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NorthCoast
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The Navigator

Current Equity Exposure

Stocks rose in July as initial earnings exceeded low expectations, and investors became hopeful about a "soft landing" scenario - sustained growth and decreasing inflation. The S&P 500 and the Dow advanced 3.2% and 3.4% for the month, respectively, while the technology-heavy Nasdaq rallied 4.1%. Despite market expectations of rate cuts in response to cooling inflation, we anticipate the central bank will hold rates high for longer. Meanwhile, we foresee second-quarter earnings likely to remain flat or even dip into negative territory, and a potential contraction later in the year with elevated wage costs eroding profit margins. Our view remains that the market's year-to-date performance is largely driven by the AI-themed Mega cap rally, which has resulted in an unprecedented 60-year high concentration of stocks in the S&P 500, raising concerns about a potential bubble. We expect increased market volatility down the road due to very concentrated stock positioning, the delayed impacts of the global tightening monetary policy on financial conditions, real estate sector challenges, consumer spending and liquidity, along with other geopolitical issues. Given this backdrop, we are maintaining a cautious approach to equities, keeping our U.S. equity exposure at 45% while slightly increasing our international exposure from 54% to 61% during the month.

The Factors

Valuation

- Valuation metrics for equity remained negative. P/E increased from 21.4 at the end of June to 22.0 at the end of July.
- Forward P/E increased to 21.3 at the end of July from 20.4 at the end of June.
- 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 eighth month, with the ISM manufacturing index slipping further to 46.0 in June from 46.9 in May.
- The University of Michigan Consumer Confidence Index jumped to 71.6 in July, supported by continued job growth and inflation moderation.
- The NAHB index continued to rise to 56.

Technical

- Technical indicators were positive overall, with positive momentum and fear signals outweighing neutral reversal signals.
- The S&P 500 was 13% above its 200-day moving average, 9% above the 100-day average, and 5% above the 50-day average.
- The VIX index remained at a post-pandemic low of 13.6 with a market rally and subdued realized volatility.

Macroeconomic

- Nonfarm payrolls rose by 209,000 in May, below consensus expectations. The four-week moving average of initial jobless claims was down to 233,750 as of July 22.
- Retail sales grew 0.2% in June after rising 0.5% in May. Stubborn inflation and high interest rates are weighing on spending.
- U.S. industrial production decreased by 0.5% in June.

What's Driving the Markets?

Inflation surprised to the downside: This month's U.S. Consumer Price Index report has surprised to the downside, with monthly core CPI hitting a 28-month low. Both the headline CPI and core CPI increased by 0.2% in June. On a year-ago basis, the headline and core CPIs rose by 3.0% and 4.8%, respectively. The most significant contributor to the downside surprise in core CPI was the reversal of the recent surge in used-vehicle prices. More importantly, disinflation momentum is observed in the shelter category, which constitutes over 40% of the core CPI. The New-Tenant Repeat Rent Index, a measurement based only on the leases of new tenants and a leading indicator for the CPI for rent, suggests that rental disinflation will likely continue. However, we expect core services inflation excluding housing to remain elevated due to wage pressures resulting from the tight labor market, which might lead to a fluctuating inflation trajectory in the coming quarters.

Recession risks pushed back: Recent economic activity and labor market indicators indicate moderate growth, pushing back the timing of the anticipated recession. U.S. GDP experienced a healthy 2.4% increase in the second quarter, following a 2% gain in the first quarter. The job market stands out as a testament to the economy's resilience. We see little reason for a significant slowdown in payroll employment over the next few months as labor demand continues to outpace labor supply. Furthermore, initial claims for unemployment insurance have been trending downward this month, reaching below 230,000 for the first time since May during the week ending on July 15. The consistent growth in consumer spending also highlights the economy's strength, demonstrated by high-frequency data such as weekly credit card spending. While the ISM index indicates that the manufacturing sector remains weak, rising new orders relative to inventory suggest that the index is likely to improve. Additionally, there is renewed vigor in the housing market, with the NAHB sentiment index rising significantly above the neutral level. Although this year's recession odds are diminishing, it is essential to recognize that the recent growth rate is unlikely to be sustainable as the impact of high interest rates starts to have more effect. Thus, the risks of a recession remain uncomfortably high next year.

Fed in the final stages of tightening: During its July meeting, the Federal Open Market Committee once again raised the target range for the federal funds rate, bringing the range to 5.25% to 5.5%. In the post-meeting statement, policymakers have reiterated their reliance on data and incorporated the flexibility to adjust their course if the downward inflation trend changes direction. We anticipate this rate hike marks the last one of the FOMC's tightening cycle after the pandemic. June's headline CPI inflation moderated to 3%, and nonfarm payroll growth was weaker than expected. Also, we foresee the upcoming CPI reports to show softer figures as shelter costs, which represent 40% of core CPI, are reliably decreasing. Of course, whether there will be another rate hike will depend on the data released between now and the FOMC's September meeting, especially the CPI reports for July and August and the two upcoming jobs reports.

As of 7/31/23. 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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