Heritage Wealth Advisors

# Second Quarter 2020 Market Outlook

*"… we have to consider the outlook and appropriateness of value, in the context of the unprecedented uncertainty and the total absence of guidance from analogies to the past."*
Howard Marks

As I sit down to write this missive, the world is in a vastly different place due to the necessary measures required to slow the spread of COVID-19 worldwide. We are all adjusting to a world with minimal face to face social interaction (not the normal human condition, for most), remote working conditions (I am writing from my breakfast room table), increasing fear and anxiety stemming from a litany of sources (health concerns, isolation, financial concerns to name a few) and uncertainty as to the timing of an eventual return to "normal". It is during these times of crisis that the power of personal relationships flourish. On behalf of all of my teammates at Heritage, I want to express our humble appreciation for the many expressions of care and concern from you, our clients over the course of the last few weeks. We value your partnership and your friendship and will continue to check in with you individually on your health and well-being.

Turning to financial markets and the economy, the first quarter marked a sea change for the economy as a result of a rapid spread of COVID-19 beyond China requiring "shelter in place" orders across Asia, Europe and ultimately the United States. Coming into the year, our view was based on an improving global economic outlook as a result of continued easing global financial conditions, a building inventory cycle supporting the manufacturing economy, strong consumer balance sheets and reasonable earnings expectations. Equity valuations, while full, were not excessive, particularly relative to interest rates, supporting our continued equity positions in line with long term targets. The world has changed… and the change has occurred with unprecedented speed and magnitude over the course of the last month. While the finance industry is guilty of seizing on words or phrases to the point of extreme overuse, in this case, "unprecedented" seems appropriate. To wit, a few examples of the shifts in market and economic conditions we have experienced over the past month:

- Unemployment claims reached 6.6 million people this past week, almost 10x the prior weekly record for initial unemployment claims of 695 thousand in October, 1982. Over the course of two weeks, unemployment claims have reached 10 million people suggesting an unemployment rate of ~10%, in line with the peak of unemployment in 1982 and 2008. Analysis from the Federal Reserve's St. Louis district economist suggest unemployment could briefly reach 30%. For perspective, unemployment peaked at 25% during the Great Depression in 1933.

- Activity has come to a standstill in certain industries (leisure, travel, hospitality) while broader measures of activity, including manufacturing and service surveys, reflect sharp declines in activity, well below prior recession lows.

- Financial markets have reacted with unprecedented swiftness and volatility to these changing conditions. The US equity market experienced its fastest decline into bear market territory on record with the S&P 500 falling 34% from the peak on February 19th over 23 days. To give historical context, a typical bear market has resulted in stock price declines of 34% over the course of eleven months as markets have adjusted to declining economic conditions and earnings power.

- Likewise, the monetary and fiscal response from the Federal Reserve and Congress has been unprecedented. The Federal Reserve has pulled out the 2008 playbook to act quickly to stabilize credit markets in the face of a rush for liquidity amongst corporations and financial market participants. By our math, the Fed purchased ~$3.5 Trillion of securities from the peak of the financial crisis in 2008 through 2014 – in the three weeks beginning March 11, the Fed has purchased $1.5 Trillion of securities. Likewise, Congress has reacted swiftly to put in place the Coronavirus Aid, Relief and Economic Security Act (CARES) representing ~$2 Trillion, or ~10% of US GDP, with a focus on those entities and people most directly impacted, including individuals and small businesses. While this will likely result in our budget deficit hitting non-wartime records, the reaction appears appropriate given the magnitude of employment and business activity declines. However, I would take exception to the characterization of the CARES act as a stimulus to future economic activity. I believe it is appropriately viewed as an economic stabilization package, not incrementally additive to economic activity and demand. As to the long-term impacts of extraordinary Federal Reserve asset purchases and budget deficits, that is a topic for another day…

We wrote back in early March that we were not qualified to make definitive statements with respect to the likely path of COVID-19 and that remains our position today. While every day provides increasing data for experts in the field of epidemiology to further sharpen their models, the outlook remains highly uncertain and dependent upon the continued efforts to contain through social distancing. There are some encouraging signs in some of the hardest hit areas, including Italy, with respect to a possible peaking in new case numbers. The return to normalization under even favorable scenarios, however, will take time and require continued progress with respect to testing and data analysis.

