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North Forty Two & Co. 2024 Investment Outlook:
Managing Risk in the Late Stage of the Economic Cycle

To paraphrase an expression commonly misattributed to Confucius by Westerners, we are living in interesting times. If ever there was a period that demonstrated how the stock market interpreted the phenomenon of an economic cycle, it was the past two calendar years. Largely driven by interest rate policy from our Federal Reserve, both stocks and bonds have retraced and advanced, gaining little ground since the end of 2021. But while investment performance may have been largely muted, the economic and geopolitical environment underpinning financial markets has been tumultuous. In this commentary, we will explore the lasting impacts of the pandemic era, where we currently sit in the economic cycle, and the implications for portfolio positioning going forward.

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First, some public policy history about how we got to where we are. Two years ago, we were in the throes of massive stimulus programs conceived in the perilous early times of COVID-19. Our elected representatives, as they did in the Great Financial Crisis of 2008, rightly gave a shot of fiscal adrenaline to boost our economy through their congressional authority over both broad spending measures and direct, immediate payment schemes. These injections of money came on the heels of a decade of profligate spending and tax cuts, as our deficit coming into COVID-19 already topped $22 trillion. Fueled by economic relief and emergency assistance from the CARES Act and the American Rescue Plan Act (and more recently through the infrastructure act), our outstanding obligations now top $34 trillion. While concerning, that surge in debt and deficit spending was pivotal to keeping our economic machine functioning properly and avoid greater distress to the American populace.

On top of the power of the pen, our monetary policymakers played their role in stimulating commercial activity. Back in 2008, the Federal Reserve, which effectively dictates the cost of money and amount of liquidity in the economy, dropped interest rates to just above zero. Then, after the better part of a decade at that unprecedented zero-bound, we had finally started the sobering process of bringing interest rates up gradually to more customary, natural levels beginning in earnest in 2017. Just when the interest rates were normalizing, enter the pandemic in the first quarter of 2020 — another seismic event for the global economy. Once again, to reverse a sharp decline in economic activity and keep the domestic economy afloat, the Fed brought interest rates down to zero and signaled a determination to keep them there until the major impacts of a global shutdown were in the rearview mirror.

Why does fiscal and monetary policy matter so much? Inflation, or higher prices, result from too many dollars chasing too few goods. All of that spending and loose interest rate policy naturally led to an expected spike in inflation — but this time, to nearly double-digit levels not seen in nearly five decades. Those prices were ultimately a function of developments on both the demand side and the supply side of the commercial relationship. While our fiscal and monetary governors played an effective role in stimulating the demand side by giving people more money and resources, conditions were certainly exacerbated by the supply side, where worldwide logistical and geopolitical challenges reduced the usual availability of goods and services. The result of both forces was the rampant, uncontrollable, destabilizing inflation that crushes purchasing power.

By the beginning of 2022, at least some impacts of the pandemic began to abate, providing the opportunity for policymakers to chart a different course of greater austerity. While Congress was resistant to entertain the idea of moderating spending, the Federal Reserve was able to act demonstrably, directly addressing skyrocketing prices through an aggressive, steep trajectory of interest rates hikes to drain liquidity from the system and keep the costs of goods from escalating much further. What is known as the discount rate quickly moved from the zero-bound to over five percent, serving to discourage higher-risk financing and pulling dollars out of the economy. In the natural course of things, a recession promptly results, and the economic cycle, cleansed of excesses, resets for a promising future.

But this time was different, or at least it has been so far. A much-anticipated recession has yet to materialize, at least statistically speaking. Some are quick to say that we have successfully skirted that recession, and there is a reasonable chance that we still will, from a definitional standpoint. But the $6 trillion in additional, unanticipated debt spending to keep the economy above water has resulted in a permanent increase in consumer demand, keeping certain price level sticky compared to history. Absent unlikely measures to raise revenue, we have a permanently higher level of government obligations to service. Government spending as a percentage of our economic output remains 50% higher than the historical pre-pandemic average with no signs of reversing trend. We now pay over $1 trillion annually just on the interest costs of that debt, a doubling of that responsibility since just the beginning of 2022. If we roll over half of that debt at current rates, the annual interest cost will double again to $2 trillion in short order. In addition, there is far less foreign interest (particularly from China and Russia) in owning our debt obligations than in years past. We may need to offer higher interest rates in the future to be able to issue the new bonds necessary to finance our governmental activities. These complex debt-related factors are a huge structural headwind for the prospects of the broader economy and must be more of a consideration for policymakers and elected officials looking forward.

