North Forty Two & Co. 2025 Investment Outlook: Navigating Policy Change Amidst Fully Valued Markets

One of the great joys of our responsibility to clients and friends is to opine on the economy, financial markets, and geopolitics in this biannual commentary. There is never a dull moment in researching and analyzing developments here and abroad and their potential impact on wealth generation and capital preservation. While we are not soothsayers, our outlook guides our investment decisions and tolerance for risk under the non-negotiable fiduciary standard of avoiding foreseeable harm. In this piece, we will attempt to inform on current conditions, delve into what lies ahead, and highlight the potential implications for investors in the near-term.

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To begin, we have just witnessed the democratic handover of stewardship from one administration to another and are embarking on a sea change in political and economic policy. What policy changes do we face in 2025 and how will they impact the domestic economy? For folks in our industry, the key issues to wrestle with are (1) a more isolationist, tariff-driven approach to global trade and economic relations and (2) any earnest consideration of the growing national debt. To be fair, the first issue is more related to the change in the executive branch than the latter, which is a continuation of decades of fiscal profligacy from Congressional legislators and accommodative monetary policy from an apolitical Federal Reserve. Let us begin with the more immediately disruptive issue, that of tariffs.

The incoming administration campaigned on using the American bully pulpit to implement broad-based duties on imports. As of this writing, the platform is for 25% tariffs on imported goods from Canada and Mexico and an additional 10% on Chinese imports beginning next week. Targeted and modest duties are an integral, long-standing part of a bilateral negotiating process to reconcile trade imbalances between nations and boost domestic industrialization. Tariffs were once a critical contributor to rapid industrial expansion in the nineteenth century and provided, at times, as high as 95% of federal revenue, until the federal income tax was instituted in 1913. The new administration is pointing to post-Reconstruction history in questioning the dependence on income taxes in lieu of a tariff-based revenue plan to support government services. But aggressive tariffs also bring the risk of instigating a potentially disastrous trade war, as evidenced by an American-induced escalation beginning in 1929 that reduced trade with Europe by two-thirds and accelerated economic and political turmoil in the 1930s, ultimately setting the stage for events that precipitated World War II.

At home, a misguided tariff policy will almost certainly result in higher inflation, spooking the Treasury market and sending equity and credit markets into a tailspin. Remember, tariffs are ultimately levied on US importers and passed through to consumers in the form of higher prices. Those duties also encourage an even stronger US dollar, which seems great on a more superficial level until the ability of our multinational corporations to export US goods is constrained by higher costs to international consumers. In our view, a downshift to a more narrow, targeted scheme and a freer trade policy stance would reduce friction and uncertainty and be more welcome to the global economy. That may well ultimately be the outcome, but the process to get there is heated and messy and rife with peril.

Another issue central to financial markets is our debt obligations and any attempt to rein in domestic spending. Our mid-year note addressed the national debt and the mismatch between government spending and tax revenues (we would encourage those interested in more detail to revisit this piece: 2024 Mid-Year Update). But in a nutshell, one statistic summarizes the dilemma — our national debt grows by $1 trillion every 100 days. In other words, on $36 trillion of existing debt, aggregate US government borrowing rises 3% every three months. According to recent testimony from incoming Treasury Secretary Scott Bessent, “the federal government has a significant spending problem.” We do.

But in addressing this spending problem, part of a holistic solution is not necessarily higher taxes. While federal revenue is in line with post-war averages at 17.1% of GDP (gross domestic product, or a measure of national output), federal spending sits at 23.4% versus a historical average of 19.8%. Research shows that around 18% is in the sweet spot for revenues to be additive to economic growth, with 15% as the bare minimum threshold for viability, according to the World Bank. Federal revenues are currently at a near optimal level, economically speaking. Bringing down federal spending is the proper remedy, but the political reality is that accomplishing truly impactful spending reductions is largely intolerable for our elected officials on both sides of the aisle.

This drastic mismatch between revenue and spending will be in the forefront in 2025, principally because the Tax Cuts and Jobs Act (TCJA) of 2017 is subject to expire at the end of the calendar year. Conventional wisdom suggests that extending the tax cuts would automatically increase the deficit; in a vacuum the answer is yes, but the issue is more nuanced than it may seem from a broader macroeconomic perspective, because again any significantly higher level of tax revenue as a percentage of GDP than at present has historically presaged recession. Recessionary conditions would then fuel even more deficit spending and pile onto the debt total. This is a complex conundrum that requires a surgical, bipartisan approach uncommon on Capitol Hill.

