North Forty Two & Co. 2024 Mid-Year Update

Interesting times, indeed. While political shockwaves across the globe are changing the trajectory of nations and shifting the outlooks for international economies, investment markets in the US are narrowly fixated on one simple question: When will we see interest rate cuts?

To review, rising interest rate cycles traditionally discourage investment, encourage hoarding of resources, and tend to dampen higher prices, corporate earnings, and stock market returns. Lower rates generally promote the opposite behavior. At present, interest rates are broadly considered to be at a near-term acme, or cycle peak. Our post-COVID economy has progressed to a point where higher rates may no longer be necessary to tamp down inflation and easier financial conditions may be both justified and on the near horizon. As we have often discussed in this space, financial markets are forward-looking and anticipatory; professional investors are now bidding up particular asset prices, eagerly frontrunning the presumptive all clear sign when rates are expected to turn more friendly.

Are calm waters ahead? Should we throw caution to the wind? Not so fast. Recall our skepticism in January when Wall Street was anticipating six or seven rate cuts by now, and our belief that inflation would remain stickier than the pundits believed, delaying any ability to trim interest rates. Investors who fare poorly often ignore risk management and are often doomed by their own hubris and faith in the wisdom of the crowd.

There is another side to the story as well, oft forgotten by many market observers. While investment markets tend to rise when there are signals of the end of interest rate hikes and the onset of a cutting cycle, once that easing cycle actually begins, markets have historically sold off rather significantly. According to Comerica, over the last fifty years, stocks have corrected just over 20% on average after the first rate cut to the market low nine months later. This phenomenon is because interest rate cuts are medicine for a weakening economy, but once that diagnosis manifests, risk capital flees for safer environs. This is not a dire forecast, but rather evidence of how euphoric investors can be in anticipation of easier monetary conditions, and how volatile results have been when economies reverse course and rate policies change. The consensus may be off base yet again.

In this piece, we will review performance, discuss interest rates and our nation's spending issues, and opine on the direction of our finances and the implications for investments beyond the election in November. There is certainly a lot to comment on.

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First, the usual look back at the past six months of investment performance. The S&P 500, the most representative index for domestic companies, gained 15.3% in the first half of the year. While that figure is

quite strong, a narrow subset of stocks – the "Magnificent Seven" technology names – really powered the outperformance.

The catalyst for these impressive movers is the technological shift toward artificial intelligence and cloud computing, and the perceived impact of those solutions on corporate revenue, human capital cost savings, and ultimately future earnings growth. But investors have been willing to pay enormous prices to participate well in advance of profit or even realization of sales projections. It is a mania, not wholly without merit, which has been reflected in the outsized gains of a handful of well-positioned companies.

Beyond the concentration of returns in a handful of names, other important diversifying asset classes experienced more modest results. Mid-sized companies rose 6.1%, while small caps declined -0.7%. International stocks rose 4.5% and emerging economies advanced by 7.6%. Bonds were generally flat on a total return basis and yields remain attractive around 5% annually. Commodities also provided lift to performance, rising 8.3% so far. In general, a well-diversified investment portfolio, mindful of risk, has recorded healthy high single-digit returns to date in 2024.

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Turning to the state of the economy, things are generally fair on the inflation and growth fronts, although there are recent signs of stress. These signals include commercial real estate distress, higher credit card delinquency rates, concerns about regional bank balance sheets, fewer job openings, lower savings rates, early distributions from retirement accounts, and reduced discretionary spending among the lower income tiers. But on balance, the economy is performing reasonably and hovering around or just below historical averages, opening the window for a shift in monetary strategy. Let us delve deeper into the implications for these policy moves looming on the horizon.

Since early 2022, COVID-era levels of inflation, resulting from both supply side constraints and government-stimulated domestic growth, have been countered by meaningfully restrictive monetary policy in the form of sharply higher interest rates. In other words, the economy was running hot, and the Federal Reserve needed to be active and sober to curtail higher prices and their detrimental impact on American citizens. Like in fencing, the economy thrusts, and our policymakers parry defensively. When the time is right, our policymakers get offensive, and counter. This is the back-and-forth game that underpins asset prices and market valuations.

At this stage of the duel, inflation is cooling, thankfully, and is now closer to target levels of 2% after spiking to nearly 9% during the depths of COVID. Getting inflation to around 3% post-pandemic is really quite an accomplishment, given (1) the transition of our economy to remote, (2) deglobalization and anti-immigration policies in a more isolationist world, and (3) energy producers using natural resources as a cudgel to hurt energy importers. But a central reason for cooling inflation is a slowdown in the economy. Forward-looking estimates of GDP, a measure of domestic economic activity, have begun to slip below normal levels. Unemployment is slowly moving higher at 4.1%, the highest level since late 2021. Payroll growth is slowing,

and wage gains are ebbing. These trends, in moderation, are in fact welcome for the populace in general despite trending in a seemingly negative direction.

Slowing job growth, rising unemployment, and falling inflation then gives the Federal Reserve an opportunity to cut interest rates and stimulate economic activity. The current consensus is that we may see two quarter-point reductions in the Federal Funds Rate in this calendar year, beginning almost certainly in September and then perhaps again in November or December. This is welcome news for capital markets and asset values since a lower risk-free rate and a potential reduction in debt servicing costs give more ammunition for consumer spending and higher corporate earnings. The parlor game for Wall Street is anticipating the magnitude and timing of these cuts and positioning early to profit should policymakers succeed in landing the plane softly and avoid sparking a recession.