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With that backdrop, turning to the prospects for 2024 and beyond, financial markets think that the Federal Reserve is about to embark on a series of interest rate cuts because, yes, inflation has come down considerably from the 8-9% levels of 2022 and because economic growth could use a bit of a boost. But the traditional rationale for slashing rates under the Fed's mandate — tame inflation and weakening employment figures — is not as clear cut. Consumer spending is still remarkably resilient. Job markets are still strong, with unemployment under 4%, as companies continue to hoard labor. Housing markets remain locked up, and existing home sales are down, since generationally high mortgage rates are discouraging Americans from trading down because assuming a new mortgage at prevailing terms might seem non-sensical. And while home prices have stayed buoyant for now, when the supply and demand functions revert to the mean over time, there should be downward pressure on home values with added incentives to sell. These conditions are less than ideal for launching an extended rate cut strategy.

While Wall Street is generally confident that we are through the worst of it and that the Fed has everything under control, the economic data is conflicting and confusing, and the outcome is not as clear to us. The aftereffects of these fiscal and monetary policy decisions, plus the myriad of sociological changes that resulted post-COVID, are blurring the data that market watchers traditionally use to gauge the health of the economy. We have already illustrated the shift in stimulative fiscal and monetary policy, but in terms of social structures, the landscape is quite different today than several years ago. The commercial real estate market is fundamentally altered with a secular move away from the office. Shifts in hourly wages, productivity, and the acceleration of the gig economy make labor data murky and standard measures like participation, productivity, and even consumer confidence less reliable than prior. Thus, in evaluating the data against history, the signal is weaker because of all the new noise.

Complicating matters, we are seeing impactful geopolitical events across the world theater: the Russia-Ukraine War, conflict over Gaza, the global immigration phenomenon, political and social uneasiness in the US, the economic slowdown in China and Europe, new supply chain challenges in the Middle East, and historic levels of sovereign debt globally. What troubles us is that global markets seem relatively immune to these disruptions, remaining highly correlated to the liquidity decisions of central banks. One wonders how long this very simple, linear relationship can continue and what will happen to global markets if that current link changes.

We are in the lower growth, late stages of the economic cycle, where global interest rates are generally restrictive. Central bankers would like to keep those levels higher for longer to discourage out-of-control inflation. But those same central banks are scrambling to balance that desire to moderate inflation with the pressure to encourage the normal economic activity that has been impaired over the past several years. With so much accumulated sovereign and corporate debt, the need to cut rates and reduce financing costs is becoming less of a luxury and more of a necessity. Striking the right approach to manage inflation while encourage growth is as critical as ever; those strategies will dictate how long a late-stage phase of contraction will last and when a new expansionary phase will begin.

Again, markets are currently positioned for a softer landing, where labor markets are reasonably strong, economic growth stays modestly positive, earnings growth is expected to be robust, and inflation gently moves toward the mandated 2% level. The Fed has prematurely messaged “mission accomplished” on inflation concerns and is signaling that nearly two full percentage points of rate cuts are on the near-term horizon. This is a lofty expectation indeed. What makes this odds-on outcome uncertain is that while down meaningfully from highs, domestic inflation remains sticky at around 3½ percent. Is a delicate landing on the historic target of 2% really a near certainty, given our spending path? If we spike the football too early and pare rates, will inflation rise sharply once again, still fueled by the spigot of liquidity from deficit spending and discretionary consumer spending? By eagerly trimming, will we have enough dry powder to address the next calamity? Balancing these risks and unintended outcomes is what keeps the Federal Reserve up at night.

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Our responsibility is to seek attractive risk-adjusted investment returns, and the key metric to work from is the risk-free rate of return, which could very well continue at an attractive 5% or more in the quarters ahead. At present, for risk assets that are largely priced to perfection, we place a premium on reasonable valuations and free cash flow yield for stocks and real, inflation-adjusted return for bonds. These are diversified positions that can benefit more than most in the late phase of the business cycle. That posturing could change in a quarter or two, as the actions of the Federal Reserve — the key input for 2024 — play out, growth prospects change, and investors are more properly compensated for taking incremental risk. We are confident in our ability to navigate this landscape, but truthfully, the range of potential outcomes in the near-term has never been wider. Prudence is certainly warranted.

We expect our asset allocations to evolve over the year toward less cash, more bonds with longer durations, and modest stock exposures on the lower side of targets until we see more clarity or a pathway to more sustainable growth. In the meantime, 2024 is a good time to communicate with us about your financial planning goals. Whether that be saving for retirement, legacy estate planning, cash flow budgeting, charitable giving, or anything else related to your peace of mind, we have invested in the resources necessary to offer sound guidance based upon quantifiable data and intelligent modeling. We encourage all clients and their families to engage with us on these matters sooner rather than later.

We continue to be honored by your trust.

Best,

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