Executive Summary:

- **Surreal feeling.** Strong performance across all asset classes seems a bit surreal given deepening political rifts domestically, heightened geopolitical tensions with North Korea (not to mention the omnipresent problems with Iran and Russia), and most recently mass murder in Las Vegas.
- **Surprise, surprise, surprise**. So far, this year has been full of surprises. Trump and the Republicans' surprise victory last November was expected to usher in a new legislative agenda aimed at stimulating the economy. The hallmarks of the agenda were tax reform, a new infrastructure program, and regulatory reform. Surprisingly, none of the programs that need Congressional action have passed.
- **Tax plan unveiled**. Republicans unveiled their tax reform package at the end of September. Included in the package is a proposed reduction of the corporate tax rate to 20%.
- **Keeping your balance**. With the stock market at all-time highs, it is important to keep balance in your portfolio. The long run up in stocks can skew the intended risk/return characteristics of a portfolio. Portfolios should be reviewed regularly and rebalanced to recapture their original risk/return characteristics.

"It's the economy, stupid." James Carville (advisor to former President Bill Clinton)

Stocks continued their winning ways in the third quarter with the Dow Jones Industrial Average posting its eighth straight positive quarter, the index's best winning streak in twenty years. Likewise, the S&P 500 is on track to have its best year since 2013. Markets have been propelled by robust earnings supported by real economic improvement. We note auto sales at their fastest pace in twelve months, manufacturing activity at a 13-year high, and service-sector activity at its best level since 2005.

Surreal feeling. Strong performance across all asset classes seems a bit surreal given deepening political rifts domestically, heightened geopolitical tensions with North Korea (not to mention the omnipresent problems with Iran and Russia), and most recently mass murder in Las Vegas. There is no shortage of issues to worry about and yet…

…The S&P 500 rose 4.5% in Q3 and *lagged* all other equity asset classes. Emerging markets tacked on another 8% to what has already been a stellar year, small caps stocks vaulted 5.7%, and developed markets posted a 5.5% increase.

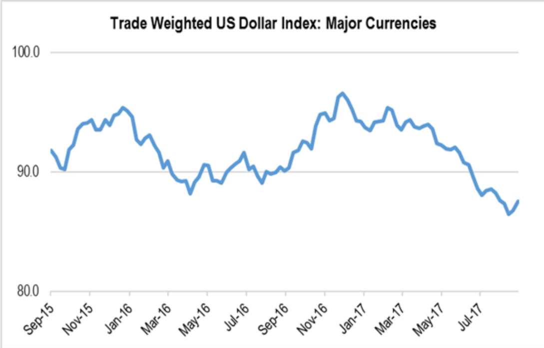
As the chart shows, cash was the worst performer in the quarter, which partly explains the strength across asset classes—your money has been treated better everywhere else.

Technology and healthcare remain the leading sectors within the S&P 500—technology is up 27.4% year-to-date and healthcare is up 20.3%. After a terrible first half of the year where it was down 12.6% and the worst performing sector, energy gained some momentum during Q3 and is now down just 6.6% through the first nine months of the year. Oil prices have moved into the low $50s per bbl and are slightly higher than they were this time last year.

Surprise, surprise, surprise. So far, this year has been full of surprises. Trump and the Republicans' surprise victory last November was expected to usher in a new legislative agenda aimed at stimulating the economy. The hallmarks of the agenda were tax reform, a new infrastructure program, and regulatory reform. While there is surely less new regulation than in recent years, surprisingly none of the programs that need Congressional action have passed. The government's plan to reflate the economy has gone nowhere.

Compared with expectations at the beginning of the year, the government's thus-far broken promise of fiscal stimulus and reflation has yielded some surprising effects. First, long-term interest rates have remained low. After spiking to around 2.5% just after the election, the ten-year yield seems stuck in the 2.3% range. Rising interest rates often coincide with an improving economy, and the failure of rates to move higher has caused concern over economic momentum.

Second, inflation has failed to percolate. Since the financial crisis, deflation has been more of threat, but a step up in economic growth, falling unemployment and rising wages were thought to be the kindling to spark inflation. This too has yet to occur with inflation still below the Fed's long-term target of 2%.

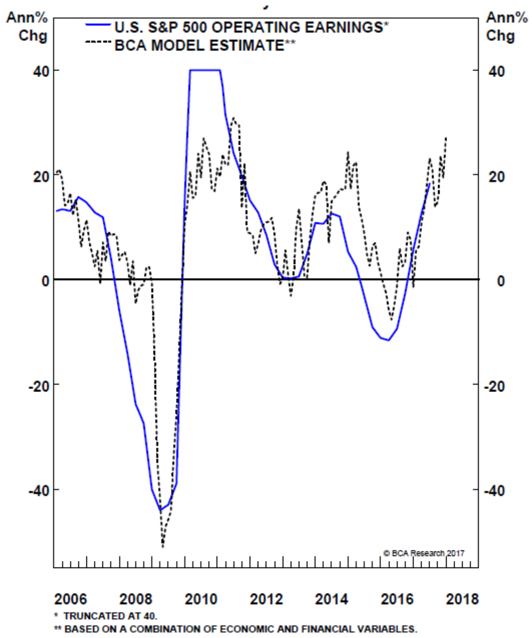


Third, after surging immediately following the election, the US dollar has weakened throughout the year—down about 9% against a basket of currencies. Although interest rates in the U.S. are low in absolute terms, when compared to many other countries around the world, they are relatively high. This favorable differential was thought to favor a stronger dollar.

