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The Navigator

August 2022

Inflation Frustration and Recession Obsession

Investors breathed a sigh of relief in July as the markets rebounded on the combination of rate reprieve, bearish positioning, and tentative signs of fading inflationary pressures. The Dow gained almost 7% and the S&P 500 was up by 9.2% for the month. The technology-heavy Nasdaq Composite outperformed by advancing 12.4%.

Inflation pressure, monetary tightening and slowing growth remain the dominant global macro themes. In July, U.S. consumer price inflation accelerated to a new peak with a 9.1% increase on a year-ago basis. Continuing inflation pressures prompted the Federal Reserve to hike by 75 basis points for the second straight meeting, boosting the target range for the federal funds rate to 2.25-2.50%, a long-term "neutral" level at which any further rate hikes would be considered "restrictive" to economic activity. We expect a slower pace of hiking from here, anticipating another 50bp hike in September and 25bp hikes in November and December, though the decisions remain data-dependent, with a 75bp hike possible in September.

While the rapid pace of price increases (especially in essential consumer categories such as energy and food) has kept the Fed in a hawkish state, the good news is that the sky-high CPI (Consumer Price Index) in June is less likely to be replicated in July. Energy contributed more than 3% to the CPI year-over-year growth in June, but energy prices dropped noticeably in July. In addition, both survey and market-derived inflation expectations showed signs of moderation with the University of Michigan's median 12-month inflation expectation slipping from 5.3% to 5.2% and breakeven inflation rates falling sharply in the last two months.

Meanwhile, activity data showed louder signals of weakening in July. U.S. GDP fell 0.9% in the second quarter according to the advance estimate of the Bureau of Economic Analysis, after a 1.6% decline in Q1. Although two consecutive declines in GDP is one common definition of a recession, we do not believe the current state of the economy will meet the National Bureau of Economic Research's criteria for depth, diffusion, and duration to be officially defined as a recession. The housing sector data was bleak, with homebuilder sentiment falling a whopping 12 points to 55, and the housing starts and permit issuance further declining. Manufacturing PMIs barely remain in expansionary territory for most developed markets now. While more storm clouds are forming, the market seemed to be able to shrug off the bad news with a dynamic that “bad news is becoming good news,” as this particular bad news might suggest the possibility of the Fed signaling a slowdown in the pace of hikes and the stabilizing of the long-end yields helped the bounce-back of cyclical stocks.

Although corporate earnings have not been recession-like, the second-quarter earnings season has shown less upside potential. As of 7/29/2022, 56% of the companies in the S&P 500 have reported actual results for Q2 2022, and in aggregate S&P 500 companies are beating the estimates by 3.1%, below the five-year average of 8.8%. In the meantime, earnings revision breadth is currently negative, indicating that more analysts are cutting their estimates rather than revising them higher.

We remain conservative (U.S.) and cautious (International) with equity exposure as we believe that near-term equity drawdown risk remains elevated with the unfriendly mix of elevated inflation, higher recession risk, and rising rates. Our base case view is that the monetary policy response priced by markets should curb inflation with only an economic slowdown or a mild recession. However, markets will likely remain volatile until the growth/inflation backdrop improves, as investors swing between inflation frustration and recession obsession.

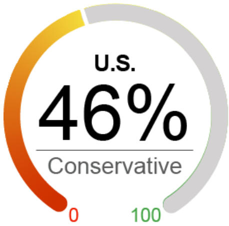
By the Numbers (YTD)[1]

-12.8%
U.S. Equities
S&P 500 Index

-15.6%
International Equities
MSCI ACWI ex-U.S.

-8.2%
U.S. Bonds
Barclays U.S. Aggregate Bond Index

-12.1%
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 7/31/2022. DATA PROVIDED BY BLOOMBERG, NORTHCOAST ASSET MANAGEMENT.

Negative Indicators		Neutral Indicator	Positive Indicator
Valuation	**Sentiment**	**Technical**	**Macroeconomic**
The S&P 500 gained 9.2% this month, and valuation metrics for equity remained negative. P/E increased from 18.9 at the end of June to 20.7 at the end of July; Forward P/E increased to18.1 at the end of July from 16.6 at the end of June. Inflation-adjusted valuation metrics continued to be negative with inflation rising.	The ISM manufacturing index declined from 56.1 in May to 53 in June, its lowest level in two years. With supply-chain issues and tightening financial market conditions, U.S. manufacturing conditions have weakened this year. Consumer confidence remained historically low, with the University of Michigan's consumer sentiment index increasing marginally from 50 to 51.5, as surging inflation stayed in the headlines. The NAHB index dropped 12 points to 55 in July, with higher mortgage rates significantly weighing on housing demand.	Technical indicators were neutral to slightly negative, with the increases in momentum and fear indexes offset by reversal signals. The S&P 500 was 5% below its 200-day moving average, 0.2% above the 100- day average, and 5% above the 50-day average. The VIX index dropped this month and settled at 21.3 at the end of July (compared with 28.7 at the end of June). Volatility declined this month as investors breathed a sigh of relief as worst-case scenarios for the economy and the Fed failed to materialize. Quarterly earnings reports from tech companies such as Amazon and Apple also lifted the market in the last week of the month.	The June employment report showed continued robustness in the labor market, with payrolls advancing more strongly than expected by adding 372,000 jobs. However, the four-week moving average of initial jobless claims rose to about 250,000, the highest level since late 2021. The CPI was up 1.3% in June compared with gains of 1% in May. On a year-ago basis, the headline and core CPIs were up 9.1% and 5.9%, respectively Retail sales rebounded strongly from their disappointing May performance, with total sales jumping 1% after declining 0.1%. U.S. industrial production slipped 0.2% in June after being revised lower in May, suggesting softening manufacturing conditions. The leading economic indicators dropped recently as well.

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

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