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North Forty Two & Co. 2020 Investment Outlook:

Preparing Durable Portfolios for Volatile Times

Through one lens, 2019 demonstrated the timeless adage that markets are not a current reflection of the economy, but rather a weighing machine attempting to gauge what is going to happen in an unknown future. Despite a background of concerning global macroeconomic conditions, asset class returns were strong across the board in the calendar year, rebounding from dramatic drawdowns in the fourth quarter of 2018.

In our view, the single greatest catalyst to market performance in 2019 was monetary policy. The Federal Reserve abruptly reversed its stated course, abandoning its strategy of tightening monetary conditions and reducing the size of the balance sheet, instead cutting interest rates and creating substantial, temporary levels of heightened liquidity for markets. This backdrop fueled asset price inflation throughout the year, and stock prices were increasingly disconnected from fundamental value and credit quality. In fact, just 8% of the stock market's return was attributable to earnings growth – the norm is 67% – and 92% of the performance of the S&P 500 resulted from multiple expansion, or elevated price levels. The Federal Reserve has only recently acknowledged its role in the stretched valuations in the current marketplace; when the ephemeral nature of monetary stimulus reverts, downward pressure on security prices will result.

From a macroeconomic perspective, one of our three key concerns going into last year – global trade disruption, Brexit, and central bank activity – is worthy of further analysis looking forward. In terms of global trade, the United States and China have codified Phase One of a trade deal. The tariff war and resultant supply chain disruptions led to the domestic manufacturing industry falling into a recession even though consumer spending remained relatively strong. The details of this initial stage remain deliberately vague and there are concerns about enforcement mechanisms to hold China to its commitments for agricultural spending and fair play in both intellectual property considerations and technology transfer demands. One important consideration, though, is that it remains to be seen if trade levels of 2017 – before the deliberate escalation of trade tension – might even be reached in 2020. However, on the face of it, warmer relations between the two largest economic superpowers in the globe are a positive.

One critical event for capital markets is, of course, the Presidential election in November. Despite a robust market in 2019, the current Administration does not have particularly strong momentum as the campaign hits the stretch run. Wage growth remains relatively stagnant, economic growth is modest, and most impacts of tax reform bill accrued to corporations and high net worth individuals. Additionally, blue collar workers are due to feel the ramifications of the recession in the manufacturing sector. The Republican platform is sure to include further reduction in regulations, less hostility toward Wall Street, and follow-on tax relief – all items that markets generally embrace. The possibility of a change in Washington could cause that aforementioned weighing machine to place different bets, resulting in increased volatility as pulled-forward returns predicated on a continuation of the current platform unwind.

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Turning to market performance, given the tailwind of outside forces described above, asset class returns were quite strong in 2019, as virtually all asset classes produced positive results. Large cap stocks, represented by the S&P 500, advanced handsomely. This performance was, however, quite narrow, as 10 stocks made up 30% of the index's returns for the year, led by Apple and Microsoft, which now represent a remarkable 15% share of large cap equity performance. The correlation of S&P 500 returns with the timing of the expansion of the Fed balance sheet is also stark – with low interest rates, that stimulus is flowing largely into equities, as well as bonds and real estate. Despite that landscape, U.S. stocks remain bedrock of portfolios regardless of macroeconomic environs, and while our overall allocation to domestic equities may not change dramatically, our reallocation within the asset class to more attractive sectors on a price basis is well underway. On the international front, our willingness to be broadly diversified on a global basis paid off nicely in 2019, as developed market equities and emerging markets showed strong gains with a fairly steady U.S. dollar.

Bonds produced outsized total returns over the course of the year – to the tune of 8.7% – as prices moved up as a result of interest rates declining in a backdrop of Federal Reserve cuts to the short-term rate. Typically, in times of stock market excess, bonds sell off as investors embrace more of a momentum-based risk-on position. This was not the case in 2019, as asset types of all flair – aggressive or conservative – rose in a favorable liquidity environment. This condition is evidence that there is no true consensus on the strength of the underlying economy. Again, the economy is not the market, and investors are placing bets on both sides of the ledger as they gauge the future given that all asset prices are at or near all-time highs.

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The question for investors is to what extent those future returns have been pulled forward in this enthusiastic environment, and how to manage risk accordingly going forward into 2020. For our part, we continue to believe in durable portfolios with consistent yet measured exposure to domestic equities. Our inclination is to build positions in and possibly overweight undervalued sectors of the marketplace that offer greater return expectations in turbulent waters. At present, these sectors of the domestic economy of particular interest include healthcare, segments of the technology space, and unloved energy stocks. We remain steadfast, as always, in seeking growth stories at a reasonable price and traditional value-oriented names that are showing meaningful revenue growth and earnings momentum.

On the fixed income side, given muted inflation projections, a still murky picture for synchronized global growth, and low levels of sovereign interest rates abroad, we are constructive on Treasuries and high-quality intermediate bonds at the expense of riskier segments of the bond market that might provide marginally higher yields with significantly greater risk characteristics. Investors desperate for income are bidding up those riskier areas of the market with little concern for underlying credit quality; in our estimation, those bondholders are not being compensated adequately for taking that risk. Our assessment is that domestic interest rates, as measured by the 10-year U.S. Treasury Note, will trade in a range of between 1.50%-2.00% due to both its relative yield advantage to other sovereigns and a demand for safe haven assets given global growth challenges and geopolitical concerns.

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With respect to foreign exposures, throughout the second half of 2019, we gradually allocated in greater amounts to the attractive relative valuations of international developed and emerging markets, as it appeared that China was being somewhat successful in engineering a soft economic landing in their country. In addition, with the first phase of the China trade deal completed, we would expect a more hospitable tariff landscape that would work to reverse the supply chain disruption seen due to the unnecessary brinksmanship of last year. The recent news of a virus outbreak in China has initially triggered a global selloff – this demands attention to see how bad the contagion gets and whether it begins to slow both global travel and economic activity. That said, with the support of anticipated weakness in the American dollar, if China can execute that soft landing and move quickly to control a potential pandemic, Euroland and emerging markets could become even stronger candidates for further investment.

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To conclude, on a strictly absolute basis we were caught a bit on our back foot last year, and our risk-managed stance, while producing strong risk-adjusted numbers, trailed more aggressive and narrow postures that paid little heed to challenges in the domestic economy. We manage investor portfolios with a keen eye on both reasonable growth and capital preservation, and as such, can lag in momentum-driven markets that care little about fundamentals. Our considerable experience has taught us that when markets turn, our prudent approach adds outsized value, and we are comfortable with our current levels of risk.

We continue to be honored by your trust.

Best,

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