However, rather than interest rate differentials determining the value of the dollar, it appears that more favorable growth rates in other areas of the world are attracting capital and leading to dollar weakness. Further positive economic momentum in developed and emerging markets will impact the outlook for the dollar.

Moreover, the dollar has been in a six and-a-half year bull market. Over a longer horizon, the dollar has tended to move in cycles, with moves up or down persisting for years rather than quarters or months. Given these competing forces we are neutral on the dollar, and our portfolios are largely hedged against currency movements.

Finally, perhaps the biggest surprise of the year is that markets have done so well without fiscal stimulus. Instead what has happened is a good old-fashioned earnings-driven recovery, and forecasts for earnings remain positive into next year. The fact that earnings have been so strong this year—up about 10% for the S&P 500—is yet another surprise.



There are a variety of implications stemming from our various 2017 surprises. Low interest rates will continue to pose challenges for investors who need yield. Persistently low rates in recent years have pushed investors into so-called bond surrogates like MLPs, REITs, and bank loans. Demand is likely to remain robust even if the inherent volatility is higher than in traditional fixed income.

Low inflation has perhaps the most significance, at least when it comes to the outlook for equities. First, it should be said that with unemployment low and the economy growing, the prospect for higher wages and ultimately a pickup in inflation cannot be ignored. That said, the deflationary effects of technology on the global economy should likewise not be ignored. If inflation remains contained then it would not be unreasonable to expect equities to continue to trade at above-average valuations, particularly in the current strong earnings environment.

Almost half of the revenue generated by the S&P 500 comes from outside the U.S. If the dollar remains weak, over the next couple of quarters foreign sales by U.S. companies will be translated into a larger amounts of U.S. dollars thus providing a potential boost to revenue growth. A strong dollar had been a bit of a headwind to offshore revenues in recent years.

Tax plan unveiled. Republicans unveiled their tax reform package at the end of September. Included in the package is a proposed reduction of the corporate tax rate to 20%.

According to Barron's, the current effective tax rate for companies is the S&P 500 is 27%. For every 1% reduction in the corporate tax rate, earnings for the S&P 500 increase by $1.50. A reduction in the effective tax rate to 27% would therefore add $10.50 to earnings of the S&P 500.

Applying the current high-teens multiple to the incremental earnings potential from a tax cut, the implied increase in value to the S&P 500 is around 200 points, or nearly 8%.

Whether the tax plan, in any form, gets passed this year is still uncertain. It does not appear as though the market is discounting passage of any major piece of legislation. The groups of companies that would benefit most from a corporate tax cut--higher than average tax payers, infrastructure companies and small caps--have all underperformed the broader market this year. If a tax bill were to pass Congress, it looks like it would surprise the markets.

Keeping your balance. Even when the bulls are stampeding, it is not unusual to have a meaningful drawdown, i.e. decline, in stocks at some point during the year. Since 1980, the average drop during a calendar year has been 14.1%. This of course includes the crash of 1987, the bursting of the dot.com bubble, and the financial crisis. If you eliminate these large drawdowns, it would still not be unusual to see a decline of 8%-10% in stocks at some point during the year. In other words, it should be expected. Thus far in 2017, the largest drawdown has been not quite 3%. Should this remain the case through the end of the year, we will add to our list of surprises.

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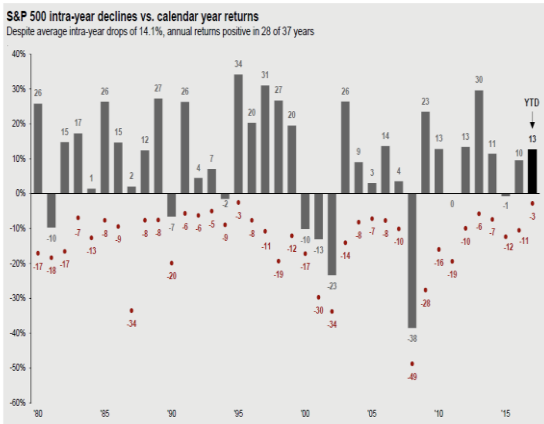

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

Take a 60% equities/40% fixed-income portfolio. Asset classes produce different returns over time that can change a portfolio's asset allocation, a concept known as "drift". Since stocks have outperformed bonds historically, a portfolio left untouched would end up with a significantly higher weighting in stocks than the original 60% over the course of time.

While enjoying the benefits of positive returns in stocks, at some point this portfolio would find itself with a much higher level of risk than originally intended. Our research suggests that most investors do not rebalance likely because it may seem counterintuitive to sell the winners and buy the laggards.

But, as noted equities are subject to periods of large drawdowns, and the memory of recent bear markets should be a reminder of the inherent risk in stocks.

Rebalancing is a formal component of portfolio management at Heritage Wealth Advisors. In fact, where appropriate, we recently performed a portfolio rebalancing for our clients. This is an important tool we use to minimize risk relative to a portfolio's original targets and in the process, minimize surprises.

In closing, we want to reiterate our appreciation for the trust our clients have bestowed upon us. As we move forward, we are committed to retaining your confidence and serving your specific needs.