NorthCoast

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The Navigator

June 2022

Fed, Inflation, and Growth Risk

The U.S. stock market experienced a roller-coaster May, with the S&P 500 dipping more than 20% below its high but bouncing back in the final week of the month. The Dow and the S&P 500 ended the month little changed, while the Nasdaq lost about 1.9%.

High inflation, Fed tightening, and recession risks remain the most substantial headwinds for the equity markets. Headline CPI fell a bit from March's peak but was a bit stronger than expected, rising 8.3% on a year-ago basis. Core CPI also pulled back less than expected to 6.2%. The encouraging news is that excluding COVID reopening categories such as airfares, the month-over-month core inflation was slightly below the prior three-month average. As widely expected, the FOMC raised the target fed funds rate by 50 basis points to 0.75% - 1% in its May meeting, marking its first 50-basis point rate hike since May 2000. The markets quickly priced in a series of steep rate hikes and are concerned that the Fed might possibly raise rates to levels that slow the economy.

What do we see as the risks with the Fed's policy? First, as the Fed is behind the curve in the current tightening cycle, the asynchronously tight monetary policy might exacerbate the slowdown in the economy. Normally the Fed would adjust its policy rate in response to changes in inflation and the unemployment rate. However, over the past year, the Fed's modified policy and their misinterpretation of the surging price increases as transitory has caused their policy to remain exceptionally accommodative, despite the fast decline of unemployment and surging inflation. The Fed now looks poised to hike the rates aggressively when inflation has peaked and the pace of drop in the unemployment rate is much slower, thus increasing the risk of overshooting and choking off economic growth.

Second, the Fed faces a more challenging situation in today's inflation as it is primarily supply-driven. Unlike in most cases since the 1990s, when inflation was largely driven by excessive demand, supply constraints caused by the pandemic and the Ukraine war are among the key forces behind today's inflation. When inflation is caused by supply factors, monetary policy is unable to directly resolve those disruptions. For example, a tighter monetary policy will do nothing to reduce uncertainty about the Ukraine war. The Fed is thus in a tough spot – slowing growth with higher rates or living with persistently high inflation. The risk is that the Fed fails to manage the trade-off properly and pushes rates to such levels that damage economic growth.

We are closely monitoring the dynamics of interest rates, economic growth, and geopolitical risks. In the last week of May, the market seemed to pay more attention to signs of slowing growth. This may alleviate inflation pressure and ultimately lead to a less aggressive pace of rate hikes. There were some tentatively encouraging signs as the PCE deflator rose only 0.2% in April, compared to gains of 0.9% in March. Our base case view is that the monetary policy response already priced in by the market should be sufficient to curb inflation and that the global economy will avoid a recession over the short term. However, uncertainties remain, and our dynamic asset allocation views reflect the risks. We stayed neutral exposure to U.S. equity with an investment level of 64%. We are 48% invested in our flagship international strategy as we downgraded European equities on energy shocks and remain conservative with emerging-market assets.

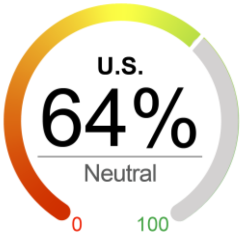
By the Numbers (YTD)[1]

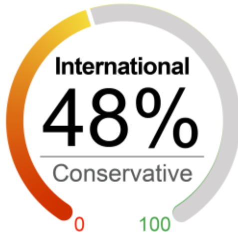
-12.9%
U.S. Equities
S&P 500 Index

-10.7%
International Equities
MSCI ACWI ex-U.S.

-8.9%
U.S. Bonds
Barclays U.S. Aggregate Bond Index

-11.1%
Global Bonds
JP Morgan Global Aggregate Bond Index





The NorthCoast Navigator is a market "barometer" displaying NorthCoast's current U.S. equity 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.

AS OF 5/31/2022. DATA PROVIDED BY BLOOMBERG, NORTHCOAST ASSET MANAGEMENT.

Negative Indicator	Neutral Indicators		Positive Indicator
Valuation	**Sentiment**	**Technical**	**Macroeconomic**
S&P was flat this month, with valuations for equity remaining negative. P/E: decreased marginally from 20.68 at the end of April to 20.65 at the end of May; Forward P/E: remained unchanged at 18.2 at the end of May. Inflation-adjusted valuation metrics continued to be negative with inflation rising.	The breadth of growth in the U.S. manufacturing sector seemed to have narrowed as the ISM manufacturing index fell for the second consecutive month, declining to 55.4 in April from 57.1 in March. The supplier deliveries index rose, indicating slower deliveries. The University of Michigan's consumer confidence slumped to 58.4, the lowest since 2011, as high gasoline prices, surging inflation, and a volatile stock market continued to weigh on the consumers. NAHB index dropped 8 points to 69 in May, pushed down by higher mortgage rates and poor affordability.	Technical indicators were neutral, with fear index signals remaining positive and momentum indicators in the negative territory. The S&P 500 was 7% below its 200-day moving average, 5% below the 100-day average, and 3% below the 50-day average. The VIX remained high for most of the month but dropped in the last week and settled at 26.2 at the end of May (compared with 33.4 at the end of April). Volatility continued to be high in May amid concerns over tighter Fed policy, persistently high inflation pressures, geopolitical risks, and COVID lockdowns in China.	The April employment report showed continued robustness in the labor market with healthy payroll gains of 428,000. Inflation remained elevated, with the headline and core CPI up 8.3% and 6.2% on a year-ago basis, respectively. Meanwhile, the Producer Price Index for final demand rose more than anticipated in April, increasing 0.5%. Retail sales continued to be healthy (up 0.9%), but the pace of growth was slowing. On the other hand, pending home sales fell back to their lowest level since the beginning of the pandemic.

[1] **Source: Bloomberg, NorthCoast Asset Management.**