NorthCoast
Asset Management

Quarterly Client Update

Q2 2021

June 30, 2021

"Each time history repeats itself, the price goes up."

~ Ronald Wright

The shared office space company WeWork's valuation crumbled in September of 2019. NYU Stern marketing professor Scott Galloway at the time compared cheap capital to a drug by saying, "People were high. There's not a human being in America who doesn't look at the number forty-seven billion dollars"—WeWork's valuation in January—"and not get goosebumps. It seems insane now, but at the time it made so much sense." (Widdecombe, 2019). In this case the chief victims were institutions like SoftBank and Saudi Arabia's wealth fund (one of SoftBank's biggest backers). Softbank, who wrote off billions of dollars, later rescued WeWork as they were running out of money in October with a cash investment that valued WeWork at $8 billion. So to recap, in January of 2019 WeWork was valued at $47 billion and planning its IPO, but by October it was worth only $8 billion. And again, this is a company that buys and leases office space! This is not a difficult valuation exercise for anyone with access to a spreadsheet, let alone the tools available to SoftBank.

So what happened? Nothing new – simply greed and ego. People were caught up in the emotion of the moment. And yet in my mind here we go again, just two years later. This time the unicorn in question is Robinhood, an online brokerage company with the stated mission to "democratize finance for all."[2] We received insight into its business this past week with the filing of its S-1 which is an SEC registration requirement for companies wishing to be listed on a national exchange. Among the 400 pages were some interesting takeaways. For the true believers, $128 million in revenue one year ago in Q1 2020 compared to revenue of $522 million today in Q1 2021 will be the most intoxicating. I wonder if people will pay attention to the other disclosures like (1) a 1,375% increase in trading cryptocurrency (primarily Dogecoin) over that same time, (2) the company is holding almost $12 billion of crypto on its books (including almost $4 billion of 0.24 cent Dogecoin), (3) the impact of the short-squeeze phenomenon of GME and AMC that saw meme stocks explode into our consciousness, (3) the $70 million payment to settle claims by FINRA for distributing false and misleading information, or (4) that 81% of its revenue comes from payment for order flow. Conventional valuation models are being thrown out the window once again even though there is nothing new about the process of valuing broker/dealers (think public companies such as Schwab, Morgan Stanley, Interactive Brokers). One interesting and eerie similarity to WeWork – Robinhood is seeking an IPO of greater than $40 billion.

When I started in this business in 1994, some early reads were books like *Grow Rich Slowly*, *The Millionaire Next Door*, and *Beating the Dow*. They resonated with my Midwest mindset by emphasizing age-old wisdoms such as there is no free lunch, the value of saving money, and compounding wealth at 8-9% a year over time. This is why I have a hard time understanding people in search of a quick dollar or lottery ticket investing like the Robinhood environment we are in now. Returns over the recent past have been significantly above average. Please don't get caught up in forecasting similar gains into the future. In fact I would ratchet down return expectations over the next 2-3 years as we absorb and navigate the trillions of dollars in government spending used to stimulate the economy along with the unintended consequences. We are already witnessing one of the few bad starts US bonds have seen the last couple of decades at a -1.60% return since 12/31/20. The typical 40 in a 60/40 portfolio is becoming a headwind vs. a longstanding tailwind as inflation expectations increase. This alone will make investment compounding for typical allocations more challenging.

From a portfolio standpoint, we are slightly more positioned for rising rates. Stock portfolios added names like DVN (oil), FCX (minerals), and ADM (food) in the second quarter aligning with the direction of the May consumer price index (measuring the cost of food, housing, gasoline, and utilities) which jumped by 5% from the previous year. In fact, food prices jumped 0.5% in May alone primarily because people want proteins, and

"The fish – will it be the market price at the time of ordering, the time of eating or the time of paying?"

gasoline has swelled by 56.2% over the last 12 months, recovering from pandemic dips. While Federal Reserve officials have said these price increases are transitory, I'm not sure retirees would agree. In our ETF portfolios, FNCL (financials) and FENY (energy) as well as interest rate hedged corporate bonds (IGBH) and high yield bonds (HYGH) are becoming more useful. Inflation, though, is not a foregone conclusion. The second quarter also saw the ten year bond rally with its yield back to 1.42% as of June 30 supporting the Fed's view. Incorporating data from the OECD (leading economic indicators), Michigan (inflation expectations), and Global PMI's will prove important as we navigate ahead. Using a sailing metaphor, I believe the rest of the year will see us continue to slowly track into inflation headwinds with securities that tend to benefit during those times.