So, it appears we are transitioning from an inflation-driven backdrop where interest rates would remain higher for longer to perhaps a more investor-friendly environment with more discretionary investment dollars in the system, certainly so for the upper income tiers. Yet inflation remains stickier than the market is reflecting. One concern is that a "new normal" of elevated prices will keep upward pressure on the longer-term rates that are outside of the control of the Federal Reserve and its manipulation of the short-term Fed Funds rate. Once corporations are required to go back into the market to refinance their debt, interest costs may effectively triple while cash becomes a far less productive income source. Rate cuts may not be as stimulative as the past, and financial markets may well be mispricing this risk to liquidity and corporate earnings.

And, while the near-term economic effects of lower interest rates policy are positive, looking more broadly, there are growing concerns about the lasting impacts of decades of profligate spending. This is a critical issue many are reluctant to address but a subject worthy of attention for both prudent capital allocators and informed observers.

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The current national debt is approaching $35 trillion. That figure reflects the mismatch between government spending and tax revenues – more simply, we are spending far more than we bring in to meet the obligations of running the country. During periods of crisis, such as wartime or pandemic, deficit spending, or the amount by which spending exceeds income, is natural and understandable. But in 2024, that gap is expected to come in at $2 trillion. Baseline spending alone is now consistently at levels rarely reached in history except in times of national emergency. Debt servicing costs are trending to be the highest, as a percentage of GDP, in two hundred years.

Elected officials on both sides of the aisle are complicit in the situation we find ourselves in. Tax cuts, loan forgiveness, foreign aid, and corporate bailouts – whether business-friendly or populist – all contribute meaningfully to soaring debt levels and rising debt servicing requirements. Since 2008, our national debt has climbed from 38% of GDP to 123%, meaning we owe more than the value of all the goods and services we

produce as a nation in a year. Our elected leaders appear unwilling to rein in irresponsible spending because of political, self-serving reasons. But servicing this debt to the tune of $2.4 billion each day reduces our ability to responsibly fund important programs that improve the lives of everyday Americans. And high, persistent debt levels suggest that over the long-term, interest rates will trend uncomfortably higher as bond buyers ask for more return for owning US government notes. Over the long-term, the situation is untenable unless our elected officials get serious about fiscal austerity and act like the adults in the room.

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Of course, this is an election year with intense political polarization. We are intentionally apolitical and clinical in our perspective and the implications for the economy and market performance. A GOP victory will usher in further tariffs on foreign goods, and the pass-through of those levies will result in higher consumer prices for inexpensive items sourced overseas, reversing progress made on inflation. Corporate tax levels will come down, and the tax cuts of 2017 will be permanently extended. This will significantly reduce federal revenue inflows and cost $4 trillion over the next decade (even without further corporate tax relief), and ultimately push our debt-to-GDP ratio to over 200%, according to the Congressional Budget Office. If the incumbent party holds serve and retains office, additional student debt relief, tax credit measures tied to reducing emissions, potential rent control measures, and robust foreign aid packages will continue to add to the bill similarly. Without legitimate, offsetting revenue measures, neither party is immune from criticism for the explosive growth of our national debt. But whichever party emerges victorious will be hamstrung by the debt and the deficit, limiting the efficacy of their policy goals with the structural millstone of massive interest costs.

We can ascribe the rising political discord, and how we as a nation got here, back to the Global Financial Crisis of 2008 and the measures taken since to keep our economy afloat. Since then, we have largely experienced a K-shaped recovery, where asset owners ("the haves") saw great gains, while others without appreciating assets struggled to make ends meet. Our economy has remained resilient, but not everyone has benefitted. Borrowers who lacked the ability to access capital when interest rates were low are now facing higher prices and a lower standard of living. On the other hand, our wealthier citizens enjoyed cheap capital for over a decade and widened their margin over their less fortunate neighbors. Whether income or ideology, the current political climate reflects an "us versus them" world that is easily exploitable by populists on either side of the aisle who stoke the flames of discord.

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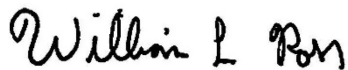
Given the state of the economy and the political landscape, how are we positioning client portfolios? We continue to diversify into asset classes that have yet to fully participate in the exuberance enjoyed by the largest technology names. Those areas include overseas exposures and an increased allocation to small- and mid-sized names. With interest rates cresting in the short term, we are rotating out of money markets and into bonds of longer yet modest duration that will provide attractive yields and the potential for price appreciation and total investment return. We look to lock in higher income levels for longer periods of time,

as the attractiveness of cash and cash equivalents abates under a lower interest rate scheme. A cautious and diversified positioning is prudent, but we remain opportunistic, ready to take advantage of a more rational risk and reward framework.

We would urge readers to reach out to discuss these complex issues and to engage with us on financial planning topics. For some, the world may seem to be out of balance. We stand ready with reassurance, guidance, and steadfast counsel. Now that the pandemic is well in the rear view mirror, it is time to review and re-calibrate to best align your goals and desires with your investment portfolio. We welcome these conversations.

We continue to be honored by your trust.

Best,



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