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'We may all be facing the same storm but in very different boats.'

Dear Clients of MacDougall Financial, January 15, 2021

There is nothing like a pandemic to bring out the 'storm' analogies. Quarter 1 (Q1) 2020 was widely labeled the 'Calm before the Storm', Q2 & 3 saw us 'In the Eye of the Storm', and finally, by Q4, we were in the 'Storm before the Calm'. The truth and inequity lying behind the opening paraphrased quote became more apparent with each passing month. "Unprecedented" might be the most overused word in 2020 but it is apt and here are a few examples:

- We witnessed the quickest recession ever, the S&P 500 fell 34% in 22 days.
- Fastest recovery ever – 5 months in total to new market highs.
- Q1 saw the largest losses in years and Q2 the best returns in years.
- The steepest quarterly decline in GDP ever.
- 20 million jobs lost in the Q2 and nearly half remain unemployed to date.

In March, facing a collapsing economy, the Fed and Treasury morphed to T-Fed, aka T-Rex, ruler of the realm, and the floodgates opened with $2.2trn of 'helicopter money'. The Fed began buying $120bn per month of all types of securities and this 'Fed Put' calmed the markets and stopped the rout. Short rates were brought to zero and yield curve control became pervasive. Bond yields remain near zero and credit spreads over Treasuries are at all-time lows. After bottoming in Q1, the equity markets rallied from Q2 on to new heights by year-end. In sum, it was a year when we got sick while slowly going nowhere at great expense….the definition of sailing!

Facing the biggest global calamity in decades, governments and central banks responded with massive liquidity measures. Given a dearth of spending options, a significant amount of this money went to the financial markets, mostly equities. Nearly all asset classes rallied except the sectors hardest hit by covid – energy, real estate, airlines, retail and hospitality. The money supply rose 25% in 2020 and right now, $1 in every $5 circulating was created in 2020. Real interest rates went negative all around the world (excepting China) leaving equities as the only growth game in town. By Q2, there was a lot of commentary on the apparent disconnect between Main Street and Wall Street. Equities and bonds were booming while a record number of Americans received unemployment benefits and businesses were filing for bankruptcy. The markets are forward-looking discounting mechanisms but the magnitude of the recent gains leave many believing that the future growth is priced into today's lofty levels. Outside of asset prices, inflation is subdued but the outlook is cloudy for the explosion of the money supply coupled with the rising demand from pent up consumers should push up prices. However, the four D's of deflationary forces – Détente (no wars), Tech Disruption, Demography, and Debt – will counterbalance the upward pressures. No one can say if these 4 D's will be sufficient. Rising inflation has been falsely forecasted since 2009 so the jury is out.

Forecasting the labor market in 2021 is as challenging as inflation. The unemployment rate exploded from historic lows of 3-4% in Q1 to over 15% by mid-year and then retreated in the second half to its current level of 6-7%. It is too early to say which job losses are temporary and which are permanent but at the very least, a multi-year economic recovery will be needed to normalize the labor market.

The bright spot for 2021 is the forecasted GDP growth rates across all countries. China is expected to grow at circa 8%, the USA forecast is for 4-5%, Latin America at 4%, & Europe at 2-3% but these forecasts depend on successful vaccination programs worldwide. A worst case scenario calls

for zero to negative global GDP growth due to the continued spread of the virus and the attendant economic dislocations. We believe the former estimates are closer to the mark than the zero growth scenario.

2020 witnessed the broadest range of asset returns in a long time. Sector returns varied from +47% for Information Technology to -45% for energy. The financial sector fell 12% while the health care and consumer discretionary sectors rose 20% & 29% respectively. Even these generalized numbers mask wide differences. Four stocks – MSFT, AAPL, AMZN & GOOG – represent 20% of the S&P 500 index and their market cap equals the market cap of the bottom 350 stocks. This concentration of returns is shown in the following facts as of the September 2 market peak:

- The big 5 stocks (add Facebook to the above list) were up on average 65% at that time whereas the remaining 495 S&P 500 stocks were up only 3%.
- 36% of stocks were still down 20% or more in September.

Since then, the market has continued to rally and in Q4, it broadened to include value stocks, small caps, international, and cyclicals. Growth stocks once again outperformed value stocks in all but Q4, but the value folks are quick to point out that their stocks have led the way out of all recent recessions. Only time and better economic data will tell if this rally peters out or has stamina. Boding well for 2021 is the continuation of monetary stimulus, improving geopolitical situations, low-interest rates, and restrained inflation.

Turning the focus to your investments, what jumps out to us is the paucity of negative returns….in a very tumultuous year! Our core bond funds returned anywhere from +2 to +10% with nary a negative return. Our equity funds sported wider ranges from -6% in small-cap value to +58% in small-cap growth. Across our 30 core equity funds covering all market sectors, 19 showed positive double-digit returns while there were only 2 negative returns, both in small value, and both single digits. The markets were willing to look beyond the sizable earnings declines to the hoped-for better times ahead. To paraphrase Charlie Munger, it was a year when the rewards came from not being "consistently stupid". We accomplish this by working with you to develop a financial investment plan and then adhering to it. Slight adjustments are warranted and normal but we all know that it is 'time in the market, not timing the market' that matters most to one's returns. To be precise, since 1950, the frequency or incidence of positive returns increases as follows: at 1day, 54% of returns are a plus, per quarter = 67%, per year jumps you to 71%, and 3, 5 & 10 year returns ratchet their way up to the high 80's percentile. We always want more of our winners and less of our laggards but that is a cost we bear for a well-diversified portfolio.

Looking ahead is more perilous than usual due to a lack of comparables. We fell wide of the economic models in 2020 and this is likely to continue in 2021. A worrisome fact is the near unanimity of positive outlooks amongst the pundits. "Don't fight the Fed" has become the chorus…so please find your place in the choir! Due to ample liquidity and modest inflation, there are many reasons to be bullish. However, the recovery will be very uneven thus further exacerbating economic inequality issues leading to rising political tensions. YoY S&P 500 earnings growth will be stellar but to some extent, this has been priced in. On the fixed-income side, it could be that the best year in decades (2020) is followed by the worst year….or not. It will depend on the interplay of forces driving the interest rates and inflation expectations.
With multiple vaccines in the pipeline, we can hope that covid morphs from a pandemic to merely being endemic. The year ahead will be both challenging and exciting and rest assured that we will do our best to navigate your investment 'boats' to safe harbors beyond the storm.

Best, Lanny