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Dear Clients of MacDougal Financial, January 18, 2018

To borrow from Yogi Berra….it's tough to make predictions, especially about the future. The 'experts' learned this in droves in 2017 for last January, they were forecasting a lackluster year for US equities (5-8%), waxing right wing movements here and abroad, rising interest rates, inflation and more global fiscal problems. Very little of this came to pass. The new Trump Presidency was tying the knickers of the Media and Democratic party in knots and no one was forecasting that calendar 2017 would see a nearly 22% rise in the S&P 500. Gloom, doom and modest expectations were the Plat Du Jour.

In fact, the year broke more records for new highs, lowest volatility, # of positive months, de minimis corrections, and ever lower levels of inflation and unemployment. The stimulus from all the key central banks was unremitting and the markets followed the old adage…."don't fight the Fed". The year proved to be the perfect virtuous storm of a synchronized and symbiotic global expansion. The Purchasing Manager's Index (a good indicator of the health of manufacturing) as well as the Service Manager's Index (non-manufacturing forward indicator) were above 50 every month, signaling an expansion across all major economies (US, EU, Asia & EM). Consumer and small business confidence indices are at or near record highs not seen since the middle Reagan years. This optimism is being driven by the longest job expansion on record (87 months), 7 years of 2 million plus new jobs annually (2.1MM in 2017), and even the 'perma-bears' (Jeremy Grantham et al) are momentarily quiescent. We are caught in a favorable bombogenesis (aka Bomb Cyclone) with low interest rates, rising earnings, modest inflation and strengthening global growth.

While the S&P 500 rose 21.8% in 2017, this masked some wide discrepancies in sector returns from technologies blistering 39% rise to 1% declines in energy and Telcos. Six sectors rose more than 20% during the year and three came in with 11-12% increases. In short, it was a very solid year with market indices rising every month, a first in 50+ years. Arguably, this might be one of the best annual total return USD performances of the World's Developed Markets ever for Argentina, Poland and Czechoslovakia rose close to 50%, the smallest rise was Russia at 6.2% and the arithmetic average increase in 34 countries was 30%! For the first time in years, most international markets outpaced the US and most Emerging Markets did even better. In the US, growth investing once again outpaced value and the weakest US performance was the small cap value sector with gains in the low teens.

Bringing these market gains closer to home, our portfolios did very well. For the first time in a few years, our active managers equaled or outperformed their passive counterparts. Our 3 most used active growth funds averaged a 30% rise, equal to the Russell 1000 Growth index; for our active value managers, all 4 beat the Russell Value index return of 13.7%; for small caps, our 4 primary active mangers nearly doubled the return of the Vanguard and S&P 600 small cap indices. Lastly, the international sector, again for the first time in years, outperformed the equivalent passive index. One year does not a trend make and "asset rotation" is the only certainty. We see this rotation in

our own investments where growth and value styles often change the leadership position, ditto for active versus passive. Who "wins" in any given year depends on defining the "who" and the time period. After 40 years of investing, I believe that once you chose the longer time frames of 5-10 years plus, then it is a 50/50 proposition as to the "winner" and more importantly, the difference between them is small (1-4%). To keep our portfolios balance and diversified, we more or less equal weight for growth and value styles, active versus passive, small cap, large cap, etc. and in this manner, we have investments in most sectors. By using a variety of screens/filters on the entire mutual fund & ETF universe, we can improve the quality of the selected pool that we fish in. Our goal is for our selected funds/ETF's to place in the top 25% of their peer group in 3 or 5 year periods. In sum, 2017 was an exceptional year for investors for as you can see in your Asset Allocation spreadsheet, there were double digit positive returns across all markets and sectors. We can only hope that we will see these returns again!

Looking forward to 2018, record highs in stocks, low bond yields, and tight credit spreads present significant challenges for investors. Economic data is strong and the tax reform provides a tail wind to earnings and GDP growth. However, the Fed has promised multiple rate hikes in 2018 and simultaneously they plan to shrink their balance sheet. Both actions add considerably to the uncertainty and the volatility in the markets. If this US tightening is adopted by the ECB or the JCB, then the risks are heightened that globally rising interest rates will cause distress and defaults in the credit markets. This will affect companies as well as countries. To date, we have seen the hottest start to any year since 2003 and both the global expansion and the appetite for risk appear undimmed. There are many conundrums in this market, like why are bond spreads so low, why are most western EU nations borrowing at rates below the US government, and what's driving the exchange rates? Many ratios such as the stock market cap to GDP, price to sales, CAPE numbers and others argue convincingly that the US equity markets in particular are at or near their peak. This does not mean they cannot go higher or go longer, for both paths are possible but the current valuations argue for caution. About the only deep value stocks globally today are in the Emerging markets, some with PE ratios below 10, but these same markets show very mediocre 3-5-10 year returns. Bonds are the traditional safe haven asset but the low yields and miniscule risk spreads mean that you get paid very little for a lot of risk. If you plan to drink from the income yield on US Treasury bonds , you will die of thirst! We are in year 9 of a bull market that has lifted the S&P 500 370% since the 2009 low so to us, this argues for a defensive stance. Our first and overarching goal is protection of your capital and we want to discuss with each of you your personal risk tolerance and be sure that our investments are appropriate. To close with another Yogi Berra'ism, the future ain't what it used to be. No one can call the inflection points, the black swan events. Better to be invested within appropriate risk parameters and then roll with the ups and downs of the market. In all of our combined market experience, stocks have never failed to recover from declines within 2-5 years and I see no reason this should not continue. Humility is a sine qua non for successful investing.

Best, Lanny