainty. Since the Brexit vote,

Market & Economy *(Continued from page 2)*

there have already been signs that UK citizens are preparing for turbulence by borrowing less and making fewer larger purchases. The process, however, has only just begun and we will be closely watching what happens.

In the US, all eyes remain on Washington

The market has continued to drift higher but low volatility could continue while investors wait for signed legislation regarding tax reform, trade policy, Obamacare, regulation, and infrastructure spending. As you can tell, the theme so far in 2017 is "wait and see." While we know significant changes are likely coming, we can't know the details, the timing or the impact, especially in the short term. The market has never been very good with uncertainty or patience, so there should be bouts of volatility up and down in the months to come.

Long term, however, we see reasons to be optimistic. The underlying fundamentals of the market are improving. According to FactSet, S&P 500 earnings are expected to rise 9.1% in the first quarter compared to first-quarter earnings last year. If they do rise that much, it would be the single-largest quarterly gain in the last five years. As you can see by the blue bars in the earnings chart opposite, companies are expecting even larger earnings gains throughout 2017.

Stocks have been trading at high valuations for some time and it is reassuring to finally see signs that fundamentals are beginning to catch up to prices. First quarter returns were positive but we await news from Washington, the Fed, and the UK that will shape expectations for 2018 and beyond. In the interim, we're rebalancing accounts and remaining true to our disciplined approach for the portfolio.

Matthew S. DeVries, CFA ■

Reagan, Trump and the Chevy Vega *(Continued from page 1)*

Dad has made some good decisions over the years but this car was a disaster. I was only six years old when the Vega came home but I remember Dad cramming all six of us into this miniature wagon to ride to church on Sunday mornings. It was tiny! To get the kids into the middle seat of the car my parents had to push us through the front door over the front seat or squeeze us in through the rear hatchback. Brother Phillips was only three years old at the time...I guess they just tossed him in and let him bounce around. For maximum fuel efficiency, our new car had no air conditioning. I remember many a hot summer day sweating on the black, 100% pure vinyl seats or jammed in with my brother untethered in the hatchback area trying to catch the breeze from the open window.

The Chevy Vega ... not my father's best decision.

Believe it or not, the Vega sold in huge numbers. Satisfying Americans' desperation for better fuel economy and a better-looking alternative to the Ford Pinto wagon (ka-boom!), Chevy sold more than 2 million units before ending production in 1977. This was unfortunate for GM. As it turned out, the car had real problems. According to a 2010 *Popular Mechanics* article entitled "How the Chevy Vega nearly destroyed GM,"

> A lack of engineering focus and the drive to keep the price low resulted in a car with notoriously thin sheet metal only haphazardly covered in anti-rust primer. Soon the Vega was earning a reputation as a "rust-prone bucket." The engine had a barely-adequate cooling system that combined with the delicate aluminum engine block for horrible results. When the engine got hot, the cylinders distorted and the piston rings wore down. Then, at best, the cars burned more oil. At worst, the distortion compromised the head gasket, caused the coolant to leak and eventually destroyed the engine. The result was that literally hundreds of thousands of buyers were having awful experiences with the car. With such a crummy reputation for reliability, the Vega's resale values soon dropped down near zero.

As I mentioned, the Vega was not my father's best decision. But this article isn't about the gradual demise of General Motors. Instead it is about the economy and financial markets of the '70s and '80s compared to the economy and financial markets of today. It's also about investor expectations.

It's no secret that the stock market has been on a roll since Trump was elected in November. From November 8th through the end of the first quarter, the S&P 500 is up more than 11%. Investors appear to be counting on a better economy resulting from the so-called "Trump-trifecta" of tax reform, infrastructure spending and deregulation. Some have suggested that we're on the verge of a period of super-charged growth in both the economy and the stock market, even comparing this moment in history to that of 1980 when Ronald Reagan was elected.

