"Eventually, we have to sit down to a banquet of consequences." **Robert Louis Stevenson**

"The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts." **Bertrand Russell**

"You can't change the wind, but you can direct the sails." **Roy Williams, UNC Basketball Coach**

Coming into the year, we remained sanguine with respect to the outlook for a recovery in economic activity on the backs of the "triple stimulus" of accommodative monetary policy, robust fiscal policy and accelerating vaccinations. By and large, this is playing out with manufacturing activity, retail sales and employment showing marked improvement over the course of the quarter. While the economy continues to recover from pandemic lows, animal spirits remain alive and well in the capital markets. This is best encapsulated in the lead story of the Wall Street Journal on the first day of the new quarter:

> *Financial markets went into overdrive in the first quarter of the year. Meme stocks such as GameStop Corp. surged. Celebrities dove into blank-check companies. Christie's auctioned off a nonfungible token attached to a digital image for $69 million. And just before the quarter's end, a fire sale of stocks that Archegos Capital Management had bet on caused well-known companies such as ViacomCBS, Inc. and Discovery Inc. to decline. If there is a unifying theme, it is that investors big and small showed no fear of risk-taking to start 2021. In fact, they embraced it…* **Wall Street Journal, April 1, 2021**

Indeed, investors have become increasingly confident, bolstered by the stated commitment of the Federal Reserve to remain accommodative coupled with fiscal spending unsurpassed in the post WWII era with more to come. On the one hand, recovering markets in the face of improving economic activity is a normal capital markets response. Positively, we experienced a continuing broadening out of performance within equity markets, led by businesses with greater sensitivity to economic growth, after the very narrow leadership experienced during the initial phases of the recovery. However, the extreme degree of speculation in segments of the market, as articulated in the paragraph above, are reflective of the potentially dangerous mix of confidence and liquidity, suggesting Howard Mark's advice to "move forward, but with caution" remains relevant today.

Intended versus Unintended Consequences

We have reached a crossroads… after forty years of what is perhaps best described as neoliberal economic policies (diminishing government involvement through deregulation, privatization, globalization), we appear to be in the midst of a profound shift as widening wealth inequality has spurred strong populist momentum towards reinserting a more meaningful role for government in the economy. This is clearly seen in the strongly stated commitment of the Federal Reserve and the Treasury to deliver stronger economic growth with a particular focus on narrowing the wealth gap. Continued accommodative monetary policy coupled with fiscal stimulus designed to direct capital to Main Street as opposed to Wall Street is intended, but certainly not limited, to drive falling unemployment coupled with stronger income growth across the labor force. The challenge, of course, with any policy is balancing the intended and necessary consequences of boosting long-stagnant median personal income growth with potential unintended consequences. While we could list multiple unintended as well as intended consequences associated with current policy, we are going to focus on a few most relevant to investors: speculation, leverage, valuation and ultimately inflation.

While broad areas of the market remain fairly if not attractively valued, we have been warning of pockets of speculation building in the market. Pick your example from the WSJ note above – each is unique yet systemic of the unavoidable speculation which arises when confidence and liquidity meet in the marketplace. The availability and cheap cost of leverage combined with low expected absolute returns due to inflated valuations and an incentive system biased heavily towards risk-taking has created a market environment best described as "Big Stack Poker" (credit to Ben Hunt of The Epsilon Theory). It is impossible to know the depth or breadth of leverage and speculation embedded in current markets making it difficult to make strong pronouncements as to the risk posed to the overall market. In this environment, we will control what we can control - simply speaking, this means not participating in the "game" with our clients' money but staying true to a focus on high quality businesses and investments to achieve long term return objectives.

Shifting Macro

It is the final unintended consequence, however, which bears the most attention for all long-term investors: inflation. Forty years of decelerating economic growth, falling inflation and falling interest rates has seemingly reached a nadir with interest rates approaching the zero bound during the pandemic. Policy makers, likewise, have shifted their risk focus from inflation to deflation. Extreme monetary accommodation, a secular increase in fiscal spending, less supportive demographics and shifting views on globalization all support a reversal in the disinflationary trends of the last few decades. The Federal Reserve is explicitly targeting higher inflation in the near term, stating a willingness to allow inflation to "run hot" for some period of time as unemployment falls and incomes accelerate. The critical question for investors will be ascertaining whether this inflation will prove durable. Markets are anticipating a cyclical pick up in inflation; long term expectations, however, remain rooted in our more recent disinflationary experience. While the evidence increasingly points to a rise in secular inflation, powerful disinflationary forces remain, including debt and innovation. We have taken steps to initiate positions in investments that would be beneficiaries of inflation (banks, natural resources, gold) - we sit ready to "direct our sails" as our conviction strengthens.

We have taken steps over the past year to lean against structural risk we observe in the market with a bias towards industry-leading companies with strong balance sheets and cash flow. We cannot know with certainty the timing or the level from which more speculative areas of the market could unwind. We will continue to steward our clients' assets focusing on the long-term and your specific objectives while avoiding areas where our judgment suggests outsized risks.

On behalf of the entire Heritage team, we thank you for the confidence you have placed in our firm.

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.