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North Forty Two & Co. 2023 Mid-Year Update

In our last commentary, we suggested that a higher-for-longer interest rate environment, flattening global growth, and fears of an impending recession would put pressure on equities over the short-term. While we still hold that perspective, we were clearly a bit early in expressing that view and have been a bit surprised by the level of optimism and enthusiasm of late. The tug-of-war between fundamental investors respectful of traditional econometrics, and momentum strategies that embrace a psychology of exuberance and complacency with risk, has favored the latter.

Year-to-date, market multiples — the stock prices paid for future earnings — have expanded to historically high levels despite slowing growth and stagnant year-over-year earnings, largely in the hopes that the Federal Reserve will move quickly to reverse course, cut rates, and abandon its stance of tightened liquidity post-Covid. This is a largely illogical outcome, for even just modest growth will not permit wages and prices to properly weaken, and interest rates will need to remain higher for longer unless and until economic activity is reined in and the labor market slackens.

Yet many investors continue to ignore these changing winds, despite compelling economic evidence that points to stormier seas ahead. We will explore these markers and their implications for the outlook of financial markets below.

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First, to recap the last six months, despite last year's weakness and very clearly deteriorating fundamentals, financial markets produced attractive results. For domestic stocks, an equal-weighted index of US large company stocks rose a healthy 7% in the first half of the year. The headline market-cap weighted S&P 500 index, containing the same companies but dominated by just a handful of technology-focused names, rose a surprising 17%, and the Russell 2000, representing smaller companies, returned 8%. For many of our clients, the most appropriate benchmark would be a composite portfolio of 60% global stocks and 40% bonds, which generated a total return of 9.4% in the first half of 2023.

The story of 2023 thus far is the remarkable strength of the "Magnificent Seven" tech names — asset-light companies including Apple, Microsoft, Meta, and Nvidia — versus the "cardboard box recession" seen by a contracting manufacturing and trade industry. These names trade at over thirty times earnings, or twice the historical stock market average. For the bear market rally to persist, we would need to see a more earnest broadening out to embrace other sectors and categories beyond technology-oriented consumer discretionary names.

On the fixed income side, bond market participants are finding opportunities for handsome results, generating attractive income at levels not seen since 2007, or before the Global Financial Crisis. As a result of the rapid, determined series of interest rate hikes from the Federal Reserve, investors now enjoy healthy yields of nearly 5.5% for virtually risk-free, tax-advantaged six-month Treasuries. Given the low return expectations for more volatile asset classes for the next decade, the risk-reward dynamics for short duration bonds is quite compelling.

Outside of the United States, international equity markets have also generated solid results for diversified investors thus far in 2023. Ex-US, global stocks are up around 10%. Despite falling into a mild recession over the winter with lingering weakness in China, European stock market prices managed to advance 16%. Emerging markets have produced reasonable results, gaining just over 5% year-to-date.

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Strong yet somewhat narrow domestic stock market performance in 2023 has been perplexing for many because it flies in the face of massive efforts to reign in the effects of a decade-plus of accommodative interest rate conditions. Because job growth and wage inflation remain stubbornly high, the Federal Reserve will be resolutely austere until the economy cracks, job creation abates, and the consumer demand that drives higher prices is destroyed. While the proverbial punch bowl, in the form of ultra-low interest rates, has been taken from the party, fiscal spending and stimulus measures from Congress add to the artificial upward pressure on prices and serves to prolong the inevitable.

Through a few final rate hikes in 2023, the Federal Reserve will throw even more sand into the gears of our economic engine and hopes to throttle activity enough to whip the dangerous price spiral that began during the pandemic. The challenge for the Fed is to cool these inflation inputs, such as those in commodities, housing, and even labor, *just enough* without seriously damaging the overall economy.