It is this uncertainty with respect to the magnitude and duration of the economic downturn which continues to impact financial markets through extreme levels of volatility – March witnessed the strongest positive daily move in stocks since 1933 and the second worst negative daily decline in stocks since 1940. In this environment, with deference to Howard Marks' quote at the beginning of this note regarding the lack of historical analogies to provide guidance, we have continued to take steps to upgrade the quality of our investments to reflect this uncertainty. A couple specifics in this regard:

- We are holding disproportionately large allocations to cash in client portfolios. This cash allocation is derived out of our continued underweight allocation to equities and fixed income relative to long term targets. While there is little, if any, income return associated with cash, we would argue - and as articulated by a client in a recent conversation - that in the current environment, cash is undervalued given the optionality with respect to possible spending needs as well as future investment opportunities.

- In equity portfolios, we have not committed additional capital into equity investments and thus remain underweight long-term targets, albeit still invested in markets with an eye to the long term. Over the course of the last month, we have taken multiple steps to reflect our goal of upgrading the quality of equity holdings. This has included shifting away from small cap stocks, incrementally away from index investments and lowering our exposure to international equities. Proceeds have been invested in liquid, well capitalized large cap US businesses at increasingly attractive valuations.

- In Fixed Income, we remain positioned with short maturity investments, including cash, given the extraordinarily low level of interest rates. While, admittedly, this position has negatively impacted performance - longer maturity US Treasury securities have acted as a counterbalance to equity declines - the case for owning at current levels is increasingly difficult. To provide some context with regard to future return expectations, if the 10-year US Treasury note were to decline from the current rate of 0.6% to 0% over the course of the next year, the total return would equal 6%. Our preference is to hold cash.

In looking at the path forward, our view remains that ultimately patience will be rewarded. While a rear-view accounting of prior stock levels reinforces a "Buy the Dip" mentality in the short term, ultimately markets typically bottom when pessimism drives valuations to levels that reflect an appropriate margin of safety in the face of continuously changing short-term earnings expectations. While stocks appear cheap versus interest rates – bond returns relative to stock returns are at historical extremes – stocks have not reached valuation levels historically associated with market bottoms. As such, while we will continue to emphasize managing appropriate levels of liquidity for our clients' specific situations in times of crisis, we will patiently focus on opportunities to invest for long term returns in the face of crisis. I find the following comment from Bruce Flatt, the CEO of one of our newer investments Brookfield Asset Management, to be both insightful and reflective of our perspective as we consider current and future investments:

> Finally, a reminder regarding investing in times like these: the underlying value of a business that trades in the public market does not change on an hourly basis. Despite the fluctuations, you own a part of an actual business, not a piece of paper or electronic symbol that adjusts on a minute-by-minute basis.
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> Acknowledging that the value of some businesses has changed, at least in the short term (airlines being the most extreme example at the moment), the long-term value of many companies – i.e., the discounted stream of cash flows based on an estimate of growth and durability into the future – has not changed substantially over the past few months. The proviso is that a company must be able to pay its liabilities when due (stay solvent), which of course will be an issue for numerous companies in the absence of government assistance.

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This time is different… verboten words in the investment industry but seemingly spot on for the times. The optimist can hold to the hope of a vaccine or treatment regimen that accelerates the resumption of normal human and economic activity; the pessimist can point to second order effects in credit markets associated with an extended period of depression-like economic conditions. The push/pull between the two will drive day to day market volatility in the foreseeable future while long term return expectations should rise as valuations decline. We will continue to work with each of you individually to ensure that we strike the correct balance between near term liquidity needs and long-term return opportunity during this unprecedented time.