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North Forty Two & Co. 2018 Investment Outlook:

Continuing to Live in Interesting Times

A little more than a year ago, in the wake of surprising results in the U.S. presidential election, we forecasted elevated levels of market volatility in both directions. While the world at large has felt varying levels of uncertainty and unsteadiness since then, the markets grinded higher in an unprecedented fashion.

As a result, current valuations are lofty across the board as the momentum factor led asset classes to levels, on a cyclically adjusted price-to-earnings basis, rarely seen in history. At the same time, markets have also produced unanticipated and uncommon low volatility. The resurgence in global growth and a backdrop of very low interest rates and modest commodity prices has traditional Wall Street in a euphoria reminiscent of our early days in the industry.

As measured by GDP, the domestic economy is improving, with recent quarters exceeding the 3% level. Further stimulus has resulted from a rapidly weakening dollar, which has temporarily fueled export growth. The recently-passed tax reform bill has provided additional short-term fuel to corporate earnings and is encouraging corporations to redeploy cash reserves and repatriate cash holdings held hostage overseas by meaningfully high tax rates at home. In fact, the impact of the tax bill is expected to deliver a boost of between 5%-10% in corporate earnings for the S&P 500 in 2018.

We now see a divergence in central banking policies between the Federal Reserve and foreign central banks. In response to positive signs in the economy, U.S. short-term rates were hiked three times in 2017; up to four additional hikes are anticipated in 2018, although the inflation picture remains complicated. Meanwhile, the European Central Bank and Japan continue to be accommodative, pushing foreign sovereign rates downward and collaring U.S. interest rates given the wide disparity in yields between U.S and eurozone debt, especially against German government bonds.

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From a valuation standpoint, it is somewhat challenging to find areas of the global marketplace – either in equities or in fixed income – that aren't stretched when compared to historical averages. That doesn't forewarn an impending, immediate pullback; in fact, momentum factors suggest that we may see a near-term melt-up in asset prices. This is a classic condition of a late-stage cycle as asset prices increase far more rapidly than the economy at large. In our view, future returns are being borrowed or pulled forward.

The consensus is for decent returns in 2018 but fluctuations are likely; the docile markets of 2017 have put us in record territory with respect to the absence of a normally regular 3%-5% drawdown. Importantly, the longer we go without having these natural pullbacks the more likely we are to experience a more significant correction, and the magnitude of that move intensifies with the duration of the current one-dimensional trend. The timing of the end of this euphoric excess is, of course, unknowable.

However, there are sectors of the stock markets where we remain constructive. These areas include energy, with expectations for increased global demand, geopolitical unrest, and accommodative foreign central banks, and technology, where market leaders are generating significant free cash flow from increased corporate capital expenditures and demands for their solutions with an outlook for upward pressure on employment and wages. Additionally, we are further increasing exposure to international companies and emerging markets, where relative valuations are attractive. Expectations for global growth are in the neighborhood of 4%, and in 2017 for the first time in a decade, all 45 OECD nations accelerated their economies. Continuing to tilt portfolios toward a more international orientation seems prudent given the long-term run-up in U.S. asset prices.

With respect to bonds, we remain well-diversified yet neutral to slightly negative on the prospects for debt prices. Prices move inversely to yields, and a rising interest rate environment will limit the prospects for price appreciation of fixed income instruments. A rapid approach to 3% on the 10-year Treasury, from current levels of approximately 2.60%, would be of significant concern for markets of all types. Credit spreads are historically tight, meaning that investors are paying more and more, and taking on more and more risk, for a desired level of income difficult to achieve with more conservative bonds. Our approach, recognizing the need for bonds as ballast in an investment portfolio, is to balance and broaden fixed income exposures to reduce the interest rate and credit risks that bonds face at current levels.

Tightening monetary policy domestically, in response to improved economic conditions, has resulted in a flattening yield curve, which in the event of an inversion, is a reliable harbinger of a future recession. Recessions – defined as a falling economic activity in two successive quarters (in opposition to an expansion) – have occurred every four years or so and last several quarters. They are necessary to eliminate inefficient companies and sow the seeds for new, emergent ones, and they provide an attractive buying opportunity. Again, our last recession bottomed out nearly nine years ago.

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To sum, we remain cautiously optimistic on the long-term outlook for the markets but agree with those who soberly believe that capital markets, over the intermediate-term, are unlikely to produce the low volatility returns enjoyed recently. For instance, a balanced portfolio of stocks and bonds since 2011 has compounded at over 10% annually without suffering a monthly decline from its high of even 5%. Volatility and associated drawdowns have been non-existent, and that has created an immunity to the pain of normal pullbacks by individual investors. Even pension plans continue to operate under the assumption that they can generate balanced returns of around 7.5%; given current valuations in the top decile of historical norms and the low level of interest rates, it is far more likely that they will experience returns of perhaps 5%.

In the short-term, it is likely that the momentum-driven market we are currently in will continue as such trends typically do, and we are willing to be cautious momentum investors. However, we suspect that 2018 will, in the end, feel very different than 2017. Signs of excessive optimism and/or widespread complacency are often a precursor to violent market swings when markets are rich and corporate performance fails to meet expectations. A durable basket of exposures and keen monitoring of global market conditions will be necessary to navigate these choppier waters.

Our long-standing approach is to obtain attractive market performance with meaningfully less risk, and to use market corrections to initiate new holdings and boost existing positions with conviction. Against the current backdrop, we anticipate increased activity as these events unfold.

We continue to be honored by your trust.

Best,

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