This dilemma has been reduced to whether we experience a “soft landing” with little fallout, or a “hard landing” with lingering implications for passengers and the value of their assets. The effect of Covid-driven supply chain disruptions on prices have been largely tamed, but now, monetary policy must traverse the stickier, more difficult “last mile” in bringing inflation from around 5% to their mandated 2% level. This is the hardest challenge; data reported over the next several months will be key in determining the timing and turbulence of the landing.

In retrospect, the data recorded thus far is hard to square with near-term stock market strength. With weakening economic fundamentals and added stresses in the banking sector (in the wake of the failure of First Republic and Silicon Valley Bank), corporate credit standards are rising, and lending institutions are more selective with their loan books and are far less willing to offer reasonable rates to small and mid-size businesses. The commercial real estate outlook is troubling, particularly for the future of office space with the normalization of remote and hybrid work. Corporate bankruptcies are at the highest level since 2010 (yet not reflected in the price of high-yield debt). For the consumer, excess savings have dried up, consumer credit usage is slowing, and many borrowers will need to resume student loan payments in a couple months, further hindering spending from the central driver of our economy.

In turning the lens to look forward, our concerns are hardly unique and are supported by data. Economists attempt to quantify the prospective health of the economy through the Leading Economic Index (LEI), a closely followed gauge which "provides an early indication of significant turning points in the business cycle and where the economy is heading in the near term." This index, which measures credit, stock prices, interest rates, consumer expectations, new orders, and jobless claims, is down fourteen months in a row. The LEI is flashing red well below levels that ushered in the past three recessions, with all indicators except stock prices either flat or in contraction. Basically, the outlook is quite poor when measured against history, even sharing similarities to 2000, and the data suggests we are in store for a harder landing.

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As the first half of the year illustrated, stock prices can remain strong despite uncertainty of the economic landscape. Markets and the economy can dislocate. With recent advances, the risk appetite from regular investors who fear missing out has returned, demonstrated both in support for speculative companies and in historically high allocations of portfolios to stocks at the expense of bonds. This is a time-tested contrarian indicator and suggests weakness to come.

We tend to be a bit more pragmatic and deliberate, and at times we are early to the other side of the boat, but not without reason. One central concern for us going forward is how highly leveraged corporations will manage their debt service in a world of more punitive interest costs. When rates were tethered to near-zero, companies were enticed to borrow with relative impunity at anemic, abnormal costs, even if they didn't necessarily need the funds. However, a stunning $3.1 trillion of that accumulated US corporate debt will mature by the end of 2025 (total US corporate debt is on the order of $24 trillion). Many firms who haven't wrestled with meaningful interest costs in over a decade will need to extend that financing at a doubled or trebled interest expense level. The impact to corporate profitability and stock prices will be quite significant and is largely not reflected in current valuations.

In short, for near-term momentum to continue at a historically elevated twenty times earnings, corporate profits absolutely must meet expectations, or we will certainly see the business cycle reset. As fundamental investors, our orientation tilts toward growth at a reasonable price and more value-oriented companies with strong free cash flow and the resilient ability to weather stormy seas. We remain positive on these fairly valued opportunities for reasonable investment return over the long-term. But the risk-reward relationship for many stocks and sectors is out of balance and does not favor a more aggressive investor, at least in our view. Our strategy remains to succeed with singles and doubles rather than overextend for home runs, and to focus on capital preservation and portfolio income when signs of stress emerge.

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While remaining responsibly allocated to stretched domestic stock markets, where do complementary opportunities lie? As interest rates reach their near-term peak, we find fixed income to be increasingly attractive from a risk-adjusted performance perspective, and we anticipate re-purposing funds from money markets and cash equivalent short-term Treasury bills to longer-duration Treasuries and corporate bonds. On the international front, we are initiating and augmenting positions in foreign markets such as Japan, which is emerging from both a multi-decade malaise and a late recovery post-Covid with strong fundamentals and relative value. It is virtually certain that thoughtful diversification will prove more valuable in the future than in the recent past.

We continue to be honored by your trust.

Best,

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

Whitney Dow
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