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

Dear Clients of MacDougall Financial, July 20, 2022

"There are risks and costs to action. But they are far less than the long-range risk of inaction" JFK
"The stock market has predicted 9 of the past 5 recessions." Paul Samuelson

Both of these quotes encapsulate our current situation – uncertainty about a recession and the aggressive actions taken by the Fed to address inflation. This is causing mayhem in the markets because, at its core, our situation is 'sui generis' (of its own kind). There is no applicable precedent and more so than ever, "the past is no guide to the future". These unique developments include the original pandemic which quadrupled the unemployment rate in only 3 months, the collapse of the service sector heretofore characterized by stability, and the supply chain shortages driven by covid and shifting consumer purchases. Plus, inflation exploded from 1.5% to 9.1% in under 1 year, and finally the Government and Federal Reserve Bank throwing trillions at both companies and people with little regard for the consequences. Economic models and forecasts were useless for none were prepared for the 15% unemployment rate, the 20 million jobs lost, nor the many other structural dislocations. We entered 'terra incognita' but that did little to dissuade the media talking heads from making wild prognostications which have grown as the market falls.

From my perspective, this looks like a standard 15-25% decline from inflated asset values to more realistic valuations. Of course, a land war in Europe, covid, energy and food shortages, and the massive fiscal and monetary response by countries everywhere are all new 'variants'. However, when you 'look under the hood', we can see the familiar pattern of an expanding money supply leading us down the primrose path to inflation. There are coincidental and collaborating factors but the principle, taught in Econ 101, is still that inflation is primarily caused by 'too much money chasing too few goods'. In hindsight, we can see that global demand was boosted by the government payments while supply was constricted by the twin pincers of inflation and the pandemic. This too shall pass, inflation will abate, yet it could be 1-2 years before we get close to the Fed's target of 2%. Interest rates will remain elevated well into 2023, economic activity will slow; but there are many strengths in the economy that should ameliorate any deep recessionary forces.

Let's have a look at those positive forces. To begin with, the labor market is exceptionally tight with 372,000 jobs being created in June alone. There has never been a recession without a decline in employment though we could be on the brink of this happening. Other strong sectors are the credit and banking markets, which are liquid, well-capitalized, and show few signs of financial stress. Housing and rental demand, although weakening, are still strongly positive across the nation. Most importantly, the consumer is in good shape due to rising wages (up 5+% in the 12 months thru June), stimulus payments, and increasing home values. Inflation is eating into their cash hoard, but trillions remain to be spent. I am not saying that we don't face sizable issues and a challenging road forward, yet I see many reasons for optimism in the entrails of this market.

That said, the first half-year has been ugly, there is no way to "dress up this pig", the carnage is all too evident in your 6/30/22 reports. Thus, it might be wise to 'socially distance' yourself from your monthly statements. It has been quite a while since we have witnessed such a sea of negative returns across all asset classes except energy. To buoy your spirits (or steel your resolve!), you can focus on the 3 & 5-year average annual returns which are mostly in the high single to double-digit numbers. Of course, we

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all wish we could avoid such declines, but they are simply part of the investing process. Ten of the eleven S&P 500 sectors registered declines with only the energy sector growing at close to 32%. Utilities and consumer staples reported modest declines (meaning under 5%) but sectors like tech, consumer discretionary, and Telco all fell by 30% or more. Rising rates are like a falling tide…all ships fall! The bear market has been pervasive with nowhere to hide for even investment grade bonds are down by 10-16%. It requires great mental dexterity to juxtapose the broad bear market trends with an economy exiting a covid induced slumber, rising wages, strong corporate and consumer balance sheets, and continuing growth in the S&P 500 earnings per share. 'Contradictory and confusing' are the descriptive words that come to mind. Overlaying the political gridlock leads us to the conclusion that the best response to the volatility and declines is to actively do nothing. Be neither a buyer nor seller, unless you are forced to, when price discovery is opaque. As the dust settles and the uncertainties diminish, we expect to start a mild 'scaling in' process, aka bottom fishing! Due to the sizable declines YTD, many market metrics are close to 'normal' territory and thus we will be in touch with an investment plan.

The declines have fallen disproportionally on the small-cap sector and technology stocks which, not coincidently, saw a disproportionate share of the gains in recent times. This is where we will focus our research and opening purchases. There are many quality companies with low debts, good cash flows, and pricing power that will weather the interest rate/inflation storms and emerge stronger and more valuable. In dollar values, your accounts are back to the beginning of 2020 having erased the gains achieved in 2020 & 2021. Note, however, that if you carry those years and 2022 at a zero return, the annualized S&P 500 performance was 5.5% at 5 years (with 3 of those years at zero!) and the longer 10-year average annual return is a respectable 10.8%. Fixed-income investments provided little shelter for 'staid' municipals were off -8.6%, the Agg bond index was down -10.4%, and many bond funds registered losses in the -13 to -16+% ranges. Even real estate, which has been strong post the pandemic, is down by -20+% ytd. Some of these falls stretch credulity and will be reversed.

We are at the beginning of earnings season which will give us forward visibility on business conditions, supply chains, and inflation. We could see a stock market recession due to falling corporate profits and yet still experience GDP growth due to the economy being driven more by services than goods. It pays to be patient especially when 'catching a falling knife' for it can always get worse! The rising dollar is a worry for all indebted & emerging countries for more than a few are going to hit the wall and have to call in the IMF. Nor can we discount further waves of covid variants or an escalating war. Countervailing these forces, we have strong demand from both public and private sources, healthy balance sheets with little debt coming due, minimal financial stresses, and valuation measures that have been brought into historical line. We continue to favor large and mid-cap US fund managers for most of our investing capital with 'side cars' for international and small-cap stocks. Fixed income has become decidedly more attractive with high yield bonds paying 8+% which rivals an equity return. Munis in particular appear to offer a favorable entry point across the credit spectrum. Rates remain negative to inflation, but few doubt the resolve of the US Federal Reserve and already there are signs of price weakness in key commodities i.e. 'Dr. Copper', oil, natural gas, wheat, etc.

The opening point of this letter was that we are in "unchartered waters" where the past is no guide to the future. We are believers in the power of a plan and some actions may be needed. This will be covered with each of you individually in our reports and recommendations. Please do not hesitate in these trying times to reach out to us with your concerns and comments. We never forget whose money it is, and we do want all our clients to rest peacefully at night.

Best, Lanny