

MACDOUGALL
FINANCIAL COUNSELING
2364 ROUTE 66 DELMONT, PA 1562

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Dear Clients of MacDougall Financial,

“Nothing sedates rationality like large doses of effortless money” – Warren Buffett

Mr. Buffett hits the nail on the head for we are at the front end of one of the largest expansions of the global money supply in history. A crisis is never wasted by any politician and the pandemic is no exception. Between the American Families Plan, the Infrastructure bill, and other proposed programs including the budget, the Biden spend, aka debt issuance, is above \$6 trillion! Trillion is a word that should be banned for it is simply too large for us mere mortals to comprehend. A billion is OK for 1bn seconds is only 31.7 years. But 1 trn seconds is 31,700 years, a figure well beyond our human time frames. This stimulus will be felt for years to come for even our government cannot spend trillions in months or even years. This fiscal fire hose of money coupled with imbalances of supply and demand are driving the inflation that we are experiencing. The June 2020 to June 2021 CPI figure came in at 5.4%, the highest annual reading since 2008. Consumers and businesses are awash with cash and predictably are spending it on ‘covid immune’ products like stocks, houses, cars and tangible assets. Neither economists nor the markets have a good record in forecasting inflation so we don’t really know what lies ahead. We are in “unchartered waters” where the past is no guide to the future for as we are learning, it was far easier to shut down than to ramp up. The inflation ‘drivers’ of strong consumer demand, supply chain disruptions, and rising wages are counterbalanced by the deflationary forces of high debt, demographics, and tech disruption. Oil prices are certainly on the rise but other commodities like lumber, copper, and many agricultural products are declining, albeit after steep advances in the past year. The sectors that were most impacted by covid, hospitality, restaurants, and leisure activities, are all on the rebound and raising prices. It currently appears that inflation is more focused than widespread for 4/5ths of the May 2021 inflation growth was driven by only 3 segments - cars, furniture and sporting goods. Despite Fed assurances, it remains to be seen if the inflation spike we are experiencing, is temporary or more long lasting.

Despite the uncertainties surrounding the inflation picture, the overall US economy appears to be strong. June added 850K in new jobs, wages in the private sector have risen 6.6% over the previous 15 months, and yet there is still close to 7mm fewer workers employed than in Feb 2020. Despite the rising inflation numbers, the benchmark 10 year T-bill rate has declined from 1.75% to a recent low of 1.3% and now stands circa 1.45%. Thus the bond market appears to be more sanguine about future inflation than the politicians and prognosticators. Gross Domestic Production (GDP) grew 4% in 2020 and is on target for a 4-6% range for 2021, which is amazing given the interruptions in economic activities worldwide. China is on track for GDP growth of over 8% this year! Despite a weakening dollar, our appetite for imported goods is strong and rising trade deficits are in the cards. Inventories are low, interest rates are negative in real terms, and liquidity is high so there appears to be plenty of room to move higher in key economic metrics – employment, wages, output, inflation, even corporate profitability. The virus induced a global ‘house cleaning’, it drove productivity higher, and as we return to some semblance of normalcy, we should see a bumpy but upward sloping curve of economic activity. Unfortunately, covid also led to greater inequality of incomes, health outcomes, and political and social divisiveness. The good, the bad, and the ugly, all part of the human covid experience.

The equity markets have been looking 'through covid' for over a year. After a steep nearly 20% drop in March 2020, the shortest market recession in history ended and the market has risen north of 90% since those March lows. Small caps fell closer to 30% but have rallied significantly since. I was as dumbfounded as anyone how the market could shrug off a global pandemic and climb to loftier heights but slowly I came to see that the markets had widened the discount window (time frame) and were in fact looking well forward to the post covid world. This was a year plus ago and we are now at the front end of that 'new world' envisioned by the markets in the Spring of 2020. Companies have shed workers, streamlined supply chains, and are "leaner and meaner". This is the first week of 2nd Q corporate reports and the majority of companies are registering excellent results. Covid provided the cover for some overdue business and employee rationalizations and these benefits should last for some time....unless you are one of the unlucky ones who does not get rehired. The equity market is at lofty valuations, a 1.5 standard deviation above the historical norms, CAPE and Forward P/E ratios are in record territory, and even the trailing P/E ratio is well north of 20. Fortunately, the rising earnings have lowered the P/E multiples but they remain above long term averages. You can see in this list of global forward P/E's that relative value lies overseas: US P/E = 19.2x, Euro = 15.6x, Japan = 13.9x, and finally Emerging Markets = 13.1x. The US may deserve a higher P/E ratio for no country has thrown more money at the viral dislocations and our vaccine progress places us in the top 5 of all big countries. The first half of 2021 has seen some amazing sector returns: Energy 45.6%, Financials 25.7%, Real Estate 23.3%, Telco 19.7%, and all remaining sectors showed double digit growth except for utilities. However, these figures are being compared to last year's numbers when everything was horrible so the 'Base Effect' is very real. We are at the front end of a large economic expansion and no one is forecasting a recession in the upcoming 12 months. It is very much a 'Goldilocks' economy but the viral variants are loose and causing panic.

I think you will be pleased with the enclosed Asset Allocation reports for our selection of funds have participated in the market upswing. I urge you to glance at all the performance figures on the right side of the page listing all your investment assets for I have never seen so many double digit positive returns across our universe of mutual funds. Even the 5 & 10 year average annualized returns are in double digit territory. A pull back will come, some of these gains will vanish, but the net positive result from the last 10 years of equity investments will be well above the long term averages. While all the pundits have focused on the mega cap tech names (FAANGM+), hidden in plain sight are some exceptional returns for value and international funds. These sectors have long been laggards compared to their growth brethren so it was nice to see patience and diversification being rewarded. 'Frothy' is an apt description of the equity markets as we have witnessed YTD nearly 40 new highs in various indices. Fixed income assets have had a difficult year due to the low yields (ZIRP) and inflation pressures so most are 'treading water'. Convertibles, Preferred's and other esoteric strategies will get you to the 3-4.5% return range but overall, there is little yield excitement in the bond world today. All spreads over T-bills are at the very low end of the range confirming the apt bond market description – "return free risk". In all honesty, it is a tough call today as to whether stocks or bonds carry more risk and that is why we advocate owning both across nearly all portfolios. One foot on the gas (stocks) and one foot on the brake (bonds).

We have truly missed meeting with you over the last 12-18 months but we are all vaccinated and have hopes for future travel. Please feel free to call or email us at any time with your questions or comments.

Best, Lanny