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North Forty Two & Co. 2022 Mid-Year Update

Coming into the year, our capital markets positioning was cautious given extreme valuations, rising inflation, and questionable prospects for continued growth. Our assumption was that an intense rise in prices for consumers — driven by a decade of accommodative monetary policy following the Global Financial Crisis extending through the COVID era — would need to be countered by a deliberate slowing of the economy through tightening economic conditions. That perspective proved correct in the first half of 2022 and was reflected in a dramatic reduction in valuations across virtually all asset classes.

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Much of our work is focused on understanding what economic policy risks lay ahead and how to position investor portfolios to both capture upside returns and avoid damaging asset impairment. Since the Global Financial Crisis, the entity most responsible for influencing capital markets has been the Federal Reserve (along with its global central bank counterparts). As the group that sets short-term interest rates and influences longer-term lending rates domestically, the Fed pursues an important dual mandate of fighting inflation while encouraging full employment. Those two goals often compete with one another, and today there is a particularly epic struggle to tame high levels of inflation — largely a result of global money printing (both pre- and post-pandemic) and supply chain issues stemming from the halt and resumption of the global economy — without derailing economic expansion.

Policymakers are now determined to whip inflation at the expense of growth. As we all are acutely aware, inflation is higher than at any period in the last forty years, with annual food, shelter, and energy prices up 9.1% over the past twelve months. This is over four times the 2% inflation goal targeted by the Fed. While the monetary policy decisions made in the wake of the Global Financial Crisis and the pandemic were perhaps both necessary and noble, when interest rates are held artificially low for far too long, and when other measures taken to stimulate economic activity remain in force for far too long, high levels of inflation are the logical and inevitable result.

The Fed's remedy has been to adjust its long-held policy stance and reduce the amount of money chasing goods and services, principally by hiking interest rates and the cost of capital. This naturally weighs down capital expenditures by both consumers and companies and reduces upward pressure on prices. The problem facing financial markets is that radically raising interest rates while the global economy is on shaky footing is likely to lead to corporate earnings results that fall far short of expectations.

We are at a time of reckoning — even though it was foreseeable, markets that became addicted to the low interest rates and abundant liquidity of the past decade have been spooked by this shift in policy.

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How unnerved are financial markets? The first half of 2022 was the worst beginning for investment performance since 1970 as those markets, the weighing machines of economic prosperity, showed a lack of confidence in our ability to course correct through troubled waters. Domestic equities, as measured by the S&P 500, fell 20% and entered a bear market. Among sectors, Energy (an overweight in our portfolios) was the only positive performer, as rising prices led to positive returns of nearly 32%; on the other hand, the largest segments of the U.S. economy — Consumer Discretionary and Technology — were down a remarkable 33% and 27%, respectively. International stocks were equally dismal, also down 20%. Even well-diversified equity investors found little safe harbor.

Historically, when stocks are declining, risk-averse investors take that risk off the table and buy bonds for consistent income and principal preservation. However, with interest rates doubling from 1.52% to 2.98%, bond investors suffered their worst performance in nine decades. The aggregate bond index, normally a safe haven, fell 10% in the six months ending in June. Many investors, particularly through employer-sponsored retirement plans, have relied on static 60% stock/40% bond allocations as prudent "balanced" approaches; that mix has produced notably poor results so far in 2022, falling nearly 18%. In fact, we track over 50 global, sector, and factor indexes, and all but three have recorded negative investment results thus far in 2022. There has been little refuge from declining markets except for elevated cash levels and overweights to energy stocks and commodities.

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Where do we see things going from here? From an economic standpoint, there are discouraging signals that we are either currently in or on the verge of entering a recession. Economic activity, as measured by Gross Domestic Product (GDP), slowed considerably over recent quarters into negative territory as rising prices impacted the consumption of goods and services. Consumer sentiment, an indicator of optimism about the economy, is at its lowest point in the post-war era. And while headline employment is still quite strong, labor force participation rates and productivity measures are in decline as the state of the workforce has transformed post-pandemic. Certainly, we are in a late-cycle slowdown, the depth and duration of which is unclear.

From a market standpoint, we lean toward more general weakness until excesses are fully flushed out and monetary policy normalizes to approximate historical levels. In our view, the bottom for asset prices is not yet in. Valuations need to continue to come down to better reflect revised earnings expectations and return to more natural market multiples. Market sentiment is decidedly poor, but those market participants have been slow to express that bearish, risk-averse view through allocation decisions; as they do, that selling pressure will amplify the headwinds for investment returns in the short-term.

How are these views manifested in our portfolio management decisions? Outside of our core allocations, we continue to be relatively defensive, a stance that has served our clients well in recent years, to ride out this storm — and it looks like we will have some more work to do in the coming days and months to further stem the tide. Some might ask how come we aren't substantially more defensive. The answer is complex, but in general, bear markets can produce exceptional counter-trend rallies that are painful to miss out on from a longer-term performance perspective. We are poised to adapt this cautious stance on the fly to take advantage of constructive market movements supported by improvements in empirical data.

We want to reiterate the need to engage with us from both an investment management and financial planning standpoint so that we are properly aligning your capital with your goals and objectives for retirement and legacy planning. This is a perfect time for an emotional check-in. Our business was specifically designed to have the bandwidth to dedicate a generous amount of time to these important conversations, and we do our best work when fully informed about our client relationships.

We continue to be honored by your trust.

Best,

William L Ross

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