MacDougall
Financial Counseling
2364 Route 66 Delmont, PA 15626
www.macdougallfinancial.com

Dear Clients of MacDougall Financial, January 20, 2022

Two young fish are swimming along when an older fish swims by and says, "Morning, boys, how's the water?" The little fish swim on for a bit and then one says to the other "what's water?"

Just like the young fish, we are all swimming in 'waters' that are increasingly unfamiliar. To begin, covid has rejiggered our social interactions affecting all aspects of our work/life routines. Second, inflation, quiescent for decades, has reared its Hydra head and is rising faster than Lazarus. Third, the 'Fed Put' has died and Quantitative Easing (QE) has been replaced by Tightening (QT). An entire generation has been raised in a highly liquid low inflation environment and now the rules are changing. Fourth, the rise of liberal democracies and Adam Smith economic policies, long taken as axiomatic by the political elite, is being questioned and even threatened by successful focused autocracies. Democracy itself is 'on the ropes' for its faults and divisions have been clearly on display. One place this is statistically evident is that in mid-December, the 7 day average of new covid cases in China was 200 while the US was north of 400,000. However, it remains to be seen if China can continue its "zero covid" strategy in the face of Omicron's rapid spread. Lastly, America's preeminence in the world is being challenged and it is unclear if we can rekindle our common interest in preserving the status quo. The US body politic is more fractious than ever. Some of the blame lies with the media who promote division and strife in the pursuit of eyeballs and advertising. Truth and Trust have been the casualties. We will not claim any prescience or make predictions but I can say that the old fish at MFC (Teri & I) and the young fish (Kurt & Liz) are focused daily on understanding and navigating these new waters.

The economy was exceptionally strong in 2021 as evidenced by the annual returns of the 11 US business sectors ranging from a Utility sector low of 13.7% to Energy's high of 47.7%! (see attached Charts) Inflation was unquestionably the big story of the year and the only thing that proved "transitory" was the consensus that it would subside. Simply put, inflation reflects an excess of demand oversupply, and pinpointing the drivers is simple: the government threw trillions at the consumer goosing demand but did nothing to improve or stabilize the supply chains. Experience has shown us the close correlation between high public spending and inflation, especially when you deal in trillions. I fear we are mortgaging our future to boost the present.

The equity markets provided exceptional returns in 2021 with the S&P 500 rising 28.7% (incl. dividends) beating the NASDAQ (more tech companies) for only the second time since 2011. The bond market was down circa 1.5% but note that this was its fourth down year in the last 45 years! The decline is not surprising in light of the resurgence in inflation and the certainty of rising interest rates. Also, we must remember that 2020, and 2019 in particular, were exceptional return years for bonds and the current 3 & 5-year bond return averages are at or above their long term medians. The US credit markets enjoyed the twin tailwinds of robust earnings and above trend growth last year but these factors failed to erase the declines in principal values due to the Fed's pivot to QT and raising short term rates. That said, there was a 'trend of stability' across the bond market in 2021 as evidenced by the 111 days of unchanged trading in municipals, one of the largest bond sectors. For reference, in the 10 years preceding 2021, the highest annual total of such 'flat' days was 19. The majority of our active fixed income managers beat the averages and registered positive 2-5% returns last year.

At the opposite end of the spectrum, the equity market was driven up by a nearly 50% increase in the S&P 500 earnings, good revenue growth, and expanding margins. These were only partially offset by a compression in P/E multiples during the year. To temper the enthusiasm for stocks, I only need to point out that the S&P 500 has risen circa 90% in just the last 3 years. While there are many signs that the US equity markets are overvalued, the reality is that, depending on the statistics chosen, a persuasive argument can be made for both over and under-valuations. Supporting the latter viewpoint is the fact that the S&P 500 yield (2.3%) is well above the current 10-year T-Bill rate (1.7%). This gap is closing but with real interest rates being negative, bonds are simply less attractive than stocks. To paraphrase Mark Twain, the rumors of the demise of *TINA FOMO* (There Is No Alternative and Fear Of Missing Out) are greatly exaggerated.

Turning to our client investments, you will see in your statements the many double-digit returns in both growth and value. There were more sizable variations between funds/sectors than normal as biotech, health care, and small caps all lagged the averages. In common with most investment managers, we did not beat the S&P 500 last year and the reasons were varied. First, many of the gains were focused on the top 10 stocks in the indices- FAANGMT- and these 'high flyers' now represent nearly 1/3rd or more of the total index capitalization and sport P/E multiples around 33 compared to 20 P/E for the remaining 490 stocks. Our portfolios are far more diversified and our small cap and international funds lagged in 2021. Our bias to equities in nearly all client allocations served us well in recent years and even those with 50% or more in fixed income, saw acceptable portfolio returns. Remember that the beauty of diversification is that pieces of your investments do very well while others pause, backfill, and even decline. Our goal is not to aim for the highest returns but to design stable, all-weather portfolios that meet your needs year after year. It is a marathon, not a sprint!

Looking ahead into 2022, the only bothersome fact is the uniformity of favorable outlooks. Liquidity and credit availability are healthy, consumers are in good shape financially, CAPEX is forecast to be strong and public policies and central banks remain accommodative. There are also early signs of moderating inflation pressures due to supply chains adapting. However, headwinds abound beginning with the impact of QT & rising rates to a significant decline in the growth of earnings. Note that this forecasted decline is in the growth of earnings, not their absolute levels which should continue to rise in 2022. Consumer spending, especially on big-ticket items, is expected to decline, some commodities have flattened or declined, and the yield curve is steepening. Offsetting these deflationary forces are the continuing increases in wages, housing, and rents. The Fed is doing all it can to prevent the current expectations of inflation from becoming self-fulfilling but their track record in this regard is a cause for concern, not comfort. While a recession does not appear imminent, it is in almost everyone's forecast for 2023 or 24. The economic cycle is alive and well and if we have learned one thing from this pandemic, it is to be wary of forecasts. We are all fish swimming into an era of predictable unpredictability (or uncharted waters?).

In closing, while we attempt to understand the big picture and both short and long cycle forces, our true focus is on the quality of our/your investment managers and the blend/diversification necessary to achieve your goals. We don't expect the year ahead to be smooth and volatility will be significant as the proverbial forces of good and evil are both balanced and mercurial. We will do our best to protect your capital but we must acknowledge the possibilities of some declines given the recent gains. We look forward to personally seeing each of you in the coming year for that is a pleasure we have missed. Please call us with your questions at any time.

Best, Lanny