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Dear Clients of MacDougall Financial, July 18, 2018

"For all the sublimity of art, physics, music, mathematics and other manifestations of human genius, everything depends on the mundane, frustrating, often debased vocation known as politics…fairly or not, politics is the driver of history". Charles Krauthammer

A bright light in the journalistic world was extinguished on June 21st with the death of Charles Krauthammer, long time columnist for the Washington Post. I will not delve into the realm of politics (a perilous endeavor even in the best of times!) but his point is accurate – "politics is the crooked timber of our communal lives". The more unpredictable it is, the more uncertainty prevails, volatility rises and wider swings in market values result. The first half of 2018 has seen an escalation of geo-political tensions and the resulting dubiety has overwhelmed the mostly benign economic indicators. Inflation, while rising, remains tame at around 2% YoY; job growth is in its 8th year of circa 200K net new jobs per month (longest streak on record); S&P 500 sales and earnings are at record levels; small business optimism is likewise at levels not seen in more than a decade; and overall the global growth forecast is circa 3.9% for 2018. Most forecasters don't see a recession until mid 2019 at the earliest, but remember that the market is a forward discounting mechanism. Also, the unpredictability of our tariff and trade policies coupled with a rising interest rates & appreciating dollar have caused negative returns in global developed and emerging markets….a harbinger? Bears are crafty and their victims rarely see them coming.

In the US, market results for the first half are mixed with the S&P 500 showing a gain of 2.6%, the Dow falling 1.7%, the tech heavy NASDAQ rose 8.8% and the small cap Russell 2000 rising 7.6%. The most notable factor for the US markets is the concentration of returns with the FAANGM stocks (Facebook, Apple, Amazon, Netflix, Google & Microsoft) accounting for essentially all the S&P 500 gains. Although the gains in small cap stocks indicates a somewhat broader market participation, the investment inflows and sky high valuations of the 5-6 "super tech" companies are a cause for concern and some re-pricing is to be expected. One factor driving these focused returns is the growth in passive cap weighted investing where the largest stocks in the index reap a disproportionate share of the gains. The concern is that a declining market facing liquidity constraints and a wave of redemptions will result in a non-linear effect on stock prices. These six stocks now impact the S&P 500 index more than the combined weight of all the energy, material, utility, and real estate companies in the index. You know something is out of line when Netflix's market cap (sales = $11bn, profits $597MM, negative free cash flow) exceeds Disney (sales $55bn, profits $8bn, circa $10bn in free cash flow). Ditto for cars where Tesla rivals GM on a pure valuation basis. I believe some of these high flyers will prove the adage that stocks/markets rise on the staircase and fall via the elevator shaft!

Looking at our portfolios, the brief outperformance of international and EM funds reversed itself in the first half and growth stocks continued to significantly outperform value stocks. Thus, detracting from our first half performance returns were our international and value funds and accretive to our returns were our growth and small cap funds. Small caps benefited from the corporate tax reform act and the perception that they are less vulnerable to tariffs. The NFIB Small Business Optimism Index is at 107.2, it's 6th highest level ever and well above the 10 and 45 year averages (92.4 & 98 respectively). A tightening labor market is slowly raising wages and increasing the labor force participation rate, all good trends. Emerging market bonds and stocks remain in bargain territory but headwinds abound in the strong dollar, rising interest rates, tariffs and the growth in nationalism. Fixed income presents some of the greatest challenges because yields are about ½ of historical averages and suffice to say that when the US and Italy borrow 10-year money at about the same interest rate, something is out of kilter. At least cash is now yielding close to 2% and rising so if yield is less of a concern, cash is a viable investment and one we support wholeheartedly. It does not decline in a recession and provides dry powder when you need it. We are also monitoring closely the cash levels in the funds you own and the quality of the underlying stocks as we feel both measures are prudent defensive moves at this stage in the economic and investment cycles.

For my outlook, I have used the "Cloudy with a Chance of Meat Balls" analogy before and feel it is appropriate once again. The economic data in the US and even in other select countries is strong, global corporate earnings are excellent and inflation is modest. However, rising interest rates are rarely good for stocks and debt levels for consumers, corporations and governments is stratospheric. Add in the political polarization and gridlock preventing the long-term demographic, pension and health care issues from being addressed and you have a toxic stew indeed. Governments have made promises far more than their current ability to pay and some form of debt restructuring is probably inevitable. If this were to happen in Europe and result in a breakup of the Euro, the resulting rise in the dollar would be very destabilizing around the world. Not to mention the pain that occurs with the re-pricing of debt and equity! Some of these problems are longer term and if the political will was there, they could be addressed without major adjustments. Unfortunately, no such 'Will' exists so I take consolation in the fact that our problems are man-made and thus will be solved by man….and the pain will be shared.

Reading all these economic "tea leaves" leads us to continue recommending a healthy 50-70%+ allocation to equities with a bias to US quality unlevered companies across the capitalization spectrum. We feel the market is long overdue for a shift from growth to value but there is no sign of this occurring yet. Thus, we remain even weight in these sectors. Depending on your risk tolerance, pair your equities with a sizable bond allocation of 25-50% focusing again on credit quality and short durations (aka cash!). It is a form of a barbell strategy with risk/reward on the equity side and safety on the other. We will be in touch with you if we feel changes are warranted in your investments or cash levels and always feel free to call or email us with any financial questions. These are exciting and challenging times but we remain cautiously optimistic.

Best, Lanny