North Forty Two & Co. 2021 Mid-Year Update

In our year-end review, we focused on several key themes that helped our ravaged economy emerge from the depths of a global pandemic and avoid a prolonged economic downturn – (1) the actions of an aggressive Federal Reserve to sidestep a violent drop in commercial activity by injecting the US economy with unprecedented liquidity, (2) fiscal policy maneuvers from Washington to support afflicted households through the duration of the pandemic, and (3) measures at a federal, state, and local levels to help put our public health – inextricably tied to our economic health – back on track.

These radical measures with hindsight proved largely successful in treating the illness afflicting the US economy. To underscore just how immediate and massive the response to the Covid-driven collapse in aggregate demand was last spring, where gross domestic production (GDP) fell 31.4% in the second quarter of 2020, that recession lasted all of two whole months, with output rising 33.4% in the following quarter. The contraction was rapid and drastic, and the recovery – engineered through extraordinary, unprecedented, and in some cases, desperate actions – was stunningly swift.

Despite the impressive reversal in the economy, the two key metrics of employment and inflation used by the Federal Reserve to shape policy remain below levels that would allow for a normalized stance and a broad reduction in accommodative liquidity conditions for financial markets. It is likely that monetary support for the economy will continue as is for several more quarters in the absence of a spike in core inflation. While there are green shoots of increased inflation in certain critical categories, the Federal Reserve appears content to stand pat and allow the economy to run hot, and with this climate, asset prices can seem to face little resistance. It is an environment that breeds complacency.

Wall Street is more than happy to embrace these Goldilocks conditions. In fact, the consensus is that we will smoothly reaccelerate to above trend growth this year and next. Our opinion is less sanguine in that we believe there are two chief threats to navigate – (1) resolving the massive debt overhang created by and resulting from dealing with the pandemic-induced economic slowdown, and (2) reckoning with the distinct possibility that the virus and its variants prevent or delay a full return to normalcy into the autumn and winter. Many of the tools deployed from the stimulative toolbox are running their course; as the extraordinary liquidity injections that goosed demand and buoyed prices are no longer available nor effective – and are inevitably reversed – markets will anticipate a less rosy scenario and react unfavorably with a rapid repricing of risk assets.

To wit, there are fundamental adaptations to the psychology of labor that have not quite yet been internalized by investment markets. The valuable support programs to assist workers through the depths of the pandemic are due to run out. Companies are evaluating the productivity gains or losses suffered through 2020 in their forecasting. When economic activity derived from transfer payments such as unemployment insurance, advance child tax credits, and payroll protection subsides, what is the effect on income and consumption of goods and

services? How has the aggregate workforce changed, both because of decreased labor participation and technological developments, and what is the opportunity cost? What takes the place of that contribution to domestic productivity and earnings growth? Markets will need to adjust to this new dynamic.

This is not to say that we are not constructive on the outlook for financial markets, but we have an elevated level of caution going into the second half of the year, as despite the early-year successes in fighting the effects of novel coronavirus, uncertainty is perhaps greater now than at the outset of the year. As the economy continues to emerge from that convalescence, continued overly aggressive monetary and fiscal policy and its resultant distortive effects present a threat to the real progress made thus far. The return to relative normalcy will be less than smooth, and an extra level of vigilance is warranted.

****

On to market performance, for the first two quarters of 2021, the S&P 500 Index of the largest US companies rose handsomely – aided and abetted with remarkable liquidity infusions – with an uncommon level of general price volatility. On a style basis, returns favored value companies versus their growth counterparts, and from a market capitalization standpoint, smaller companies tended to outperform as their relative valuations offered a more compelling opportunity.

More specifically, sector leaders included value-oriented reflationary areas such as Energy at 45.6% and Financials at 25.7%, areas that have not received much positive attention over the past decade but remain integral in our approach. Correspondingly, laggards included defensive stocks like durable Consumer Staples (5.0%) and Utilities (2.4%) that generally thrive during more bearish environments. International stocks also bounced, with developed markets returning 9.2% and emerging economies delivering 7.6%.

Performance for bonds in the first half was challenged by a backdrop of rising interest rates, with the 10-year Treasury note rising in yield from 0.93% to 1.45% [Note: as of this writing, yields plunged to 1.12% before a modest reversal]. As a result, the Barclays Aggregate Index, a broad measure of bond values, fell -1.60%. Most investors limit their total exposure to fixed income to this narrow index; our diversified fixed income model allocates to more esoteric areas of bonds including inflation-linked Treasuries, emerging market bonds, and senior loans. These diversified exposures were not only modestly additive to performance but also quite helpful in mitigating risk.

****

In the intermediate-term, beyond monetary policy and concerns about variant spread, there are political challenges to the capital markets outlook worth noting. Equities are pricing in massive spending on infrastructure to upgrade to our national transportation system, communication networks, and public works. However, the size and success of that "hard" infrastructure bill is tethered to the scope of the expansive reconciliation bill focused on "soft" infrastructure investments in human capital, social services, and clean energy. Politically, the current administration is wrestling with how to fund the extent of both ambitious agendas, without piling on to our

bloated debt burden, through a hopefully nuanced balance of corporate and personal tax hikes. Concessions on the human infrastructure side may well be necessary to meet the lofty forward-looking expectations of a robust hard infrastructure package.

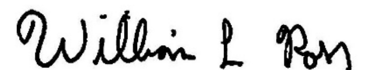
In our more immediate focus are three areas of concern – rich valuations for certain bellwether companies combined with weakening market breadth, underlying rolling corrections beneath the surface of broad market indexes, and cyclical fatigue as a normal 10%-15% drawdown is considered overdue. Of course, these conditions can certainly persist, particularly when supported by a great deal of money printing supporting asset values. But there are more recent signals of heightened inflation, as expected, and questions of if those rising prices are transitory or permanent and what that means for economic growth and policy decisions going forward.

With this perspective, for our clients we are actively reviewing portfolios and adjusting sector and company weightings to opportunistically take advantage of drawdowns and specific price dislocations as they arise. Also, in this low-yield world, we are actively looking to enhance our exposure to asset classes and idiosyncratic situations that offer incremental income potential, particularly as market multiples seem to be overextended. Our view remains that fundamental research and active investment management, with an overlay of global macroeconomic analysis, proves quite valuable both in the times of relative euphoria and in inevitably more difficult environs.

We continue to be honored by your trust.

Best,

Whitney Dow
President
North Forty Two & Co.



Will Ross
Founder & Chief Investment Officer
North Forty Two & Co.