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North Forty Two & Co. 2023 Investment Outlook:
Understanding the Winds of Change Upon Us

In this space twelve months ago, our view was that rapidly rising global inflation and the resultant restrictive monetary policy would create challenging conditions for capital markets, and that a defensive position was called for. That position proved valuable, as a bias toward risk aversion avoided meaningful capital losses.

The stock market corrected -18.1%, only the second negative year in the last fourteen, and produced the largest drawdown since the Global Financial Crisis of 2008. Investors seeking a normal safe harbor in bonds were not spared either, as the broad-based fixed income index fell -11.8%. Outside of gains in the energy space and in defensive sectors like utilities and consumer staples, investors suffered notable paper losses. 2022 represented one of the worst investment years of the post-war era, with results largely beyond the scope of lofty expectations.

Fortunately, many of the structural issues that fueled rampant risk-taking and encouraged nosebleed valuations and a massive spike in inflation have begun to abate. We are now on the path to more normalized market conditions with sharply higher interest rates. The fever from cheap access to capital is breaking, and those resulting excesses are being wrung out of markets. While this is ultimately a healthy development, we are not quite out of the woods yet.

In addition to this adjustment to (for some) unfamiliar interest rate levels, we also see a more challenging geopolitical environment emerging as a new and unfamiliar backdrop for investors. As such, the post-pandemic landscape looks to be very different than it has over past decade-plus. These two changing winds represent the first stages of a transformational wave that demands a more nuanced and deliberate approach to investing.

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In this medium, a fully comprehensive discussion of (1) evolving global monetary policy and a (2) shifting international relations dynamic is impossible. However, let us review recent history at a higher level and address these two specific issues — how and why they are changing, and how they inform our positioning going forward.

Beginning with monetary policy, we are entering a new phase after more than a decade. During the Global Financial Crisis of 2008, economic activity seized up. Years of over-borrowing, de-regulation, and excessive risk-taking in the United States broke the globally inter-connected financial system, which came within days of failing. After extraordinary measures to restore the faith in financial institutions, the Federal Reserve needed to restimulate that commercial activity. That stimulus came in the form of reducing interest rates to zero and purchasing trillions of dollars of government debt to inject money into the markets.

Up to and through the pandemic, nominal interest rates, which represent the cost of borrowing and influence the number of dollars chasing assets, had been held artificially low. Again, the objective at that time of crisis in 2008 was decently noble. Central banks across the globe wanted to prevent worldwide destabilization and encourage consumer spending and business investment at all costs.

By instituting a zero interest rate policy, central banks traded one immediate and acute problem for another more chronic issue that proved to be difficult to manage. The challenge for those quasi-government officials was how to move off a low interest rate scheme that encouraged asset bubbles and inflation and allow markets themselves to adjust those values naturally. Just as zero- or low-interest rate policies encourage investment and amplify risk-taking, higher interest rates discourage economic activity, since credit requirements become more stringent and there are fewer dollars chasing goods.

While central banks tried to bring interest rates from the zero boundary towards normalization in the second half of the last decade, the global pandemic offered another opportunity to reverse course. By switching gears and bringing rates back down, the Federal Reserve provided further accelerant to asset values. Risk appetites were robust, since there was no alternative in the form of more conservative options, and corporate valuations became quite extended. However, inflation also exploded to the upside, further propelled by supply chain disruptions during the depths of COVID.

Inflation is an expected by-product of loose monetary policy and interest rates that are loo low. Central bankers tried to pass this off as a transitory phenomenon, but ultimately the specter of higher prices for commodities required monetary policymakers to embark on a strategy to reduce the abundant liquidity in the system. A violent move upwards in interest rates resulted in a re-pricing of inflated stock market values. This induced bull market ended in January of last year, and we are now faced with operating in a marketplace with stiffer structural headwinds for equities (accompanied by better conditions for debt investors) in the form of these higher borrowing rates.

