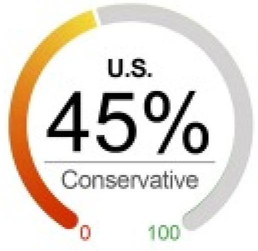
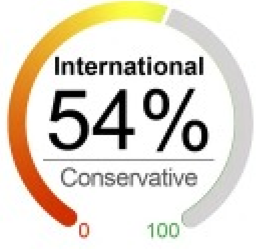
NorthCoast
Asset Management | A Connectus Partner

July 2023

The Navigator

Current Equity Exposure





Major equity indexes ended the month of June higher: the S&P 500 and the technology-heavy Nasdaq rallied 6.6% and 6.7% respectively, while the Dow advanced 4.7% for the month. We attribute stock performance year-to-date primarily to the expansion of multiples, as reflected in the P/E ratio expanding by approximately 17%. While the economy has displayed resilience recently, we believe the full impact of the monetary tightening is yet to be experienced. We anticipate a more challenging macro environment in the equity markets due to uncertainties in monetary policy, weakening consumer trends, and heightened recession risks. Moreover, we see a deteriorating tradeoff between growth and policy in the Eurozone, as the European Central Bank is expected to maintain a hawkish stance, Eurozone PMI indicators have softened, and the benefits derived from China's reopening are diminishing. Meanwhile, recent China data has also missed expectations across the board, including fixed assets investment, retail sales and industrial production. Against this backdrop, we have maintained a cautious stance in equities, with our U.S. equity exposure remaining at 45% and a reduction in international exposure from 61% to 54% during the month.

The Factors

Valuation

- Valuation metrics for equity remained negative. P/E increased from 20.0 at the end of May to 21.3 at the end of June.
- Forward P/E increased to 20.4 at the end of June from 19.1 at the end of May.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remained negative with high bond yields.

Sentiment

- U.S.manufacturing activity contracted for the seventh month, with the ISM manufacturing index dropping to 46.9 in May from 47.7 in April.
- The University of Michigan Consumer Confidence Index rose to 64.4. It remained weak with persistently high inflation, high interest rates, recession fears, and higher layoffs.
- The NAHB index rose above neutral level in June to 55.

Technical

- Technical indicators were positive, with momentum and fear signals outweighing negative reversal signals.
- The S&P 500 was 11% above its 200-day moving average, 8% above the 100-day average, and 5% above the 50-day average.
- The VIX index fell to post-pandemic low at 13.6 with market rally and subdued realized volatility.

Macroeconomic

- Nonfarm payrolls rose by 339,000 in May, far exceeding expectations. The four-week moving average of initial jobless claims was still high at 257,500 as of June 24.
- Retail sales grew 0.3% in May after rising 0.4% in April. Stubborn inflation and high interest rates are weighing on spending.
- U.S. industrial production decreased by 0.2% in May.

What's Driving the Markets?

Fed policy: a hawkish pause: After ten consecutive rate hikes, the Fed chose not to raise the target range of the federal funds rate, keeping it steady at 5% to 5.25%. However, there were upward revisions in the projections for the peak of the Fed funds rate, which increased from 5.1% in March to 5.6%, implying two more rate hikes down the road. The upward revision of Fed rate paths came as a hawkish surprise to most market participants and was attributed to the slower-than-expected decline in core inflation this year. We anticipate that the Federal Open Market Committee (FOMC) will not initiate rate cuts until next March, as inflation is more persistent than anticipated.

Core inflation still elevated: The overall US inflation in May was softer than expected, primarily due to falling energy prices, with the headline Consumer Price Index (CPI) rising by 0.1% from the previous month and 4.0% from last year. Core CPI, which excludes food and energy, remained steady, experiencing a 0.4% increase in May and a significant 6.6% rise on a yearly basis. Encouragingly, the CPI for Owners' Equivalent Rent (OER)*, a significant component (40%) of core CPI, rose by 0.5% for the third consecutive month, a notable slowdown from the 0.7% increase in February. However, it's worth noting that the impact of future disinflation from OER on core PCE inflation (the Fed's preferred measure) would be less significant due to its lower weight of 17%. Core PCE inflation was up 4.6% in May from a year ago and has hovered consistently above 4% since late 2021.

Resilient growth with concerning signals: US equity market participants were encouraged by the recent resilience of the economy. On average, nonfarm payrolls increased by 314k monthly during the first half of 2023, and the Atlanta Federal Reserve reported a 6.0% wage growth for May. Despite mortgage rates reaching as high as 7%, housing activity in the US has reached its lowest point and displayed positive conditions as homebuilder confidence exceeded the 50-point threshold. Additionally, construction spending has witnessed three consecutive months of growth. However, beneath the surface, there are concerning signs emerging. The PMI index indicates that manufacturing activity in the US has contracted for the seventh month in a row. The leading economic indicator has entered a recessionary phase, and initial jobless claims have reached their highest level since late 2021. Looking forward, we anticipate more weakness in the economy from the lagged effects of the Federal Reserve's tightening policy, combined with banks restricting credit.

*Owners' equivalent rent (OER) is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property.

As of 6/30/23. 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.

NorthCoast Asset Management
One Greenwich Office Park, Greenwich, CT 06831, United States
+1 (203) 532-7000