NorthCoast
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The Navigator

July 2022

Weak Growth and Elevated Inflation

After a poor start to the year, markets continued to sell off throughout the second quarter of 2022. A respite in May was followed by downwards momentum in June, with all major equity indexes logging steep declines for the month. Both the S&P 500 and Nasdaq dropped more than 8%, while the Dow lost 6.7% in June.

We believe that high inflation, Fed tightening, and recession risks remain the most substantial headwinds for the U.S. equity markets. In May, U.S. consumer price inflation surprised on the upside by increasing 8.6% on a year-ago basis, the highest pace in 40 years. Also, Michigan's long-term inflation expectations rose to 3.1%. Continuing inflation pressures prompted the Federal Reserve to raise the target range for the fed funds rate by 75 basis points to 1.5% to 1.75% in its June meeting, the first 75-basis point increase since 1994, with their concurrent statement suggesting that the central bank won't stop raising rates until inflation comes down.

Accelerated monetary policy tightening has weighed on risk appetite, and the market has priced in reduced odds of a soft landing and a higher probability of recession. While the Fed has the dual mandate of price stability and maximum sustainable employment, it seems price stability will take precedence over growth, based on Chairman Powell's recent statement. The important question is how much recession risk has already been priced in. We believe that recession risk is fair/modestly overpriced by the market currently as equities tend to decline about 30% during a typical recession, and the market is down 20% year to date. While some of the signals in our market timing model including leading economic indicators are softening, recession does not seem imminent.

At the same time, we see two growth drags building: the sharp cooling of the housing sector and weakening consumer support. The recent run of housing data indicates that the housing sector is already feeling the impact of Fed tightening and the jump in mortgage rates: housing starts sank 14% (the most significant drop since the pandemic) while building permits (a proxy for future construction) declined 7% in May to the lowest level since September of last year. Consumers have been one of the major sources of support for the U.S. economy since the reopening after COVID, buoyed by high levels of excess savings and a robust labor market. However, signs have emerged that U.S. consumers are pulling back as retail sales growth declined for the first time this year in May. Meanwhile, the recent high-frequency credit card data showed a decelerating spending pace as consumers react to surging prices and tighter financial conditions. Both the University of Michigan and Conference Board consumer confidence measures declined to record lows.

Given the backdrop of slowing growth, stubbornly high inflation, tightening central banks, ongoing geopolitical risk in Ukraine, and lingering concerns about the COVID lockdown in China, we believe that risky assets could continue to face challenges and the current high volatility regime is likely to linger. While more attractive valuations and more bearish positioning have slightly improved the risk appetite, we think that better macro momentum – including a convincing peak and deceleration in inflation – will be needed for a sustained rally. We remain conservative to cautious with equity exposure and have increased our cash level, which has helped to mitigate the impact of the recent sell-off and given us resources to deploy when we see more optimistic growth/inflation pictures.

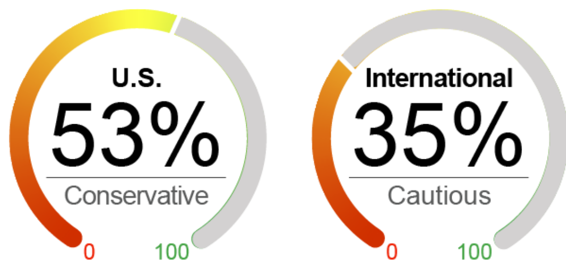
By the Numbers (YTD)[1]

-20.1%
U.S. Equities
S&P 500 Index

-18.4%
International Equities
MSCI ACWI ex-U.S.

-10.3%
U.S. Bonds
Barclays U.S. Aggregate Bond Index

-13.9%
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 6/30/2022. DATA PROVIDED BY BLOOMBERG, NORTHCOAST ASSET MANAGEMENT.

Negative Indicators		Neutral Indicator	Positive Indicator
Valuation	**Sentiment**	**Technical**	**Macroeconomic**
The S&P 500 tumbled 8.3% this month, and valuation metrics for equity improved but remained negative. P/E decreased from 20.7 at the end of May to 19.0 at the end of June; Forward P/E decreased to16.6 at the end of June from 18.2 at the end of May. Inflation-adjusted valuation metrics continued to be negative with inflation rising.	The ISM manufacturing index increased from 55.4 in April to 56.1 in May, the first increase since February, but remained below its six-month moving average. U.S. manufacturing conditions have softened this year with supply-chain issues and tightening financial market conditions. The University of Michigan's consumer confidence slumped to 50, dropping below the prior record low in the 1980s, as high gasoline prices, surging inflation, and lower stock prices continued to weigh on the consumers. The NAHB index continued to drop to 67 in June, pushed down by higher mortgage rates and heightened input costs.	Technical indicators were neutral to slightly negative, with fear index and momentum indicators offset by reversal signals. The S&P 500 was 14% below its 200-day moving average, 10% below the 100-day average, and 6% below the 50-day average. VIX index increased this month and settled at 28.7 at the end of June (compared with 26.2 at the end of May). Volatility continued to be high in June amid concerns over tighter Fed policy, persistently high inflation pressures, geopolitical risks, and lingering concerns around the COVID lockdown in China.	The May employment report showed continued robustness in the labor market, with payrolls advancing more strongly than expected by adding 390,000 jobs. Inflation remained elevated, with the headline and core CPI up 8.6% and 6% on a year-ago basis, respectively. Meanwhile, the Producer Price Index for final demand was slightly less than anticipated in May, increasing 0.8%. On a year-ago basis, the PPI was up 10.8% in May. Retail sales growth declined for the first time this year in May, with falling auto sales offsetting price-driven gains in gasoline sales. U.S. industrial production also rose less than anticipated in May by 0.2%, after a revised 1.4% gain in April, suggesting softening manufacturing conditions. The leading economic indicators dropped recently as well.

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

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