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North Forty Two & Co. 2020 Mid-Year Update

In mid-January, we posited that the capital markets were vulnerable due to elevated valuations resultant from accommodative monetary policy. Prescient yet somewhat passing mention was made to "a virus outbreak in China…[that] demands attention to see how bad the contagion gets and whether it begins to slow both global travel and economic activity."

The spreading of COVID-19 led to a global shutdown, an unprecedented decline in economic activity, a dramatic drawdown in equity markets, and massive unemployment claims totaling over forty million. A partial list of the fallout:

- U.S. gross domestic product (GDP), a measure that economic activity, fell 5% on an annualized basis in the first quarter and is expected to fall up to 50% in the second quarter.
- Global growth was similarly sluggish, as experts now predict a contraction of -4.9% in 2020 (slightly stronger than calendar year expectations for the U.S.).
- Oil prices cratered, falling to a low of under $19 per barrel from year-end levels of $61, with oil futures contracts trading temporarily at negative price levels.
- Bond market liquidity dried up, leading to short-term price instability that required central bank intervention.

As it turns out, the United States entered a recession in February, ending a historic 128-month expansion. Double-digit unemployment is now higher than at any point during the Great Recession of the late '00s or at any period in the post-World War II era. The American consumer, who represents an all-time peak of nearly 70% of GDP, is quite understandably either unable or unwilling to spend as they had in the past given this uncertainly. As early as last year, GDP was already shrinking meaningfully in the business-related components of exports and private investment; as the most important segment of the three, current weakness in the consumer segment is particularly concerning.

The Federal Reserve, by rapidly expanding its balance sheet to $8 trillion, and Congress, through $2.4 trillion in fiscal stimulus via rebate checks, unemployment benefit enhancements, and small business relief are rightly using much of the arsenal at their disposal to revitalize commerce. Yet, our inability as a nation to fully implement and follow proper guidelines to mitigate coronavirus transmission from the onset of the outbreak is muting the broader impact of these liquidity initiatives beyond inflated asset prices.

Adding to this backdrop is the fact that we are in an election year with our nation facing increasing socioeconomic division and social unrest unseen in five decades. Amplified by these differences, the polarization and politicization in Washington with an eye toward November has further hindered our recovery efforts. The success of our economy in moving forward from this tremendous setback – and our ability to avoid a second wave in the fall/winter – is wholly dependent on the condition of our public health. As of this writing that state is still very much in question.

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Turning to market performance, at our March lows equity markets were down -34%. Since that point we have seen a rather shocking reversal in index levels, led largely by a handful of participants. The S&P 500 ended the first half of the year down -3.1%, but that figure fails to capture the underlying tumult in investment sectors and styles. The stock market is rather narrow – five technology stocks account for 25% of the S&P 500 and are larger than the entire financial services, industrial, materials, and energy sectors combined. While the average S&P 500 company is down -10% in 2020, the momentum-driven technology sector is well into positive territory, up 15%. On a style basis, large-cap growth stocks – trading at a nearly 60% premium to historical valuations – rose 9.8%, while large-cap value stocks fell -16.3%. At these levels, the market is trading at a valuation resembling 1999.

In terms of diversifiers to domestic equities, few asset classes offered safe harbor. International equities struggled in the first half, with developed markets falling -11.1% and emerging markets falling -9.1%. The slowdown in global growth hit commodities to the tune of a -19.4% decline. Real estate offered no solace, losing -13.3% in value. From a valuation standpoint, global markets are relatively inexpensive to domestic markets and still offer attractive diversification benefits on a risk-adjusted basis.

Bonds fared well in the first half of the year as the Federal Reserve signaled that interest rates will remain substantially low until at least 2022 to stimulate economic activity. The Barclays Aggregate, a measure of the fixed income market consisting of both government and corporate issues, rose 6.1%. High-yield bonds, an area we have historically avoided, fell -3.8% as default rates rose steeply due to debt servicing concerns. Interest rates appear to be relatively range-bound, giving investors some measure of protection to downside risk; however, with low coupon rates, the ability to generate meaningful income from holding bonds remains quite challenging.

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The question at hand is why there is such a divergence between stock prices and economic data. In the short-term, prices are driven by investor sentiment, momentum, technical factors, and an assumption that the Federal Reserve stands at the ready to support any dips by any means possible. Central bank actions and fiscal stimulus are temporary measures but serve to give investors a larger appetite for risk assets than justified by fundamental analysis. This condition is not sustainable and serves to heighten market volatility, especially as companies give lackluster forward guidance in reporting several calendar quarters of impaired earnings.

Our stance throughout the turmoil has been to be prudent risk managers and to avoid swinging for the fences. It is likely that the road to recovery is not V-shaped but rocky, and that the path to future prosperity is more W-shaped (or swoosh-like) – a disappointment to those professionals and a rising number of amateurs who are exuberantly bullish. Without therapeutics and a vaccine in very short order, measures which would usher in a period of normalcy relative to where we were just six short months ago, it is difficult to envision a scenario that justifies the current valuations that have been distorted by monetary stimulus and a lack of price discovery.

At the end of the day, our job is to sift through the day-to-day noise of politics and financial media and invest around sound principles that reflect our best thinking. 2020 is shaping up to be a year where our strategies look both brilliant and less than so. Our central focus remains on the risk/reward relationship of various global asset classes and what the most likely outcomes are to myriad events happening in real time. We are confident in our time-tested approach yet want to underscore just how uncertain these peculiar times are.

We continue to be honored by your trust.

Best,

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