Looking back to the period just prior to Reagan's election is instructive. The economy had struggled mightily with moderate growth coupled with inflation, also known as "stagflation." The oil shocks of 1973-74 and 1979 were punishing for the economy. Richard Nixon's attempts to control wages and freeze prices while urging the Federal Reserve Bank to keep interest rates low proved to be a

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Reagan, Trump and the Chevy Vega *(Continued from page 3)*

disastrous combination. Neither Gerald Ford's "Whip Inflation Now" speech in 1974 nor Jimmy Carter's "Crisis of Confidence" speech in 1979 did anything to solve the economic problems of the country. Unemployment was high and the cost of borrowing put home ownership out of reach of many Americans.

It is worth noting that despite the inflation, energy price spikes, deep recession and severe market decline that occurred during the ten-year period (1971-80) prior to Reagan's election, real GDP averaged 3.2% during this period and the stock market as measured by the S&P 500 averaged 8.5% annually. I'll go on record and say that I'd be delighted if the next decade delivered numbers like these. So what happened after Reagan was elected? Remarkably, during the subsequent ten-year period (1981-90), the economy grew at an identical rate (3.2%) to that of the prior period but the stock market posted a whopping average annual return of 13.8%.

Why the strong market return? What did Reagan inherit? And most important for us as investors today, how is what Reagan inherited different from what Trump has inherited? Could we possibly expect stock market returns to exceed 10% in the next ten years? What about bonds? Here are the stats:

	Reagan's Economy (1981)	Trump's Economy (2017)
Government Debt	$800bn	$19,800bn
Gov't Debt/GDP	31%	105%
10-Yr Treasury Yield	12.4%	2.5%
Previous Year Inflation (CPI)	13.5%	2.1%
Unemployment	7.5%	4.7%
S&P 500 Trailing P/E	9.0x	25.5x
S&P 500 Dividend Yield	4.7%	2.1%
Fed Funds Rate	18.70%	0.75%
Fed Reserve Balance Sheet/GDP	5.1%	24.0%
Previous 10-Yr GDP Growth	3.2%	1.3%

In studying the table above, it doesn't take long to figure out that the economic and market metrics inherited by Reagan can only be described as a powerful tailwind for future stock and bond returns. In contrast, what Trump has inherited can mostly be categorized as a headwind. Diving in:

- **Government Debt:** Since Reagan was elected, we've put $19 trillion in debt on the books. With current debt to GDP at 105%, our credit limit is arguably nearing its maximum.
- **Bond Yields:** When yields fall, bond prices rise. We've obviously enjoyed a wonderful ride in bonds as yields have fallen from the sky-high levels of the early eighties. It is pure math—we can't expect bond returns of the next ten years to match those of the last 26 years.
- **Inflation:** The Fed under Paul Volker (1979-87) stopped inflation with aggressive action (extremely high interest rates) and the economy has generally enjoyed a benign inflationary environment ever since. This too has been a huge market driver. Today risks seem balanced between inflation and disinflation/deflation. As always, the market is watching closely.
- **Employment:** Today's unemployment rate is low but much has been written about stagnating wages in the middle class. Trump promises better jobs through tax policy and trade policy. It's early but he's learning that Washington doesn't run as efficiently as a business. Stay tuned.
- **Market Valuation:** This one is a doozie! Stocks were cheap when Reagan was elected. Not so today. Stocks seem priced for perfection. History makes it painfully clear: Below average returns usually follow periods of high valuations. Be prepared.
- **Fed Funds:** Money was expensive in 1981. For the last eight years, it has been dirt cheap. Despite the low cost of borrowing, economic growth has been subpar. One look at the Fed's balance sheet makes it clear that the central bank has already used a lot of its ammunition. We can't count on cheap money to spur the economy.
- **GDP Growth:** This is the wildcard. Real GDP growth has averaged 1.3% for the last ten years. If tax policy, trade policy, deregulation, infrastructure investment, business investment, technological innovation and productivity can ramp up economic growth, a lot of problems will be solved.

We're optimistic that the pro-business policies of the Trump administration will indeed result in a higher rate of economic growth. But we think it makes sense to be realistic when setting expectations for market returns for both stocks and bonds. We wouldn't be surprised to see solid economic growth coupled with below-average portfolio returns in the decade ahead. Not below-average like the Chevy Vega...but certainly short of a Corvette with a Turbo V8! Depressed? Don't be! With good financial planning and diligent portfolio management, we think the future is bright.

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

Sincerely,

Benton S. Bragg

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