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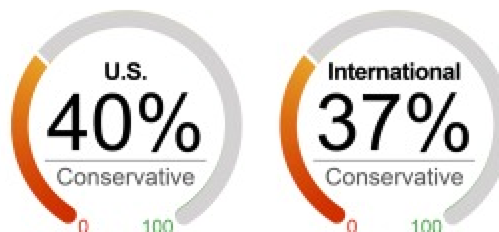
February 2023

The Navigator

Current Equity Exposure



Markets advanced in January, driven by moderating inflation, China's reopening, and hopes of a soft landing. However, we remain underweight equity in the short run as we believe such a rally is short-lived, and markets are vulnerable to negative surprises – policy uncertainties, declining earnings expectations, and worsening activity momentum. Despite cooling inflation, some recent economic data, including contracting PMIs, weakening consumer spending, soft homebuilders, and falling leading economic indicators, demonstrated weaknesses in business and consumer conditions. Also, we see central banks keeping monetary policy tight to combat high core inflation, rather than the market views for rate cuts sometime soon this year.

The Factors

Valuation

- Valuation metrics for equity remained negative. P/E increased from 18.6 at the end of December to 19.8 at the end of January.
- Forward P/E rose to 18.4 at the end of January from 17.4 at the end of December.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remain negative with high bond yields.
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Sentiment

- U.S. manufacturing activity continues to contract, with the ISM manufacturing index falling to 48.4 in December.
- University of Michigan consumer confidence rose in December to 64.9 but remains strikingly low, with higher interest rates and high inflation weighing on sentiment.
- The NAHB index increased to 35 in January, helped by the moderate decrease of mortgage rates.
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Technical

- Technical indicators were neutral, with the decline of short-term reversal signals offset by momentum signals and fear indexes.
- The S&P 500 was 3% above its 200-day moving average, 5% above the 100-day average, and 3% above the 50-day average.
- The VIX index decreased slightly this month and settled at 19.6, with optimism on moderating inflation, China's reopening, and a potential soft landing.

Macroeconomic

- The nonfarm rose by 263,000 in December. The four-week moving average of initial jobless claims fell to 197,500 for the week ended January 21.
- Retail sales tumbled in December by 1.1%. High inflation is eating into real income growth, while rising interest rates are increasing financing costs.
- U.S. industrial production fell 0.7% in December.

What's Driving the Markets?

China's Reopening: Chinese stocks rallied in January with the optimism that domestic demand will recover after Beijing abandoned its zero-COVID policy. A Reuters survey forecasted that China's economy would grow at the rate of 4.9% this year versus a rate of about 3% in 2022. We believe that China's reopening will also benefit EM assets as China represents a significant portion (about 30%) of EM indexes. Also, growing Chinese demand will likely boost exports for other EM countries with strong links to China.

Corporate Earnings: The blended earnings decline for the fourth quarter for the S&P 500 was 5.0% as of January 27. We see a more challenging outlook with negative earnings revisions as 2023 progresses since 1) Corporate pricing power will likely start to decline with producer price disinflation (PPI fell 0.5% in December). 2) Supports from pent-up demand and consumer excess savings are dissipating. 3) As earnings revisions are strongly correlated to PMIs, contracting PMI (48.4 in December) indicates that earnings estimates might be susceptible to further downgrades.

Inflation: Peaking inflation continued to be a silver lining for the equity market, with headline consumer price index and core consumer inflation falling to 6.5% and 5.7%, respectively, on a year-ago basis, the slowest pace in over a year. We expect inflation to moderate further this year, but our view is that U.S. inflation will likely settle closer to 3% (versus the Fed's 2% target). Also, the pressures from a tight labor market might keep elevated inflation stick around longer than investors have expected. Our wage index shows that wage inflation moderated in December but remained high at 5.7% YOY.

Federal Reserve Policy: We expect monetary policy uncertainty remains high despite the slowing pace of rate hikes. Inflation has peaked but will likely stay above target; thus, Fed needs tight financial conditions to keep growth below trend. We anticipate a peak fed funds rate of about 5% (a 25bp hike in February and possibly another 25bp in March) and remain there for a while.

As of 1/31/23. Data provided by Bloomberg, NorthCoast Asset Management, Federal Reserve History.

1 The NorthCoast Navigator is a market barometer displaying NorthCoast's current U.S. and international equity exposure and outlook. This aggregate metric is determined by multiple data points across four broad market-moving dimensions: Technical, Sentiment, Macroeconomic, and Valuation. The daily result determines equity exposure in our tactical strategies.

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