As you will read on the pages ahead, we are still optimistic about the equity markets as the backdrop continues to support higher prices. Flush with liquidity and consumer demand, our base case today is that snap corrections may be scary but shallow (-5-8%) as stocks still present themselves as one of the best ways to protect long-term purchasing power. Until we begin to see economic conditions slow and investor sentiment shift, our investment level will most likely stay above our long-term historical average. Our portfolios have benefitted from this positioning YTD and I believe will continue to do so (although I'm guessing more muted in the second half). We had that little correction in May (-4%) due to inflation tension, which I believe will remain the root cause for any volatility throughout the rest of the year. Capital will be absorbed and will adapt to conditions, creating air pockets along the way. If you have any questions or comments about your portfolio, please check in any time. Our advisors are terrific and stand ready to help with portfolio positioning and financial planning. Enjoy your summer! Personally I'm excited for the Olympics and more backyard barbecues. Go USA!

Warm regards,

Dan Kraninger
President & CEO

Notes:

1 Widdecombe, L. (2019, April 10). *The Rise and Fall of WeWork*. The New Yorker. https://www.newyorker.com/culture/culture-desk/the-rise-and-fall-of-wework
2 https://robinhood.com/us/en/support/articles/our-mission/
3 Data sources: Bloomberg, NorthCoast Asset Management.

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Inflation and the Fed

Julia Zhu
Senior Vice President, Market and Security Research

The second quarter has seen broadening economic recovery, booming global manufacturing and rebounding business and consumer sentiment along with significant market-moving events such as massive inflation beats and a hawkish Fed surprise. So far, the bond market reaction to these developments has been mostly muted with the 10-year U.S. Treasury yield drifting lower by 27 basis points to 1.47%. The decline was initially driven by real yields as the labor market recovery was slower than expected and later driven by the breakeven rate as inflation fear retreated last month (Figure1). Overall, real yields were a dominating force of the move (24bps).

Over the past few months and likely for the rest of year, the markets will be focused on two major themes:

1) Should we be concerned about the recent higher inflation surprise?
2) Could a hawkish Fed derail the market, especially after the June FOMC?

Our view is that the recent rise in inflation is largely driven by transitory factors. Headline CPI rose 0.6% in May after rising 0.8% in April. Looking closely at the data (Figure 2), these transitory factors added 0.4% to the CPI in May, and included skyrocketing used car prices (caused by a global shortage of semiconductors) along with solid gains in airfares after consumer travel resumption.

Looking forward, we believe that spiraling inflation is unlikely to occur given the amount of slack in the labor market and the still-anchored inflation expectations combined with a relatively flat Phillips curve. In the expectations-augmented Phillips curve model – the main framework the Fed utilizes to differentiate between transitory and persistent inflation ($\pi_t = \pi_t^{\,e} - \beta(u_t - u_t^{\,*}) + e_t$) – the inflation rate can be forecast using three factors: 1) inflation expectations; 2) the slack term determined by the unemployment gap; and 3) the error term. As we have observed, both the market-derived 5y5y breakeven and the University of Michigan survey-based inflation expectations have generally drifted lower since 2015, and they actually softened after the hawkish signal from the June FOMC. For the slack term, the Fed has to consider the recent mixed labor market data and realize that the unemployment rate is still as high as 5.8% – quite a ways from full employment. Furthermore, the statistical relationship between employment and inflation is less significant in recent years (a flat Phillips Curve). The movements in the error term capture mostly short-term inflation dynamics, including much of the “supply shocks" that we are currently experiencing such as energy price increases and supply bottlenecks. Nevertheless, we expect these supply constraints to ease in 2022, and inflation to moderate in the medium term together with the passing peak of pent-up demand.

