Heritage Wealth Advisors
Third Quarter 2020 Investment Perspectives

"The question now is not whether we're growing again. We are. The questions are how fast is that growth, and how long will it be before we return to 2019 levels of output?" **James Rickards, Economist**

"Uncertainty has seldom been higher - oddly neither has the stock market." **Ben Inker, GMO Strategist**

There are inherent risks built into communication today. It is challenging to find the right words to convey the range of emotions and thoughts borne out of a dynamically changing world. A global pandemic, economic lockdowns, historic job losses, intensifying social unrest – any one of which would have been extraordinary in isolation – have created an unprecedented (there's that word again…) backdrop of uncertainty with respect to the global economy. Yet, after enduring a 34% decline from the peak in equities during the first quarter, we have witnessed the strongest quarter for equity markets in decades, almost entirely erasing market declines in the first quarter while the technology-laden Nasdaq is hitting all-time highs. Credit markets, likewise, have strengthened in parallel with investment grade bond yields hitting record lows. What gives? Admittedly, markets were oversold in March with pessimism reaching extreme levels. Reasons for optimism followed:

- Global economic activity has broadly rebounded (albeit from extremely depressed levels) as countries have reopened suggesting the worst of the economic downturn may be behind us.
- Initially, shelter at home polices enacted nationwide effectively began to "flatten the curve" of the COVID-19 virus spread.
- Government and private dollars alike have been allocated towards finding a vaccine for the COVID-19 virus with guarded hope for success, a likely prerequisite to the resumption of normal social and economic activity.
- Fiscal stimulus amounting to double (or more) the levels seen in 2008-2009 has provided a bridge for businesses and individuals alike with the promise of more stimulus in the event of further weakness.
- Finally, central banks around the world have eased financial conditions aggressively with short term interest rates globally at or approaching the zero-bound level.

Bluntly, we have been surprised by the strength of the market recovery over the course of the last three months. To our way of thinking, the extreme level of uncertainty with respect to the magnitude and duration of the economic downturn coupled with valuations that did not appear cheap on normalized earnings argued for a heightened emphasis on risk management and quality. In retrospect, fundamentals and valuation have taken a backseat to the extraordinary liquidity provided by the Federal Reserve - the axiom "Don't fight the Fed" has arguably never rung truer. The combination of monetary and fiscal stimulus along with incrementally positive news flow has boosted expectations for recovery with consensus estimates now projecting broad market earnings for 2021 in excess of 2019. Domestic equity markets are approaching or exceeding all time highs based on this heightened level of optimism for a full recovery in earnings – essentially, markets are assigning a 100% probability to this outcome.
The challenge in this optimistic assessment is that it appears to either discount or ignore building risk in both the economy and financial markets that bear consideration in any decisions with respect to capital allocation. To list a few:

- Accelerating virus cases and the responses by multiple states to reverse reopening steps give pause to the optimism for a rapid return to work.

- Corporate debt levels have spiked to record levels while corporate yields are at all-time lows, a seemingly incongruous relationship if not for the actions of the Federal Reserve.
- Delinquency rates for debt securities are rising while projections for corporate default rates suggest a base case comparable to the 2008 financial crisis.
- The dependence of the economy and financial markets on the continued largesse of central banks and governments to fill the gaps in a global economy projected to be down 4.9% in 2020.
- Election years create the potential for material policy change.
- Structural risk within equity markets continues to rise with the increasing influence of price-insensitive passive investors.
- The concentration of the US equity market into a small group of megacap technology stocks has reached levels historically associated with heightened risk for equities.
    - An interesting anecdote: the five largest stocks in the S&P 500 (Apple, Microsoft, Amazon, Alphabet, and Facebook) collectively hold a market capitalization higher than the GDP of Japan, the third largest economy in the world.
- Valuations in equity markets at the higher end of their historic ranges coupled with interest rates at historically low levels suggest the prospects for future returns are muted.

Our view coming into the quarter suggested a bias towards quality and patience would ultimately be rewarded as the economy and markets reached equilibrium in a post-COVID world. As stocks (or more accurately, a narrow subset of stocks) have rallied sharply in the ensuing months, the divergence between markets and underlying fundamentals appears to have reached extreme levels. It is this push/pull between aggressive monetary/fiscal policy and continued weak underlying fundamentals that gives us pause as we see building risk in capital markets. Investors are now being asked to pay prices reflective of top decile valuations on normalized earnings in an environment with deep variation of potential outcomes with respect to the economy and earnings. Truthfully, we will not have clear answers to the ultimate path of the economy and earnings for several quarters, outside of any virus-related negative shocks. Could stocks then continue to move higher on the backs of excess liquidity? The answer is unequivocally yes. However, when we step back and assess the overall landscape of return opportunities relative to the level of risk building in markets, the scale tilts heavily towards continued caution and an emphasis on quality. We have acted aggressively over the course of the last quarter to shift portfolios to reflect this outlook resulting in higher activity than is typical for your portfolios. A summary of major changes follows:

- From an overall asset allocation perspective, we remain defensive with an above normal allocation to cash and short-term bonds relative to strategic targets. We will continue to look for opportunities to deploy capital where return expectations appear compelling.
- In equity portfolios, we have shifted portfolios largely out of passive investments into a portfolio of businesses that we believe hold characteristics that we associate with quality: strong balance sheets, understandable, defensible business models, more stable earnings and cash flows. Businesses that we have high conviction in the durability of their market position in spite of the uncertainty of the current environment.
- In fixed income portfolios, we continue to emphasize investment grade credits while limiting maturities given the exceptionally low levels of interest rates.

Rising markets, rising liquidity, rising corporate and government debt, rising virus case counts and falling interest rates… to paraphrase investor John Hussman, typically risk in the economy and markets builds "gradually and then suddenly". In an environment where we see the underpinnings of risk building, we will continue to react to the current environment with an emphasis on risk management while remaining positioned to take advantage of long-term opportunities. We look forward to continuing to work with each of you to ensure the appropriate balance for your portfolio.

The information contained herein has been obtained from sources believed to be reliable, and its accuracy and completeness is not guaranteed. No representation or warranty, express or implied, is made as to the fairness, accuracy, completeness or correctness of the information and opinions contained herein. The views and other information provided are subject to change without notice. This site is issued without regard to the specific investment objectives, financial situation or particular needs of any specific recipient and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not necessarily a guide to future results.

Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your IA Firm account holdings correspond directly to any comparative indices or categories. Please Also Note: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your IA Firm accounts; and, (3) a description of each comparative benchmark/index is available upon request.