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North Forty Two & Co. 2019 Investment Outlook:

Navigating the Late-Stage Phase of the Economic Cycle

In many ways, 2018 signaled that we are likely in the final stages of a unique and largely uninterrupted recovery from the global financial crisis of 2008. As we predicted in this space one year ago, the low volatility of the preceding year was followed by dramatic swings in asset prices throughout 2018, and despite the economic expansion reaching near-record levels, the year closed without a single risk asset class producing positive returns for the calendar year as concerns about the future rose.

The year began with already lofty valuations that were spurred by pulling forward the effects of the tax reform bill, which were expected to boost already healthy corporate earnings by 5%-10%. A strong jobs report and wage growth in early February caused bond yields and volatility to spike, with a corresponding sharp drop in equity prices, as the market digested the prospect of rising interest rates, rising inflation, and a more aggressive Federal Reserve.

Markets grinded higher from those February lows, after market participants felt the needed correction was in and the outlook remained constructive, and year-to-date returns were decently positive into September. However, fourth-quarter returns were decidedly negative, as certain sectors including energy and technology were quick to enter into a bear market territory, defined as a 20% decline in prices. Most commodity prices sagged; credit markets began to show concern; the yield curve flattened considerably – and in some instances inverted, which is considered a reliable harbinger of a future recession, albeit with an uncertain start.

The drawdown in asset prices, while dramatic, was somewhat normal and overdue. Unfortunately, the protectionist tariff measures enacted by the administration, and the threat of further punitive trade measures, are providing further headwinds to global growth and are having a meaningful impact on future earnings projections for U.S. businesses dependent on foreign consumers.

Despite these conditions, the Federal Reserve continued its prescribed path to tighten monetary conditions by following through on its fourth interest rate hike of the year – with continued hawkish commentary about future quantitative tightening – at its December meeting. The key phrasing of a rigorous, systematic reduction in the Fed's balance sheet, with inflexibility to market gyrations, spooked the markets. The unwinding of stimulus that boosted asset prices and depressed interest rates is in full swing, and markets last year reflected uncertainty about the effects of that backdrop.

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Turning to market performance, on a price basis, the S&P 500 Index declined -6.2% in 2018; on a total return basis, it returned -4.4%. The index, a broad measure of large capitalization U.S. companies, declined 20% on a peak-to-trough basis during the year – a drawdown consuming much of the fourth quarter. The U.S. market, over history, has declined in 25% of calendar years; 2018 happened to be one of those occurrences. It is notable that last year was the first in seven decades where the S&P 500 was up over 10% only to finish in negative territory.

International equities fared no better, generating double-digit negative returns of over -13% with softening growth in China and Europe and a surging U.S. dollar. Across the board, country-specific returns were overwhelmingly negative, with a handful of exceptions such as Brazil and Russia. Diversification worked to dampen volatility but gains in broad-based indexes and individual names were virtually impossible to find in 2018.

Typically, fixed income provides some comfort during periods when equity prices fall. In 2018, however, bond returns were flat to negative as the Federal Reserve raised interest rates four times to normalize those rates from the extraordinarily low levels maintained as a result of the financial crisis. Tightening liquidity causes asset prices to fall and risk premiums to rise, adding to well-founded growth concerns.

On a positive note, the rise in the Fed funds rate boosted the returns of two important asset classes that are effectively risk-free – money markets and short-term Treasuries. For the first time in a decade, the risk-free rate of return is quite attractive at around 2.25%, especially given muted mid-single digit capital market assumptions in the intermediate-term.

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For our part, our positioning going into the year had a defensive bias, with muted expectations for equity and bond market performance in the short-term given lofty valuations and the prospects for a rising interest rate environment. With elevated cash levels, reduced interest rate risk in fixed income, a bias to quality within equities, and global diversification in many portfolios, we are largely pleased to have avoided a fair amount of the extreme volatility many investors suffered in 2018. Despite our sound positioning, there was no true place to avoid negative returns, but attention to risk added value on a relative basis.

In this late stage of the economic cycle, domestically we are inclined to further reduce exposure to broad-based large cap indexes and focus more on individual stock selection and asset allocation. We are redoubling our sector analysis to focus on segments that have already corrected substantially or in our view are undervalued when compared to the market at large. We will likely focus on increasing exposures to financial and energy stocks as well as specific healthcare, industrial, and technology companies that have already corrected meaningfully.

From a foreign perspective we believe that it continues to be prudent to dollar-cost average into higher percentage exposures to international developed and emerging markets and to re-enter the emerging market debt space at some point after nimbly exiting at the beginning of last year.

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Looking forward, after a recent bounce the trajectory of global growth and the near-term direction of markets is contingent on several key events: (1) the outcome of trade talks with China; (2) how Brexit materializes at the end of Q1, and (3) central bank activity in reconciling balance sheet reduction and interest rate hikes in 2019. In addition, a prolonged government shutdown will have a material impact on U.S. GDP. In our view, the outcomes of these issues are critically important for the health of the worldwide economy, and thus risk asset prices, in the coming year.

With those three main considerations as the landscape, we believe that at present there is an asymmetric return profile for asset prices with a negative skew to the downside. We are already seeing deaccelerating global growth and deaccelerating earnings. Wall Street earnings expectations remain elevated in our view and are likely to be repriced, with resultant volatility, as forecasts are guided downward.

From our perspective a 10% upside could be achieved with a palatable trade deal with China, no hard Brexit, domestic GDP growth between 2.5%-2.9%, and decent earnings growth in the 4%-7% range; conversely, a further decline in markets would stem from less favorable results from trade talks, a hard Brexit, a less flexible Federal Reserve, and a continuation of slower global growth and weaker earnings domestically.

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In short, we are cautious about the short-term outlook for the markets. The decline in asset prices is welcome to us as long-term, fundamental investors because they present the opportunity to initiate and augment positions at attractive levels. The economic expansion is losing steam, and expectations for a somewhat overdue recession by 2020 are rising. It is important to note that recessions are typically short-lived and beget expansions of vastly longer length – a market rhythm that has produced considerable wealth for steady investors with long-term horizons. Our responsibility as a vigilant steward of client assets is to weather these storms to avoid foreseeable risks, smooth the ride, and be positioned properly for the inevitable next cycle of prosperity.

We continue to be honored by your trust.

Best,

Whitney Dow
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