Turning to the monetary policy outlook, we expect the Fed to initiate a gradual tapering of its asset purchase later this year, mostly likely in December but possibly in its September policy meeting. In our baseline scenario, we expect yields to remain range-bound even as the tapering announcement gets closer since markets have already been reasonably priced for the tapering process. In fact, even prior to the Fed’s June meeting, investors were expecting the Fed to begin tapering in early 2022 and have pulled forward the timeline after the June meeting.

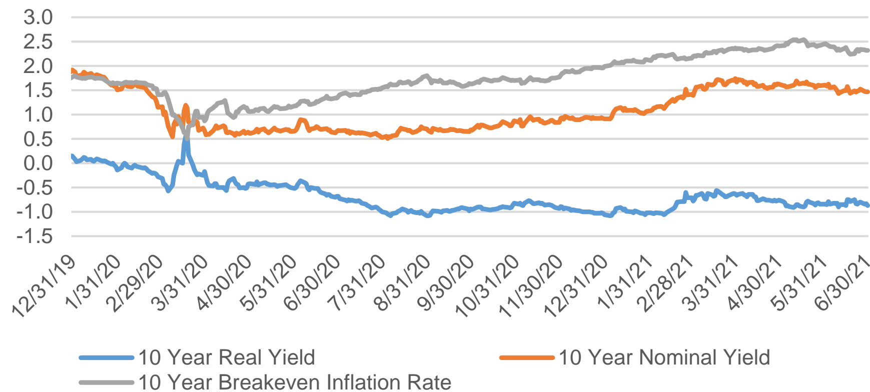
Given our positive outlook for the economic recovery, benign inflation view, expectations of well-communicated monetary policy together with accommodative fiscal policy, we maintain higher than benchmark exposures to credit and alternative assets in our Tactical Income portfolio. On duration, we keep a modest underweight position versus our benchmarks as our proprietary duration model indicated a slightly negative duration score. In the meantime, we think it’s still worthwhile to tactically hedge inflation risk as we expect a possible upside inflation surprise in the short term. Since March 31, 2021, our Tactical Income strategy has returned 2.6% net of fee, outperforming both the U.S. Aggregate Bond Index (1.8% return) and the Global Aggregated Bond Index (1.3% return).

For ETF selections, we continue to favor IGF and AMLP, supported by our positive outlook for the energy sector and growing chances of President Biden passing an infrastructure bill. Together with our real estate exposure through VNQ, these real assets ETFs also provide

efficient inflation hedging. We have added our senior loan exposure (SLRN) for its decreasing default rate and high yield, and believe that variable rate loans should benefit in the rising rate environment. We continue to allocate to duration hedged fixed income ETFs: HYGH and IGBH to actively manage duration risk.

Figure 1

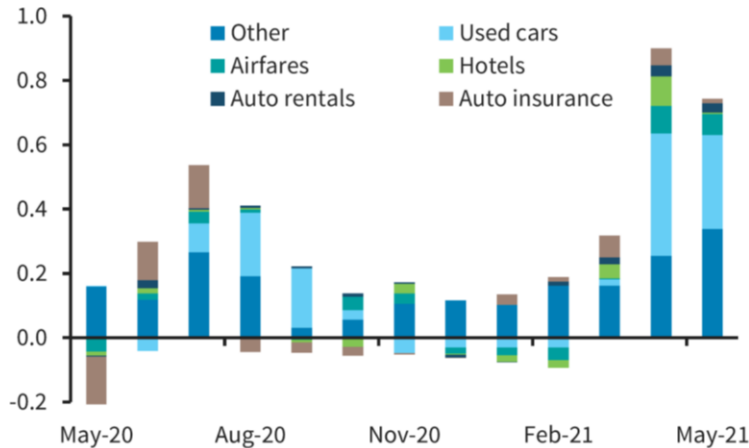
Treasury Yields Declined in the Second Quarter of 2021



Source: Bloomberg, NorthCoast Asset Management.

Figure 2

Contributions to Core CPI (%m/m)



Source: Bloomberg, NorthCoast Asset Management.

Note: Data from Bloomberg, NorthCoast Asset Management.

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