Heritage Wealth Advisors

Second Quarter 2022 Investment Perspectives

"In times of change learners inherit the earth; while the learned find themselves beautifully equipped to deal with a world that no longer exists." **Eric Hoffer, American philosopher**

"When the facts change, I change my mind. What do you do, sir?" **Paul Samuelson, American economist**

We concluded last quarter's commentary suggesting that 2022 would be a year of transition for the economy and capital markets – so far, so good (or bad) on that prediction. A few of the challenges capital markets have been digesting over the first months of the year include inflation at a forty-year high, a reversal in Federal Reserve monetary policy from Quantitative Easing to Quantitative Tightening, more hawkish rhetoric related to interest rate increases, war in Ukraine, rising geopolitical tensions across the globe, and persistent supply chain bottlenecks. Against this backdrop, global equity markets broadly experienced corrections (down 10% or more) in the first quarter. Higher growth, more speculative areas of the market experienced steeper declines while businesses with stable end markets and strong balance sheets exhibited less volatility. Fixed income markets, likewise, experienced negative returns as the interest rate on the 10-year Treasury Note increased from 1.7% to 2.3% (2.8% today), challenging traditional balanced portfolios as bonds to date failed to provide an offset to weaker equity prices while commodities were sharply higher in the face of supply constraints.

Understanding markets typically "climb a wall of worry", our current assessment of the economy suggests a rising probability of recession relative to our views even four months ago while expectations and valuations across asset classes continue to suggest that the risk-reward relationship for investors is skewed to the downside. We have remained positioned in client portfolios with a strong bias towards quality given what we find to be an increasingly difficult landscape for investors. As we communicated last week, we have recently taken additional steps in client portfolios to attempt to mitigate risk given this less sanguine outlook. Objectively, if you wouldn't take risk down in the current environment, when would you?

While we remain focused on the underlying dynamics within the economy and markets today, our assessment of longer-term trends suggest we may be reaching an inflection point for the economy that requires investors to think differently. As we look back over the last forty years, a few dominant macro tailwinds have driven an exceptional period of returns for financial assets. In short, falling inflation and interest rates have dominated the landscape for investors supported by broad trends within the economy. In some cases, these trends appear to be at risk of reversal with meaningful implications for investors. Amongst them:

- Globalization
  - The era of globalization has had a profound impact at the macro level as well as the company level. Shifting production to lower cost areas of the world helped mute wage inflation while lowering capital intensity. At the macro level, this shift helped to drive inflation lower while corporate margins benefited meaningfully from lower costs. Benefits have skewed to the largest businesses with the ability to leverage scale in building out global supply chains supporting persistently higher margins.

    As we look forward, globalization appears to be giving way to reshoring. A fundamental desire to insulate supply chains from geopolitical risk while also building redundancy to create more secure sources of supply will come at a cost to Corporate America. While a year doesn't make a long-term trend, at the margin, globalization is unlikely to remain a tailwind for corporate margins and disinflation trends suggesting earnings growth expectations may need to be revised lower.

- Demographics
  - At the very base level, we think of economic growth as the combination of labor force growth and productivity growth. Demographics have been broadly supportive over this period as the combination of a large workforce driven by the baby boom population coupled with the trend towards dual wage-earning households provided an abundance of "labor force supply". As the baby boom population ages out of the workforce and the tailwind from dual wage families dissipates, a tighter labor market suggests higher wage inflation in the future.

- US Dollar/Federal Reserve Policy
  - By virtue of the US dollar's status as the world's reserve currency since the Bretton Woods agreement at the end of World War II, the Federal Reserve has arguably had more flexibility to manage monetary policy aggressively without fear of currency volatility creating inflation. As a result, the "Fed Put" has provided a backstop for investors driving increasingly speculative behavior across asset classes. In an environment of potentially higher inflation, coupled with an international community (allies and enemies alike) increasingly motivated to diversify currency exposure, the Federal Reserve appears to be at an inflection point. For the first time in forty years, they may be forced to increase rates in the face of rising inflation as opposed to strong growth.

Ultimately, the last forty years have been highly supportive for investors as the combination of rising margins, falling inflation, and falling interest rates supported expanding values across asset classes. The challenge for investors is determining whether shifts in the economy are cyclical or represent secular changes. While our crystal ball remains cloudy, the evidence is building to suggest we may be in an environment where inflation and interest rates trend higher over the longer term with profound implication for portfolios. While we have taken down equity exposure in the near term, we maintain higher positions in cash and gold with an eye to taking advantage of any volatility in equity markets. In fixed income markets, we continue to tread carefully with an increasing emphasis on credit quality as interest rates have risen given a rising probability of recession.

We thank you for the trust that you and your family place in our firm.