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And now to pivot to our second theme for a different investing landscape, manifested in a shifting geopolitical paradigm. One of the hallmarks of the post-war era was a dramatic rise in the openness of cross-border trade. The world was going through a great integration where alliances were certain and international cooperation was vibrant. Nations and corporations were eager to export investment and to take advantage of lower cost resources — both natural and human — around the globe. An exponential rise in technology and computing power and the clearly tangible benefits of offshoring fueled this exciting phenomenon.

Following the Global Financial Crisis of 2008, modern globalization began to trend sideways, and even began to reverse course. China began to focus inward to encourage the native development of industry. To the dismay of NATO members, Russia began saber-rattling in Ukraine over Crimea and its value to Russian commercial activity. Our own government erected barriers to efficient trade in the form of withdrawals from and renegotiations of key bi-lateral and multi-lateral trade agreements, as well as protectionist tariffs on imports of raw materials. Nation-states around the globe began tilting toward ensuring their own national security by reducing dependence on foreign actors for natural resources and other elements of the supply chain.

The worldwide pandemic served to underscore the perils of interdependence and served to further crystallize this trend away from liberalized globalization. The Eurasia Group calls the current state one of "arrested global development." Social unrest and political conflict around the globe are on the rise, fueled by cultural issues, economic uncertainties, concerns about access to affordable energy, and food and water insecurities. Alliances are shifting, and the historical world order led by US hegemonic strength is more in doubt than in recent memory.

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These two themes — a tightening of worldwide monetary policy and a shifting geopolitical landscape — represent to us the dawn of an investing backdrop for the next decade that looks very different from the last. We are at an inflection point right now. The loose monetary policy that led to inflation that spurred a rapid hiking of interest rates is resulting in a flattening of global growth and a rise in recession risk. On the domestic front, while the US may just avoid an economic recession by the strictest definition, an earnings recession appears on the horizon. Consumer confidence is shaken; housing prices have reversed course; and attitudes for job security, assumption of debt, and consumption of goods and services are trending in the wrong direction.

In response to these transforming conditions, reckoning financial markets are in the process of a much needed revaluation. While a good amount of the damage occurred in 2022, we would still anticipate revisiting lower levels in the first half of this year. Central to this outlook is the fact that the Conference Board Leading Economic Index — a gauge of ten components that quantify prospective economic health — has accelerated to the downside of late. Broad investment performance in the short-term will be greatly influenced by the pace of interest rate increases and whether this sea change in policy results in either a softish landing with decelerating inflation and limited impacts to employment, or a harder landing in which a rock-solid job market is rattled by weak corporate earnings in the first few quarters of 2023. Recent job cuts from our largest technology employers suggest business leaders are girding for the latter.

Over the medium-term, we look forward to a return to a more normal, pre-2008 monetary landscape with less distortive stimulatory measures. We prefer the markets that are more naturally grounded in fundamentals that have been largely ignored in the past era of reckless risk-taking. Specifically, in the wake of rising interest rates, fixed income markets are becoming increasingly more interesting with higher starting yields. Both at home and overseas, growing economic nationalism and the trend toward de-globalization also offers attractive opportunities for investment, in areas such as infrastructure and energy markets. In this less synchronized world, differentiated returns will be available for active investors of thoughtfully diversified portfolios.

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Our principal mandate on the more clinical investment side is to produce attractive risk-adjusted returns throughout the entirety of the investment cycle — bull markets, bear markets, and those in-between. The experience of our investors during the past calendar year is rooted in our focus on risk management and reflective of our anticipation of the winds of change that ushered out a too-long period of artificially accommodative financial conditions.

Our purpose on the more human financial planning side is to supply the tools, perspective, and guidance to help our clients achieve their unique goals when it comes to their wealth. We will continue to encourage you to embrace these capabilities that enable us to deliver maximum value to you and your extended families. We stand firm as an unbiased resource for sound counsel.

We continue to be honored by your trust.

Best,

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