Heritage Wealth Advisors

First Quarter 2022 Investment Perspectives

"Inflation was, after all, supposed to be transitory, a word that started out as a forecast, then became a hope, and ultimately turned out to be a punchline." Jason Trennert, Strategas Research Partners

"Inflation in 2021 was highest in 40 years" Wall Street Journal January 12, 2021

We begin the new year on the heels of yet another twelve months of exceptional performance from global stock markets propelled higher by strong earnings growth coupled with favorable liquidity conditions. Domestic large cap stocks once again led the way although leadership appears to be undergoing a transition. Megacap technology stocks continued to stretch the boundaries of the law of large numbers with strong stock price appreciation matched by strong earnings growth. Inflation beneficiaries including energy and real estate stocks led markets higher while small cap and international stocks lagged. While markets were broadly higher, the index masked significant volatility under the surface. Active managers underperformed the index while more speculative areas of the market experienced extreme volatility. Meme stocks like AMC and Gamestop are down by more than 2/3, stay-at-home/work-from-home stocks like Peloton and Zoom are down 60-80% and this cycle's "investment celebrity" Cathie Wood's ARK Innovation fund is down by 50% since early in the year. Crypto currencies, likewise, have corrected with Bitcoin down 33% from highs reached in the Fall. Less dramatic in terms of magnitude but meaningful in the context of overall asset prices, the Barclays Aggregate Bond index return was negative for only the fourth time in the last thirty years as the 10yr US Treasury Note climbed from 0.9% to 1.5%.

At the risk of oversimplification, the drivers of returns over the last couple years can be boiled down to the following: extraordinary liquidity (monetary policy), fiscal stimulus, strong earnings growth, (particularly in goods producers and stay-at-home beneficiaries), and aggressive investor attitudes towards risk. Looking forward, there appears to be a fundamental shift occurring within the economy and the pillars of support for the market. We have expressed our challenges with the inexact science of forecasting short term economic or market moves, instead focusing on long term return expectations and risk characteristics in portfolios. We remain confident in our emphasis on quality in building portfolios designed to weather more challenging environments while participating in more positive markets. There are, however, current dynamics in markets and the economy that deserve consideration. The irony of last Wednesday's WSJ headline noted in the opening quotes is that it could be followed by the comment "and yet, short term interest rates remain at the zero-bound with long term rates near historic lows." It is this "mismatch" between inflation and interest rates that is central to any outlook.

We view the way forward as "path dependent": the path for inflation, the path for Federal Reserve policy, and the path of the Covid virus. Taking each of these individually, starting with the last, the current Omicron variant cycle coupled with continued increasing vaccination rates globally may allow for a continued return to normal as we move towards warmer weather. This has profound implications for an economy with significant pent-up demand in the service sector coupled with strong consumer balance sheets and rising wages. The potential for an acceleration in economic growth creates significant policy challenges for the Federal Reserve. Current market expectations for moderating growth coupled with ongoing resolution of supply-chain issues frames the narrative for moderating inflation. However, an acceleration in economic activity in the face of a very tight labor market (less than one unemployed worker per current job opening) and continued underinvestment in natural resource production suggest the path for inflation may remain stubbornly high. In this scenario, the Fed will have to choose one of two paths: more aggressive monetary policy tightening to arrest inflation, or a more modest tightening designed to allow the economy to "run hot" in favor of supporting labor markets and financial markets. We do not profess to have inside knowledge on which path the Fed may take, although recent history would suggest the odds favor the latter scenario. While rates remain low and the yield curve remains positively sloped, suggesting continued economic expansion, we will be closely watching the path of the Federal Reserve given the profound implications for the economy and financial markets. An aggressive response from the Federal Reserve risks an outsized impact on economic growth given the increased sensitivity of the economy to both interest rates and financial markets. A more dovish response from the Fed may boost economic growth (and inflation) in the near term but create additional challenges in the future.

After an extraordinary period of returns in equity markets, with returns over the last five years compounding at greater than 17%, forward looking expectations definitionally must be adjusted downwards given moderating earnings growth and full valuations. Despite more speculative areas of the market experiencing significant declines last year, speculation remains at elevated levels. To wit, 15% of the companies in the S&P 500 sell at greater than 10x sales, 44% of the market capitalization of the Russell 2000 do not have earnings, single stock option volumes exceed stock trading volumes, and valuations broadly are at the high end of historical ranges. Further, the valuation premium for long duration, high growth stocks most correlated to interest rates remain at all-time highs; conversely, lower duration, more economically sensitive stocks remain at record discounts. There is an unfortunate tendency in our industry to equate portfolio activity with portfolio returns - we intend to maintain our bias towards quality businesses and investments selling at reasonable valuations. We believe this will best position our client portfolios to generate attractive compounded returns over time.

Fixed income markets remain a challenge. A starting point of 1.7% 10yr Treasury yields and an inflation rate of 4.5% - 7% (dependent on the measurement) suggest the Federal Reserve is behind the curve. Our portfolios continue to be positioned in short duration, investment grade fixed income providing stability and liquidity for portfolios while minimizing the price risks associated with rising rates. Additionally, we continue to explore alternative solutions to provide income with a sharp eye towards managing risk.

The coming year is likely to be one of transition for the economy and the financial markets. The potential paths that inflation and the Federal Reserve may follow are ultimately unknowable - we will remain focused on emphasizing quality in portfolios while assessing risks as "paths" become clearer. We hope you and your family remain healthy and safe. We thank you for the trust that you place in our firm.

Recent Portfolio Activity

We initiated a position in Meta Platforms Inc., formerly known as Facebook (symbol: FB), as our research suggests the stock possesses attractive long-term total return potential with strong top-line growth and free cash flow characteristics at a compelling valuation multiple. Below we share more detail on our rationale for this investment.

Meta Platforms is the largest online social network in the world, with 2.5 billion monthly active users. Its family of apps include Facebook, Instagram, Messenger, and WhatsApp, which are among the most widely used apps on both iPhone and Android smartphones. Users engage with each other by exchanging messages and sharing news events, photos, and videos. FB has attracted users and increased engagement by providing additional features and apps within its ecosystem. The growth in users and engagement offers significant value to advertisers, as the Company can place targeted ad campaigns more effectively on its apps. Growth in average ad revenue per user reflects advertisers' willingness to pay for FB-placed ads, as they expect a higher return on investment. The Company should continue to benefit from an increased allocation of ad spend toward online advertising. Additionally, FB is taking steps to further monetize its apps, such as providing interactive ads and tapping into ecommerce. The Company is also applying artificial intelligence and virtual and augmented reality technologies to various products, which may increase user engagement and support future growth.

Our research suggests that FB's unique, defensible positioning in an industry with powerful secular trends should support durable top-line growth and free cash flow. With gross margins above 80%, the Company operates at a 30%-plus margin. The stock has a free cash flow yield of 3.8%, above the broad market at 2.4%. Additionally, the stock is trading at a price to forward earnings multiple of 22.4x (P/E, less cash of 21.1x), below its long-term average of 27.8x. While utilization of consumer data is under scrutiny, we believe the current valuation multiple appropriately discounts this uncertainty. In summary, we believe we have the opportunity to purchase a high-quality business with sustainable earnings power and a healthy balance sheet at a compelling price point.

If you have questions about this information or your investment portfolio, please contact a member of the Investment Research Team or your Advisor.