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

January 20, 2023

Dear Clients of MacDougall Financial,

ANNUS HORRIBILIS!

The late Queen Elizabeth used these words to sum up 1992, the year many 'tears' surfaced in the Royal Family fabric. Fast forward 30 years to 2022 and these words provide an apt and succinct description of the year. After a long period of slumber/repression, inflation, interest rates, and commodities came roaring back. Never have so many key economic facts risen so fast over the short span of a few months. Inflation peaked mid-year in the US at circa 9%, housing and food prices rose strongly, gasoline prices nearly doubled , and European heating prices rose from €125 in Jan, to €311 in June, ending the year at around €77 per MWh. Many commodities followed similar 'spike' patterns. Predictably, this caused havoc in the equity and bond markets and no sectors (excepting energy) were spared. The range of returns for the 11 S&P sectors has rarely been wider: +65% for the energy sector (favorably impacted by the war) to -40% in communication services. The tech and consumer discretionary sectors fell 30% and utilities, consumer staples and health care were close to flat. Most of the FAANGM stocks are in either the Tech or Comm. Services sectors so it is no surprise that these bore the brunt of the declines; but even after the carnage, many are merely back to their early 2020 prices. Basically, 2022 erased 2-3 years of returns, depending on the sector and stock, but the double digit equity returns between 2013-2019 are still 'in the bank'. This is why most 3 and 5 year average annual return figures are acceptable and many of our equity funds are still in the capital gains column. The odd best performer of the indices was the Dow Jones down only 9% compared to the S&P 500 at -18%. The Dow's more equal sector weightings, value focus, and large cap tilt all helped.

Nearly all bond funds lost value in 2022 because rising rates are akin to a falling tide, all ships fall. The US Agg bond index was down 13% and IG corporates fell closer to 16%. Municipal bonds were the one brighter spot declining 'only' 8.5%. It was the worst year in decades across the quality and duration spectrums and the rapidly rising sovereign yields nearly torched the British banking and pension companies. Worldwide pension and insurance portfolios were challenged by the declines in asset values but coming to their rescue was a much higher discount rate, which reduces the value of their future 'promises'. The good news is that current bond yields are high, near the top of their historical ranges, and provide a competitive return to equities in the near term.

Looking ahead, while a recession seems to be a foregone conclusion in the financial press, it failed to materialize in 2022 and its severity in 2023 is being revised downwards daily. The prerequisites for a recession are declining consumer demand and rising unemployment. Neither have occurred to date. The ratio of job openings to job seekers is 1.7, indicating strong demand for labor coupled with a scarcity of workers. The recent lay-offs in tech and finance have been all over the news but recall that these are coming after years of strong hiring. Goldman Sachs increased its work force by 34%, circa 12,000 employees, in the last 4 years and is now laying off 3,200, 7% of its workforce. This pattern is repeated all over the tech and finance sectors so bear this in mind as the layoff notices mount. Despite the broad inflationary pressures on the consumer wallets, there is no sign yet of falling demand or retrenchment. Yes, credit card debt is

rising and consumers are feeling the effects of rising interest rates but helping them cope are the nominal wage increases, falling gas prices, and for homeowners, rising property values.

Turning to your investments, the negativity in the economic data carried over to your accounts. Such markets require an ability to focus on the 3 & 5 year average returns and to remind yourself that what falls also rises! It was a year of new beginnings with value trumping growth both domestically and abroad for the first time in years. Note that the value outperformance was only losing 9 to 14% as opposed to the negative 20-30% for growth stocks. Small cap returns mirrored their large cap cousins with value besting growth. The classic time honored 60/40 portfolio showed its worst total performance since 1937, but a word of caution is to not let one bad year detract from years of stellar results. For the first time in decades, most bond funds produced low double digit negative returns. The good news is that after a decade of "zero interest rate policies", fixed income is finally providing attractive cash returns of 4%+ and the 'spreads' over T-Bills for all bonds have risen to near historic heights. This presages a banner year for bonds but remember that nearly all interest rates are still negative in real terms (adjusted for inflation), which is not the Fed's desire. Equities present a challenging investment picture for while the declines have brought prices and multiples down to reasonable levels, there are still signs of froth in many growth and energy stocks. If inflation continues its ameliorative path, it could be a good year for all investments…aptly following an 'annus horribilis' for all investments. Time will tell.

Truly, the direction 2023 takes will depend on two unpredictable factors: the war and inflation. Presently there is no solution for the Russia-Ukraine problem and a 'weak' ceasefire may be our best hope. There are likely to be defaults among some emerging market countries but as the dollar weakens, this pressure lessens. It is a safe bet that interest rates will not rise in 2023 like 2022 but predicting their peak and subsequent path is a fool's errand. We believe most of the inflation pain is behind us but the path to 2% will be lengthy. If interest rates can plateau around the 5% level, which will depend on the inflation numbers, that is historically acceptable for both the public and private borrowers. With some luck, we can substitute a shallow/shorter recession for a deeper/longer one, but the jury is still out. However, the time to invest is after declines while there is still some 'angst' in the markets. Thus, although the outlook is 'cloudy', we believe it is time to begin investing in both equities and bonds via multiple small 'scale in' purchases undertaken over the coming year, each deploying 5-20% of available cash balances in one's various accounts. There are good opportunities in both equities and bonds and as the data unfolds, we will inform you of the purchases beforehand.

Thank you for your patience with the upcoming Custodial transfer work (see attached letter) that has resulted from the Schwab-TDA merger. This has not been undertaken lightly but we firmly believe the price and service advantages offered by Pershing are worth the effort.

Please feel free to contact us about this or any other matters.

Best, Lanny