Comments from Joe Terranova, Chief Market Strategist, Virtus Investment Partners
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"The prudent approach in today's climate is to pursue balance and avoid excessive leverage."
– Joe Terranova

A re-risking of portfolios driven by ample liquidity

- Equity markets have made substantial gains since the trough of last March. The recovery is being driven by optimism about the economy, but also by the continued liquidity that the Federal Reserve (the Fed) is providing.
- In August of 2019, the Fed's balance sheet stood at $3.76 trillion. At the height of the pandemic, it reached roughly $4.7 trillion. At the start of 2021, that balance sheet was $7.3 trillion, and has continued growing by nearly 6% this year.
- Leverage levels are becoming uncomfortable, but only in certain areas of the capital markets. That excessive leverage is chasing high-beta opportunities in niche areas such as Special Purpose Acquisition Companies (SPACs). Since 2009, there have been 782 SPAC initial public offerings (IPOs), with 556 of them occurring since the onset of the pandemic.

Overconcentration presents risks, as it did in 2015-16

- As abundant liquidity and economic optimism drive investors toward high-beta themes, we're seeing concentration creep into portfolios. Concentration is never a strategy for success.
- In 2015, the country experienced a manufacturing recession. While the S&P 500® Index was down only about 0.70% for the year, select industries were injured or impaired by the recession. Oil & gas was down 35%, consumer finance lost 21%, and construction machinery and heavy trucking declined 31%.
- In 2016, the S&P 500® Index recovered, returning 9.5% for the year, but it was a very concentrated recovery. Oil & gas was up 31.5%. Construction machinery rose 40%. And consumer finance gained 18%.
- Today, there is the same temptation to give in to concentration, which investors should avoid.

A significant rebalancing opportunity

- Investors who wish to deploy their capital wisely should be looking for rebalancing opportunities in areas that are not perceived to be high beta.
- Among the companies in the S&P 500® Index, there are several sectors and styles that are ripe for rebalancing, based on their underwhelming relative year-to-date performance:
    - High-quality stocks: 8%
    - Strong balance sheet stocks: 7%
    - High revenue growth stocks: 4%
    - Emerging markets: 4%
    - Health care: 7%

- While this approach is often called diversification, the word balance may be more accurate. The goal should be to add balance to portfolios rather than swimming in the pool of excessive leverage.
- In addition, active management is making a strong return in 2021. Year to date, 52% of large-cap mutual fund managers are outperforming their benchmarks, compared with the 10-year average of 33%.
- In this high-valuation environment, active management is a constructive, strategic approach that can prepare portfolios for periods when expected returns may be lower than they've been over the past decade.
- The Fed's balance sheet will be pared back at some point. And when it is, the high-beta areas will be the first to see outflows of capital. Investors don't want to be caught there. They want to be invested in more reasonable and lower-beta opportunities.

Pondering the sustainability of the economic expansion

- Some market watchers have wondered whether a strong recovery is already priced in to the equity markets. It is never a good idea to invest based on predictions about economic growth.
- That said, it is important to set reasonable expectations. And the disparity of performance between the Russell 1000® Growth Index and the Russell 1000® Value Index reflects an expectation of outsized, above-trend economic growth in the U.S.
- The general economic consensus says that, after a contraction of 3.5% in 2020, the U.S. economy will grow by about 7% in 2021. In 2022, the expectation is for continued economic growth, but somewhat less robust, at a rate of roughly 4%.
- To find a year in which the U.S. economy grew at 7%, we have to go back to 1984. And that year was followed by 4% economic growth in 1985.
- Economists are modeling the 2020 recession, which was V-shaped in its nature, against the recession of 1981–'82. That's because both recessions were policy induced, rather than resulting from a market imbalance. In both cases, the economy was placed into recession for a societal benefit.
- In 1981 and '82, Fed Chair Paul Volcker dramatically raised interest rates to mitigate the rampant stagflation of the 1970s. The U.S. lost 2.5 million jobs between 1981 and 1982, but the losses were temporary. It normally takes five to seven years to recover from job losses in a normal recession. The recovery from March of 1983 to March of '84 saw the return of close to four million jobs.
- That period also saw a V-shaped economic recovery, with the S&P 500® Index up 43% from the second quarter of 1982 to the second quarter of 1983.

A V-shaped recovery does not point to another "Roaring '20s"

- There has been some talk about a possible reprise of the Roaring '20s, when the U.S. economy saw above-trend growth for the decade following a deadly pandemic.
- Investors should not give in to that projection, which would dictate that they continue to concentrate toward high-beta, economic momentum-oriented portfolios. We believe that is the wrong approach.
- To put the 1920s in context, the boom did not result from the ending of the pandemic. Rather, the Roaring '20s were based on the single most dramatic change in individual tax rates in this country.
- When Woodrow Wilson left office in 1921, the country had endured a pandemic and a World War. The federal tax rate, which had been introduced in 1913, was at a mere 7%.
- By 1921, tax rates had reached a high of 77%. Wilson's successor was Warren Harding, who named Andrew Mellon to the position of Treasury Secretary. Mellon introduced tax revenue acts that lowered the top marginal rate from above 70% in 1921 to 46% in 1924. Between 1925 and 1928, the top rate averaged 25%. Despite the cuts, tax revenue actually grew 62% during that time.
- With that historical background, it is clear that we should not expect 7% economic growth to continue for a decade. Nor should there be a dramatic shift in the way investors think about allocating their portfolios. Because that would take them away from the concept of balance.

Reflation, not inflation

- Given the amount of fiscal stimulus and monetary support, fears of impending inflation have arisen. But investors should be thinking about reflation as the dominant economic climate in the U.S. Reflation refers to an effort by policymakers to bring economic growth back up to long-term rates through fiscal and/or monetary stimulus.
- Inflation exists in certain areas, including agriculture pricing, select energy, and base metals such as copper, which have exposure to the growth of renewable energy. Copper is critically important to electric vehicles.
- But we do not believe that the economy is at an inflationary moment. In fact, real inflation was found in the economy prior to the pandemic in health care, education costs, and urban real estate. The pandemic relaxed those trends.
- Additionally, we note the significant disparity in vaccine distribution between the U.S. and the rest of the world. As Europe lags in vaccinating its people, a disinflationary environment persists.
- That environment is somewhat being exported to the U.S., as reflected in the easing of Treasury yields from about 1.8% to 1.55% for the 10-year.
- The perception of inflation is real, and it may warrant a single-digit portfolio allocation to protective assets such as domestic or global real estate investment trusts (REITs), base or precious metals, or private equity.
- But the reality of deflation and the existence of disinflation in the rest of the world make the prospect of serious inflation less likely.
- To that point, the U.S. remains an intangible asset economy that values the algorithm,

the artificial intelligence, and the software program more than it values the machinery, the automobile, or the airplane. As long as that dynamic persists, pricing power will continue to be transferred to the consumer from the producer – the exact opposite of inflation.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Russell 1000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Russell 1000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies.
The index is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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