We need to sharpen our pencils — the current administration will need to find a way to make the math work, within reason. To fund the costs of the tax cut extension, they cannot simply rely on tariff revenue as they might have in a less interconnected global economy such as in the nineteenth century. The challenge is that tariffs that are too onerous will change consumption behavior and suppress anticipated revenue gains. In addition, as our $36 trillion debt bill grows and foreign sovereigns continue to curtail

their purchases of US government obligations (perhaps even encouraged by the change in tariff policy), rates are likely to rise, as buyers require greater return for owning our bonds. Higher rates, regardless of cause, are a punitive headwind for the economy and financial markets and remain one of our principal concerns going forward.

In short, our current fiscal situation is extremely uncomfortable, any fix will be complicated and fraught with uncertainty, and the elixir will not taste great. But we are past the point of simply hoping to grow our way out of this mess without significant course correction.

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Widening the lens from a narrow focus on our immediate fiscal position, where do we stand now economically? Despite some heated political rhetoric suggesting otherwise, the domestic economy is comparatively healthy, yet still on unsteady footing. On the economic front, growth is slowing yet acceptable, labor markets seem generally strong, and inflation is relatively under control compared to the pandemic era. Let us review these three critical economic measures in more detail.

First, a look at the central measure of economic growth, which is naturally impacted by the latter two factors of labor and inflation. An ideal economy grows at between 2% and 3% annually as measured by GDP. Growth below the lower bound requires stimulus, and growth above the higher bound suggests more restrictive monetary policy ahead to avoid an overheated economy. Globally, GDP growth for the G7 nations (which includes the US at a remarkable 52% weighting) stood at around 0.5% through September, a very modest figure. Domestically, US GDP for the first three quarters of 2024 stood at around 2.6%. For illustrative comparison, GDP in the 2010s averaged 1.9%, and that slower growth required more a more accommodative, aggressive liquidity stance — fiscal spending and tax cuts as well as sustained zero interest rate policy — to stimulate economic activity into the desired range. By these parameters, economic growth is solid; however, upon further scrutiny, the data is noisy and there are conflicting underlying signals that point toward a more difficult backdrop for investors. US growth is trending lower over the past several quarters, which in concert with an uptick in inflation, suggests more stagnant market conditions to come.

Next, a review of labor markets. Ideal labor markets are assessed through the unemployment rate for those citizens of working age, who are available to work, and are actively seeking employment. A healthy workforce naturally has an unemployment rate between 4% and 6%. At the lower end, there is overheated upward pressure on salaries, and at the higher end, there is a threat of decreased consumer spending and resource hoarding for better times. At the end of 2024, unemployment stood at 4.1%, and the outgoing administration recorded job gains in each month of the prior four-year period (although this headline accomplishment is heavily influenced by post-pandemic rehiring). Labor markets are generally tight, yet the prevailing sentiment is that the balance of power will gradually shift back in the favor of employers, with both positive and negative implications for wages and quality of work life. This

data is also noisy. It is important to note that while government jobs represent under two percent of the total workforce, 18% of recent job gains can be attributed to federal government hiring. Certainly, novel governmental efficiency initiatives under the new administration will tamp down those job gains and put upward pressure on unemployment.

Finally, some thoughts about inflation, which has been a principal issue for American consumers and served as a central issue in the Presidential election. After spiking in the wake of the pandemic to 8% in 2022 and just over 4% in 2023, the most recent core inflation reading for 2024 slowed to 3.2%, and overall inflation rose 2.9% year-over-year. Directionally, things appear fairly good — the Federal Reserve targets a 2% rise in prices annually as ideal price stability for a well-performing economy as they try to balance rising prices and economic growth. When inflation is elevated, monetary policy adjusts to take money out of the banking system to throttle rising prices. So, for now, headline inflation remains elevated relative to target and trending decently over the multi-year period. But closer scrutiny since mid-year reveals a reacceleration in monthly readings. We are certainly not out of the woods on the inflation front and continue to monitor this key input to asset prices.

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Now that we have addressed economic conditions and policy considerations going forward, we can turn to a review of the past calendar year. Coming into 2024, many stocks were rich by any objective measure. The consensus was that earnings growth would be slightly above average at just over 9%. All things being equal, without expanding the already extended price-to-earnings ratio (the standard metric for reasonable value), the high end of assumptions reflected that percentage increase, or about an average market return of 9%. When the final scoreboard was tallied, performance vastly exceeded those expectations and defied the prognostications of many market observers, ourselves included.

What happened in 2024? Earnings growth came in generally in line, but prices accelerated and price multiples advanced as future returns were pulled forward by euphoric investors. The S&P 500 Index rose 23%, driven by a remarkable increase of 67% in the “Magnificent 7” group of large-cap growth companies. Artificial intelligence emerged as the key theme, boosting communication and technology names to nosebleed valuations with a yet-to-be determined understanding of future profit potential.

