NORTH FORTY TWO

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North Forty Two & Co. 2021 Investment Outlook:

Embracing Diversification and Managing Risk Amidst Global Uncertainty

In this space just twelve months ago, our theme was to prepare client portfolios to weather heightened volatility. We even mentioned the potentiality for a localized contagion to evolve into something more substantial. Those words, while prescient, read inadequate in hindsight, as no one could imagine the staggering toll a full-blown global pandemic would have on our populace and on our financial markets.

In review, in mid-February our always forward-looking markets rapidly adjusted to a COVID-led global slowdown in growth. In just thirty-some days, already frothy stock prices, fueled by already accommodative monetary policy, collapsed by 34%. For context, that decline approximates what occurred in 1987. Common measures of volatility, which gauge the level of risk, fear, or stress in markets, rose to levels exceeding the global financial crisis of 2008, when equity prices fell in half.

To avoid a complete meltdown and support asset prices, the Federal Reserve acted quickly to (1) lower the federal funds rate to effectively zero, (2) step in as a buyer of government securities to stabilize "safe" markets and (3) establish lending programs and paycheck protection measures to keep small businesses and their workers afloat. These extraordinary liquidity measures were largely successful.

With central bankers moving aggressively to pump liquidity into the system, prices of all assets adjusted quickly in response – when the risk-free rate is zero, money flows to riskier places in search of yield and return. Financial markets stabilized and ultimately advanced through the end of the year. These measures are a leading indicator of better times to come for asset values; however, the underlying economy continues to show weaknesses and many continue to suffer. Unemployment spiked to an astonishing 14.7% and has settled at an elevated level of nearly 7%., hitting the services sector, a key driver of productivity, particularly hard. We should remember that there are still ten million displaced workers struggling due to no fault of their own.

While America is still mired in the depths of the coronavirus crisis, there is finally a clearer path to putting this tumult behind us. Potential remedies for coronavirus are at hand, if not in hand. Success in vaccine distribution is critical to shortening the timeframe to economic recovery – as we've said before, our economic health is inextricably tied to our public health. The central risk in the near-term is that markets have priced in widespread vaccinations and a return to relative normalcy by the summer. Any meaningful disruptions in that vaccination plan or, as we are seeing, the virus mutates into forms more resistant to existing vaccines, can give great pause to financial markets and downward pressure on asset values until the pandemic is truly in the rear-view mirror.

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Turning to market performance in 2020, while asset prices are dislocated from economic fundamentals, diversified and disciplined investors were ultimately rewarded because of this abundant monetary support. A fully-invested, broadly diversified portfolio returned 10.6%, despite suffering a double-digit drawdown in the first quarter. International stocks, which tend to be in more mature, less exciting industries, rose 8.3%. On the fixed income side, as 10-year Treasury yields dropped nearly 100 basis points to 0.93% at year-end, bond indexes jumped 7.5%. Upon reflection, investors at both the most aggressive and most conservative ends of the risk tolerance spectrum experienced outcomes in the top tier of their expectations. An odd phenomenon, indeed.

Those gains across asset classes – again where different types of investments normally uncorrelated are trading near or at all-time highs – are quite extended. By the traditional measure of price-to-earnings ratios, large company stocks have considerable momentum and are trading at over 22 times forward earnings, or 38% above historical averages. This trend can certainly continue, but in our view, there is an asymmetrical skew to future outcomes, where more modest gains may happen but disproportionately larger drawdowns should be anticipated and mitigated through prudent risk management.

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As we look forward with guarded optimism, two key inputs inform our outlook and expectations for 2021, both involving considerable spending to further stimulate the economy. First, we expect an additional relief package in the first quarter of the year to include checks for individuals, some follow-on support for small businesses, and a measure of aid for states and local municipalities. Second, we would anticipate progress on an economic recovery plan focused on infrastructure – roads, bridges, ports, and mass transit – with a nod toward clean energy initiatives.

These expansive fiscal plans, in conjunction with an accommodative monetary backdrop from the Federal Reserve, are internalized by markets through a continuation of a weaker dollar with upward pressure on interest rates. In addition, as investors begin to deploy their pent-up savings and stimulus payments into goods and services, prices for those consumptions should rise. In this scenario, investment diversifiers beyond the large technology companies that have dominated weighted indexes should benefit, and as such we are more constructive than usual on real assets and commodities that serve to protect from inflationary pressures.

On the fixed income side, we are implementing measures to diversify what considerable risk there is in bonds at these low interest rate levels. As inflation rises and rates creep higher, bond prices decline, and as currently constituted, a 50 basis point increase in rates would result in a decline in principal of perhaps 3-4%. We are actively working to reduce duration and diversify exposures to mitigate this risk and reduce the impact of incremental rises in rates should that occur.

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In hindsight, this once-in-a-century pandemic has radically impacted the course and trajectory of economies and financial markets. Industries and businesses that operated in one manner prior to this massive disruption to daily life have now, forced by public health measures and fueled by technological advancements, charted a different course to survive the near-term and thrive in a different post-pandemic reality. This shifting environment creates interesting and exciting opportunities to re-position capital in a variety of asset classes and sectors.

We continue to be honored by your trust.

Best,

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