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North Forty Two & Co. 2018 Mid-Year Update

Six months ago, in our 2018 Investment Outlook, we offered the following perspective:

- The domestic economy is strengthening, yet the current economic cycle is late-stage
- Equity valuations are lofty, yet momentum remains strong and is likely to continue
- Anticipated interest rate hikes are a headwind to bonds, and the yield curve bears watching
- 2018 should feel very different than 2017, particularly from a volatility standpoint

In this Mid-Year Update, we hope to highlight developments in global economies and markets that have either reinforced our thinking or given us reason to shift course.

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The domestic economy continues its long recovery from the global financial crisis of 2008, although the pace of that recovery has trailed prior expansions by a sizeable amount. In fact, GDP growth exceeded 4% in 2Q18, fueled by global central bank activity, the tax reform bill, and companies acting aggressively in front of threatened and enacted retaliatory tariffs from the current administration. While that headline number is impressive, in examining each of these three contributing factors, we remain somewhat concerned about future growth.

First, with respect to global central banks, we are entering a period of quantitative tightening, a condition unique in history. By unwinding the stimulus which boosted asset prices and slashed interest rates, central banks, led by the Federal Reserve, could usher in a period of sharp volatility in asset prices. Our focus on global rates and currencies for rate of change variation as an indicator for future bumpiness remains vigilant.

Second, the tax reform bill has certainly resulted in the repatriation of foreign profits, boosting stock buybacks and dividends. The direct impact of lower corporate tax rates on economic growth, or GDP, is debatable given other inputs. It is more likely that there will be upward pressure on interest rates given a continued increase in the national debt.

Finally, and perhaps most importantly for global economic growth, tariffs result in a higher unemployment, lower wages, and lower productivity and often have a lasting damage on countries that impose them. As it stands, current trade protection measures are somewhat targeted and localized, having specific impacts concentrated on manufacturing and agriculture. Our hope is for no further escalation such that GDP is meaningfully impaired.

Moving to equity valuations, stock prices, as measured by the S&P 500, finished the mid-year up 2.6%. Growth names outpaced value names, fueled by price momentum. Smaller capitalization companies also flourished, as they are less exposed to a significant slowdown in global growth in China and Europe and less damaged by trade protection policies. Leading sectors include Technology and Energy, while laggards include Consumer Staples and Telecom. Earnings have been quite strong across the board; however, price gains are such that the forward price-to-earnings ratio for the S&P 500 has come down to 16.1, or right in line with historical averages. Meanwhile, other measures we follow – cyclically adjusted price-to-earnings (CAPE) and price-to-cash flow –

suggest valuations are stretched. As such, we are harvesting some profits from concentrated holdings and re-allocating to beaten-down sectors and companies with stronger prospects given our macroeconomic view and at more attractive price points, on a relative basis.

Fixed income is an area where we have been quite active in reducing risk and adding value. Our thesis is that over the medium-term, interest rates will continue to rise, negatively impacting the prices of bonds. Bonds are a valuable component to a portfolio in terms of managing risk and offering safe haven in risk-off environments. However, longer-term issues are more sensitive to interest rate pressures. We have shortened the duration of our fixed income exposures to reduce the impact of future price declines. In addition, we have taken advantage of rising yields by allocating to instruments that take advantage of a risk-free rate that is approaching 2%. These include short-term fixed income ETFs and money market funds. For the year, as measured by the Barclays Aggregate, bonds are off -1.6%; only three times since 1975 have bonds produced negative returns, largely due to a favorable environment of falling interest rates and relatively high coupons. Due to our reduced duration positioning, we have experienced more attractive results than those relying simply on the common benchmark.

Finally, yes, 2018 is feeling quite different than 2017. We have experienced a broad 10% correction already; the largest drawdown last year was a remarkable -3%. As of this writing, the market-leading FANG names (Facebook, Amazon, Netflix, and Google) are experiencing their own 10% correction over a matter of days. The volatility that was historically muted in 2017 has been more traditionally active this calendar year. Geopolitical battles, trade skirmishes, and quantitative tightening are key contributors to a complex backdrop for investors.

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To sum, in terms of shifting course, throughout the first half of the year and continuing into the near future, we are shifting ready cash into higher-yielding money market funds; cutting the interest rate risk of our fixed income holdings; trimming highly-concentrated equity positions that have performed to expectations to de-risk those exposures; and redoubling our sector-level analysis to overweight and underweight areas of the market that offer different prospects. All in an effort to obtain attractive market performance with meaningfully less risk.

We continue to be honored by your trust.

Best,

Whitney Dow
President

Will Ross
Founder & Chief Investment Officer

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