Returns for mid- and small-capitalization stocks were more normalized at around 13% and 9%, respectively. These diversifiers proved worthwhile from a risk standpoint but continue to lag the performance results of their large company brethren. Similarly, developed international stocks rose 3.5%, emerging markets advanced 6.5%, and despite three rate cuts (far fewer than anticipated by others), bonds gained just 1.3%. Cash and cash equivalents, earning over 5%, proved to be far more attractive than fixed income of a longer duration.

While the marquee performance of stocks was double that of the average of the last decade, a modestly diversified balanced portfolio returned 10.6%. A more evenly weighted portfolio with greater allocations to traditional diversifiers such as value stocks, international equities, real assets, and cash paled in comparison to concentrated US stock portfolios. By that measure, our calendar-year results may have fallen short, although we consistently ask to be measured through a longer time horizon and through complete market cycles. Our orientation is toward intrinsic value and investment performance reversion, through the prism of risk management and wealth preservation. A momentum market such as 2024 will not fully reward that prudent stance. Like many, we did not benefit as much as we would have liked from the exuberance of technology stocks last calendar year. For that, we are humbled.

What is the outlook for investments going forward? Here there are two considerations — the changes in policy, and current price levels. To start, on the policy front, measures supportive for markets include a tax cut extension, further deregulation, and an increase in merger and acquisition activity. A shift in tariff stance portends a wide range of outcomes, ranging from mildly positive to decidedly negative. A crackdown on immigration will change the mosaic of the labor force and potentially introduce unanticipated influence on goods inflation. And to repeat, the elephant in the room of persistently increasing debt and deficit levels will threaten the probability of meaningfully lower interest rates, absent the winds of recession.

In terms of asset prices, we are students of financial market history, and the single greatest input for future returns is the level of starting valuation. US equity markets are in the top decile of overvaluation going back to when we were in short pants. Growth stocks are trading at a 35% premium to historical norms. The equity risk premium, or extra compensation to investors for owning stocks, is negative and at a level last seen during the dotcom boom and bust in 2002. The last time price-to-earnings ratios (a measure of valuations) were this high, the next decade of stock market returns was a cumulative zero. This occurred in the aughts, and the performance-detracting diversifiers in which we are positioned currently drove returns and helped mitigate the impacts of a narrow stock market, similar to the conditions we have now.

Caution remains warranted, and we are not alone. For instance, Vanguard recently published long-term capital market assumptions — among the projections that underpin our financial planning process — that share our moderated outlook, suggesting that the average annual return for stretched U.S. stocks will settle out between 2.8% and 4.8% over the next decade. For more Wall Street-oriented firms such as JP Morgan or BlackRock, that estimate is a shade over 6%. In the aggregate, pundits expect future returns for the US stock market to be meaningfully below historical long-term averages, and investor attitudes should be adjusted accordingly.

At the portfolio management level, we are looking to take advantage of relative valuation disparities in underappreciated asset classes and sectors. Specifically, we expect value-oriented, dividend-paying stocks in more defensive sectors such as financials, energy, and healthcare to offer greater prospects for excess return. With interest rates trending between 4.5%-5%, debt servicing is a far greater challenge than in the zero-bound era, and the higher-growing names in the technology sector face greater headwinds versus companies with higher free cash flow trading almost as an afterthought. Additionally, we are increasing allocations to profitable mid- and small-capitalization stocks that are trading at significant discounts to historical levels, to take advantage of a widening market.

On the fixed income side, our expectation is that interest rates will normalize at slightly higher levels around 5%. With a more traditional economic backdrop, we might be quite satisfied buying intermediate-term bonds knowing that the desire is to bring short-term rates down. But between inflation, Treasury demand, and our need to roll over and refinance *nine trillion* in maturing debt in 2025, interest rates are likely higher for longer. The notion of six or seven quarter-point cuts in the Federal Funds rate, largely a consensus at the beginning of last year, is now but a fantasy absent a financial calamity. We will be adding tactically to longer-duration fixed income positions as the interest rate picture becomes clearer and the risk of value impairment abates.

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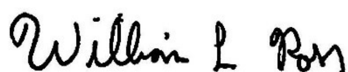
One of the great American investors and writers is Howard Marks of Oaktree Capital. One of his mantras is that "the riskiest thing in the world is the belief that there is no risk." Our sober approach reflects this mindset. We are rationally objective investors in a "fear of missing out" world, comfortable with not participating fully in frothy, exuberant financial markets to preserve investment gains and manage the life-altering impact of natural drawdowns to which investment participants are exposed. Our results in the past year may not have met our expectations, but we remain confident that our durable portfolio management approach will successfully navigate the next inevitable storm of volatility.

We continue to be honored by your trust.

Best,



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