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North Forty Two & Co. 2019 Mid-Year Update

Six months ago, in our 2019 Investment Outlook, we highlighted three areas of concern in unsettling times against a backdrop of a late-stage economic cycle:

- Global trade disruption and geopolitical risks with respect to China
- Brexit and the relationship between the UK and the European Union
- Central bank activity in influencing asset prices and global economies

These three issues are rooted in rising populist and nationalist sentiment around the world. In this Update, we will initially focus on the geopolitical risks that are an existential threat to economies and markets, and then turn to how we are managing durable portfolios to lessen the downside risk we face as a result of global instability.

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First, the evolution of U.S.-China trade relations is troubling. While U.S. tariffs damage the Chinese economy, the damage from hostile trade policies is threatening our economy; at present there is considerable evidence that supply chain disruptions will tamp down already moderate domestic growth and fuel unexpected and uncommon price inflation. The domestic economy is feeling the impact from tariffs, first in the agricultural sector and now in manufacturing, as businesses reevaluate capital expenditures and their desire to aggressively expand in a shifting environment. Added to the China situation is anticipated trade tension to come with India and the European Union.

A decent segue into our second concern, as in April, European Union (EU) leaders extended the timeline for the U.K. to leave the EU to the end of October. Theresa May stepped down as the Conservative Party leader, and the party will install a new Prime Minister in the coming weeks. British oddsmakers favor Boris Johnson, who shares common perspectives with U.S. leadership, to succeed May and to lead the Brexit proceedings. As in the case with the Sino-American trade war hastily initiated by the U.S.,, protectionist policies run counter to decades of globalization and the resultant market disruptions serve to throttle interconnected economies in the near-term.

Finally, global central banks continue their quantitative easing to stimulate lackluster growth. We are amidst a bizarre interest rate landscape where global sovereign bonds – and now, even international “high-yield” junk bonds – have negative yields. Lenders get back less than they originally lent, and investors are hoping that those bond issues will appreciate despite not providing any income. The Trump administration railed against a Federal Reserve hike in December, and the tenor of the Fed has shifted to a more dovish stance with an anticipated rate cut or more to “insure” the economy from a downturn. There is a disconnect between the language of the Trump cabinet and the underlying fundamentals, as a “strong” economy would not require this loose monetary policy.

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Turning to market performance, volatile asset prices jumped in the first half of 2019, largely as a result of a reversal in Federal Reserve policy and a continuation of easy monetary conditions worldwide. Despite shrinking earnings growth in the first quarter and rising margin pressure, prices surged and quickly wiped out much of the significant and violent drawdown we experienced in late 2018 – which was the worst December for U.S. stocks since the Great Depression. If we do not see improved and broader earnings growth from second-quarter results, equity prices will suffer from here.

Risk-managed portfolios that are diversified broadly across asset classes have faired well during 2019. U.S large-cap stocks rose 18%; International stocks climbed 6%; and the Barclays Aggregate Bond Index rose approximately 6%. Oddly enough, both risk-on (equities) and risk-off (bonds) are at very high valuations, giving credence to the concept that while money is nearly free, investors aren't sure whether to add risk or to take risk off the table.

As long as central banks continue to spike the punch bowl, the party can go on – although like many parties, the crowd dwindles and things can get crazy the longer the fun lasts. The inverted yield curve, when short-term rates rise at the expense of the long end, is a constant concern and is often a harbinger (albeit imperfect) for a lackluster long-term outlook and an impending recession in the short-term. The Federal Reserve is in a precarious position, needing to manipulate this low-yielding, flattish curve without adding to the asset price bubble. They are not helped by an administration that fails to grasp the impact of an ill-timed step on this financial tightrope and is barking for lower rates to hyper-stimulate growth and a stock market melt-up in the short run.

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In this geopolitically sensitive environment, we are comfortable with our current positioning, with high-quality equity and fixed income exposures and some ready cash. We have reduced our holdings in riskier parts of the bond market, as stretching for yield results in a greatly heightened risk position. We are trimming equity positions that have had a good run in sectors more sensitive to slower growth. With so much turbulence seemingly on a daily basis, it is our responsibility to separate the signal from the noise and manage constantly-evolving, resilient investment portfolios that can weather the inevitable storm.

We continue to be honored by your trust.

Best,

Whitney Dow
President
North Forty Two & Co.

William L Ross

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