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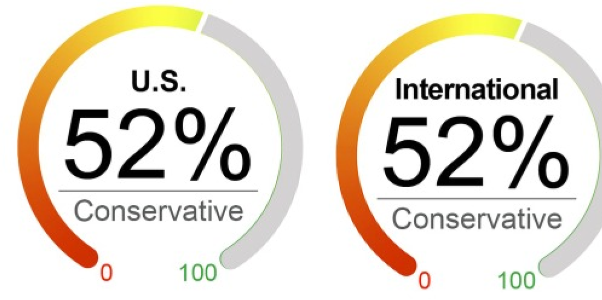

April 2023

The Navigator

Current Equity Exposure

U.S. 52% Conservative (0–100)

International 52% Conservative (0–100)

Major equity indexes ended the month of March higher: the S&P 500 and the Dow gained 3.7% and 2.1%, respectively, while the technology-heavy Nasdaq advanced 6.8%. However, the ride hasn't been a smooth one as the month began with turmoil in the banking sector. Although it's still too early to have a clear view of the current financial sector stress implications, we believe that the recent events may lead to further tightening in bank lending standards and a pullback in credit availability that could prove to be a headwind for economic activity. At the same time, we expect central banks to come closer to the end of rate hikes, while keeping interest rates high to fight high inflation. We stay underweight equities as we believe the risks remain skewed toward the downside but are nonetheless ready to seize opportunities as risks become priced into the market. We utilized the sharp equity selloff as an opportunity to slightly increase our equity exposure to 52% for both the U.S. and international markets.

The Factors

Valuation

- Valuation metrics for equity remained negative. P/E increased slightly from 19.0 at the end of February to 19.6 at the end of March.
- Forward P/E increased to 18.7 at the end of March from 18.1 at the end of February.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remain negative with high bond yields.

Sentiment

- U.S. manufacturing activity contracted for the fourth month, with the ISM manufacturing index remaining below 50 at 47.7 in February.
- University of Michigan Consumer Confidence Index fell to 62, with persistently high inflation, recession fears, and financial market stress.
- The NAHB index increased by 2 points in March, indicating builders are cautiously optimistic.

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 4% above its 200-day moving average, 3% above the 100-day average, and 2% above the 50-day average.
- The VIX index spiked amid stress in the banking sector during the month but decreased and settled at 18.7 with a relief rally.

Macroeconomic

- Nonfarm payrolls rose by 311,000 in February, exceeding expectations. The four-week moving average of initial jobless claims edged higher to 198,250 as of March 25.
- Retail sales slipped 0.4% after soaring 3.2% in January, with average monthly growth over the last four months still slightly positive.
- U.S. industrial production was unchanged in February.

What's Driving the Markets?

SVB closure and market implication: While we believe that the SVB closure is unlikely to escalate into a systematic banking crisis, what happened at SVB indicates a more widespread mismatch between bank assets and liabilities. The failures of SVB and Signature Bank might lead to a pullback in credit growth in the economy, which can be a meaningful headwind to overall economic growth. Banks with less than $250bn in assets accounted for 70% of loan growth last year and 80% of the outstanding commercial real estate bank loans, indicating the impact that recent bank failures may have on the economic landscape. At the same time, we believe that large banks (compared with smaller banks) are better positioned with greater liquidity, heightened risk management, more regulatory oversight, and better diversification.

Fed near the end of the hiking cycle: The FOMC increased the target range for the fed funds rate by another 25 basis points to 4.75% to 5% in its March meeting to continue its attempts to tame stubbornly high inflation amid turbulence in the banking sector. We believe that we are now closer to the end of the rate hiking cycle. The Fed's statement replaced its previous statement, "ongoing increases in the target range will likely be appropriate" with "some additional policy firming may be appropriate" – taken by the market as a dovish shift. Also, we believe the recent development in the banking sector is likely to result in tighter credit conditions, which would work to slow economic growth and eventually affect inflation. As a result, the Fed might need to do less tightening for its monetary policy.

Inflation: mixed signals: The February inflation sent some mixed messages, with the headline index decelerating (from 0.5% in January to 0.4% in February) but the core index rising more than anticipated (from 0.4% to 0.5%). Tight labor markets have kept wage inflation high. However, as the market rents already decelerated significantly in 2022, we expect the shelter and rental inflation (43% of core CPI) to moderate meaningfully later this year, which will be a key source of core disinflation (the rent growth shows up in the CPI calculation with a lag).

As of 3/31/23. 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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