Heritage Wealth Advisors

Third Quarter 2022 Investment Perspectives

"In the real world, things fluctuate between pretty good and not so hot. But in the markets, they go from flawless to hopeless." **Howard Marks**

"Lao Tzu wrote, 'A journey of a thousand miles begins with a single step.' In recent months, the financial markets have taken the first step toward normalization. Unfortunately, having taken one step, the most prominent question we hear is 'Are we there yet?!?!'" **John Hussman, Hussman Investment Trust**

We came into the year with a healthy level of skepticism that the drivers of returns over the last decade would persist given building inflationary pressures and stretched valuations across asset classes. While we claimed no special insight with respect to the timing or shape specific risks might take, our assessment of an unbalanced investment landscape supported our strong bias towards quality and risk management in client portfolios. Fast forward six months, inflation is no longer considered "transitory", the Federal Reserve is aggressively raising rates to stabilize prices, and expectations for an economic slowdown, if not recession, are moving towards consensus. Capital markets have reacted accordingly with domestic and global equities in bear market territory, down 20%. This represents the worst first half performance in over 50 years. The US Bond index declined 10.3% as fixed income investors adjusted to rising inflation and tightening monetary policy with the US 10-year Treasury rate increasing from 1.5% to 2.9%. High yield spreads have widened from 300 basis points to 600 basis points as credit concerns build in a slowing economy. A generation of investors have been conditioned by the extraordinarily easy monetary policies of the last two decades to "buy the dip". The sharp, steep decline in asset prices to date would seemingly qualify as an opportunity to add risk back to portfolios. While we expect opportunities to present themselves through the cycle, we are skeptical that we have reached "normalization" in capital markets.

Are we there yet? In order to answer this question, investors need to have a framework for assessing the path forward and the variables that will ultimately determine future returns. Last quarter we wrote: *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.* In assessing the path forward, it is important to keep some perspective on the recent trends in financial markets. While equity prices have fallen into bear market territory, prices remain 10-15% above the February 2020 levels reached just prior to the shutdown induced downturn and unprecedented monetary and fiscal stimulus response. Similarly, while interest rates have risen sharply, they remain at low levels relative to history as well as current rates of inflation. So where do we go from here? Tightening financial conditions coupled with the absence of fiscal stimulus appear to be impacting the economy with current readings suggesting we may have already entered a technical recession (two consecutive quarters of declining GDP growth). Housing appears to be the tip of the spear – while secular trends remain supportive, mortgage rates have risen from below 3% a year ago to approaching 6% at the end of last month. The average home price has increased ~20% from a year ago. The resultant increase in monthly mortgage payments for new buyers relative to income has returned to levels last seen at the peak of 2007 housing cycle. This appears to be having an impact with home purchase contract cancellations reaching 15% in June. Similarly, industrial activity appears to be slowing with the ISM Manufacturing New Orders index in contraction territory. While slowing economic activity will logically help arrest cyclical inflationary pressures,

longer term macro trends including declining globalization and demographics suggest the potential for inflation to persist at higher levels than the Fed's 2% target.

What does this mean for investors? Starting with the equity markets, we would characterize the downturn to date as a "valuation correction" from extended, and in some sectors excessive, valuation multiples. Our challenge going forward is squaring a slowing economy with increasing odds of recession, peak margins and elevated cost inflation to earnings expectations of double-digit growth in 2022 followed by continued trend growth next year. We would anticipate the next phase of this market cycle to require investors to come to grips with realistic earnings expectations, likely starting with guidance from companies through the current earnings season. As long-term investors, we focus on the long-term earnings power and cash flow characteristics of our businesses to assess potential return expectations. Our analysis of normalized earnings power continues to suggest unrealistic earnings expectations challenging expected returns for the index. While stocks have rebounded from oversold levels and negative investor sentiment (contrary indicator) is supportive of rallies, our bias remains to focus on quality and stability with a strong emphasis on domestic large cap equities.

In fixed income markets, rising interest rates have increased future return expectations, albeit at continued muted levels. The challenge remains, however, that real rates (interest rates minus inflation) remain decidedly negative. Given the potential for inflation to persist, we continue to be cautious in adding maturity risk to portfolios. Similarly, while the increase in credit spreads suggests improving return expectations, a slowing economic environment suggests we are not yet being appropriately compensated to take significant credit risk. As a result, we continue to emphasize shorter maturities in client portfolios with a higher allocation to Treasury Bills (cash).

As we look forward, our cautious positioning with respect to client portfolios is reflective of our continued muted views with respect to future returns relative to potential risks. Public and private markets alike appear to be in the midst of adjusting to price levels more reflective of underlying fundamentals. With a nod to Howard Mark's wisdom, a year ago markets were reflective of unrealistically optimistic underlying fundamental expectations. Over the course of the next few years, we will likely see the pendulum swing back towards realistic, if not overly pessimistic, expectations. In this environment, we will continue to manage risk while actively assessing opportunities to add high quality investments where our conviction in underlying fundamentals is accompanied by attractive valuations.

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

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