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North Forty Two & Co. 2022 Investment Outlook:
Negotiating a (Hopefully) Post-Pandemic Landscape

It is difficult to believe that this is the third consecutive investment letter that has addressed the potential or actual impact of COVID-19 on financial markets. It appears the worst of it is over, and we are entering into an era of tolerable coexistence with the virus. Financial markets, as forward-looking mechanisms, are adjusting to this forecasted condition and are anticipating a new chapter as we resume the natural business cycle.

In this commentary, we will cover new challenges to our economy surrounding inflation and the workforce, our expectations for 2022 in terms of potential risks and rewards to certain asset class exposures, and our perspective on how society emerges from what we hope are the final innings of the pandemic as COVID and its related variants develop into endemicity.

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From a broad economic level, 2022 is likely to be a year where investment markets face meaningful but navigable headwinds as accommodative monetary policy – think extraordinarily low interest rates – reverses, leading to less of the abundant liquidity supporting historically high valuations. That excess liquidity has created elevated short-term inflation, particularly in durable goods (as opposed to services, which have yet to fully regain their footing with each oncoming COVID variant). In recent years the Federal Reserve has focused on only one of its two mandates – full employment – rather than the price stability side of the equation. In the upcoming year, to quell a recently hot inflation print not seen in four decades, monetary policy must become more hawkish, and the Federal Reserve will look to raise short-term interest rates perhaps three or four times before calendar year-end, provided that economic growth remains above-trend and markets behave reasonably well. However, we have seen more misbehavior in the first several weeks of the new year, so that consensus view may be misplaced.

On the inflation front, the end of the pandemic, or at least the perception of an end to most disastrous effects of the virus, should prove to be deflationary and reverse the sharp upward trend of prices for consumer goods and other necessities. Two inputs are important to this thesis – savings rates and shifting preferences. While wealthy consumers remain flush with cash, more broadly among the general populace the hoarded savings that peaked in the first quarter of 2020 and again in the first quarter of 2021 have normalized to historical averages, reducing squeezed demand and the upward impact on prices. In terms of preferences, the spending that does occur will pivot from stuff (durable goods) to experiences as COVID-caused frictions dissipate. This will also help ease the supply chain issues that have both disrupted commercial activity and fueled the jump in the cost of goods. Still, price increases will not moderate overnight, and investors who haven't experienced substantial inflation since the '80s need to adjust both their return expectations and their investment portfolios accordingly.

We also now have a new labor paradigm in the wake of COVID, one that has also exacerbated wealth inequality. The labor force – both how and where we work – has shifted inexorably for some industries, and those with particular skills and leverage have a different notion of comfort and confidence versus those in essential roles that have yet to capitalize on new bargaining power. But they will, as there is a now a new mindset where many workers are less loyal to their employers and emboldened by demand for their services, resulting in wage inflation (finally). That wage inflation is also fueled by low unemployment and a new, concerning lower level of labor force participation as able workers have dropped out of the employment pool. Industries need to adapt to this new labor environment and corporate earnings are more likely to disappoint while those distracting adjustments are made.

Again, to address inflation, interest rates must rise to remove some of the dollars chasing after these goods and services. The variable that capital markets are wrestling with at this writing is how quickly and with what magnitude will the Federal Reserve both reduce asset purchases and raise short-term interest rates. We are in a challenging situation. If inflation remains sticky at these elevated, albeit seemingly temporary levels, even more aggressive action will be warranted to rein in rising prices. But that action spooks financial markets.

The key is the execution, and a common automotive analogy often cited by US Treasury staff may be helpful. Our economy is a car, and the Federal Reserve is the driver. The driver is trying to maintain a constant speed on a hilly road. At the crest of a hill the driver needs to ease off the gas, and on the downhill hit the brakes to ensure a smooth ride for us as passengers in the back seat. For nearly a decade, conditions have been such that many times we've been able to hit the gas on a long, generally uphill climb. As we approach the crest of a hill (mid-cycle peak in financial terms) we need to lay off the gas and start using the brakes.

To torture the analogy further, the driver needs to avoid an overcorrection in transitioning to pumping the brakes. From our perspective, there is a huge potential for discomfort in the short- and intermediate-term at this part of the drive. The Federal Reserve needs to do just enough to moderate speed yet avoid interfering too much. But by simply launching more restrictive measures to reduce excess liquidity and preserve purchasing power, the odds of an economic contraction – read, recession – increase significantly looking forward to late 2022 and into 2023. We are in a more defensive stance as a result.

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What is the outlook for specific asset classes? Given the incredible liquidity in the system that will be flushed out and, given the high valuations for virtually every asset class, the notion that outsized returns are easily attained is difficult to support. The risk/reward relationship is heavily skewed to the point where incremental excess returns demand a healthy and non-commensurate risk appetite.

Generally speaking, while a bold, concentrated approach to asset allocation has produced the best nominal returns in recent years, 2022 looks to be a year in which a more thoughtful, diversified stance could produce the best risk-adjusted experience. On the equity side, while the multiple expansion that buoys

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stock prices will be more difficult to achieve than in prior years, we are more constructive on international equities and the cyclical areas of the domestic economy – financials, energy, materials, and industrials – that are more fairly valued based upon their earnings history. These positions generally behave better in the aforementioned rising interest rate environment.

That rising rate environment, however, is a large headwind to fixed income instruments, which have performed well for much of our lifetimes with the backdrop of falling interest rates. While government bonds provide important risk-reducing ballast to portfolios, higher interest rates mathematically reduce the performance of those assets. For illustration, the rise in interest rates from 0.93% to 1.52% in 2021 resulted in negative performance for fixed income, a scenario which has happened with little frequency over the past forty years. Both investment-grade credit and high-yield bonds, while very expensive, provide more relief from rising rates than government bonds and those high-grade corporate bonds are our preferred exposure where fixed income is necessary. But risk of investment loss is certainly heightened in what have traditionally been safe-haven positions.

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2022 is about taking stock of what truly matters and aligning your decisions and planning accordingly. COVID has taken a long-lasting toll on our psyches as our families continue to navigate this ever-changing landscape. Aside from the astounding human loss, the trajectories of lives for friends and family have changed radically from two years ago. Beyond investment markets, our principal concern today is our collective psychological well-being. Many of us and/or our family members have struggled mentally or emotionally due to an unprecedented period of disruption and isolation. Our sincere hope is that the worst is behind us.

We would encourage clients to further engage with us on the financial planning side, as goals and dreams have shifted due to the world around us. The firm has made a considerable investment in our capabilities to assess and quantify the ability of our clients to achieve specific milestones or make capital investments in those things that bring them joy and peace and improve their lifestyle. We would like to have more of those conversations and share these dynamic, state-of-the-art tools with you to improve your financial and emotional lives.

We continue to be honored by your trust.

Best,

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