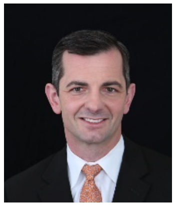
NorthCoast
Asset Management | A Connectus Partner

Quarterly Client Update

Q4 2023

December 31, 2023



"We naturally fear the unknown, and the future is always unknown."

~ Peter Bernstein

2023 was full of noteworthy events: the discovery of a "spy balloon" over North America escalating US-China tensions, increasing conflicts with Russia-Ukraine and the Israel-Hamas war, new supply chain tensions and labor supply challenges, unprecedented and aggressive Fed rate increases reaching 5%, which then resulted in significant multiple bank failures requiring emergency government measures (SVB, Signature Bank, First Republic Bank, Credit Suisse), the unprecedented removal of the speaker of the House as a result of party in-fighting, the unexpected recovery of bitcoin on the heels of the FTX collapse, and the surprising impact of Artificial Intelligence on the "Magnificent 7" stocks. Given all these significant occurrences in 2023, who could have predicted that the market would end the year up 25%?

As we move into 2024 and reflect on the unpredictable nature of these events, we are reminded that the only constant in the world of investing is change. Our team is dedicated to the analysis of market trends and the identification of economic indicators that assess outcome probabilities in each scenario. We then work to position your portfolio accordingly, as we see change and economic surprises as a balanced combination of uncertainties and opportunities.

Our goal is always to provide you with innovative solutions adapted to the uncertainty of investing, guiding you through an optimal allocation according to your financial goals and risk tolerance. Now for my view on the topics affecting your investments.

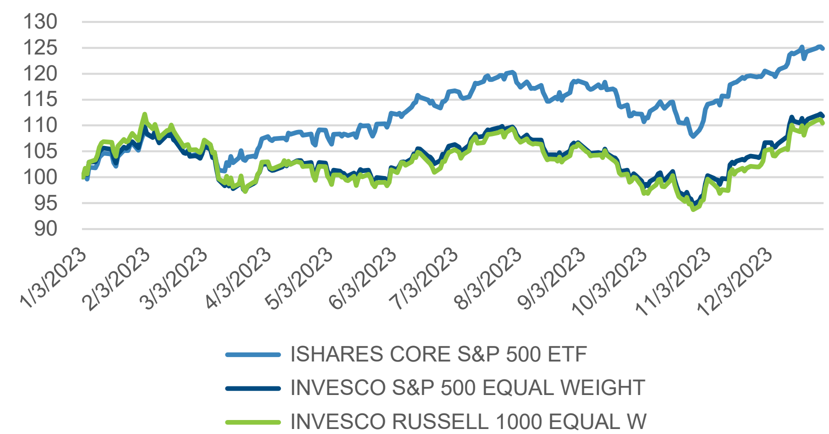
A CIO's View

These events are monitored daily by our models. We also regularly cover these topics in our monthly Navigator and quarterly Fixed Income Commentary.

Market Return: Historical Narrow Rally for Cap-Weighted Indices Only

We had mentioned in a previous newsletter the magnitude of the distortion of index returns caused by the run-up in the "Magnificent 7" stocks in the S&P 500 Index (the largest 500 companies in the U.S. weighted by market capitalization). These seven companies represent 26% of the weight in the S&P 500 and were on average up 111% in 2023. For 2023, the S&P 500 Net Total Return Index was up 25.7% while the S&P 500 Equal-weighted Index (an index representing the same 500 largest companies but allocating each of the 500 companies to an equal weight) was up 13.9% and the Russell 1000 Equal-weighted index was up 12.2% (Exhibit 1). Note that both equal-weighted indices were in negative territory two months before year-end. The median return in the S&P 500 in 2023 was 9.7%, with 34% of the stocks having a negative return and only 27% beating the S&P 500 Net Total Return Index. In other words, if you were a stock picker in 2023, you had a 75% chance of picking stocks that did not beat the S&P cap-weighted index.

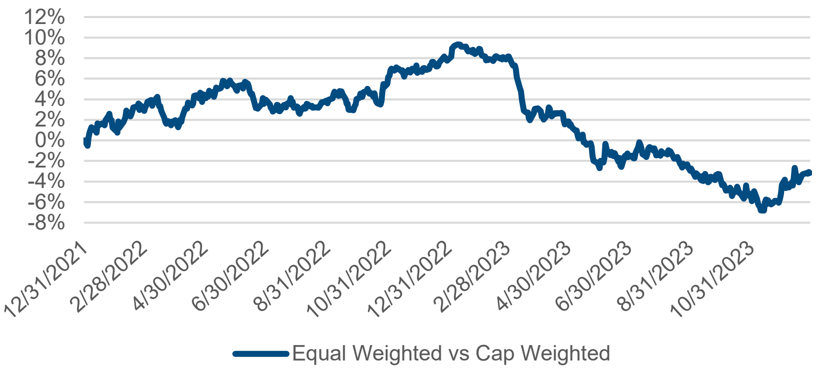
Exhibit 1: Cap-Weighted vs. Equal-Weighted Indices



Source: Bloomberg

Fortunately, this trend has started to reverse, with a broadening of the rally and a softening of these seven stocks. (Exhibit 2)

Exhibit 2: S&P500 Cap-Weighted vs. Equal-Weighted Performance



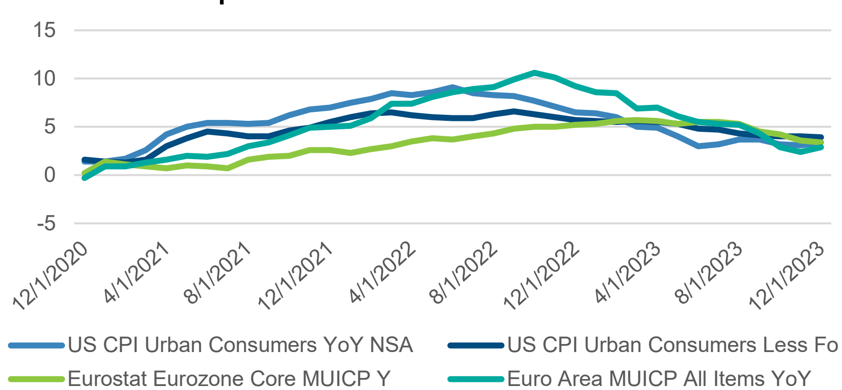
Source: Bloomberg.

Inflation: Improvements so far with some resilience

Core inflation has continued to abate but is now doing so slower. Core inflation today stands at 3.4%, while headline inflation barely inched down to 3.9%. While the trend is in the right direction, the pace is slower than the market anticipated, and this last data point created a negative surprise as consensus was 3.2% and 3.8% respectively. The food CPI measures were reasonable between 0.2% and 0.3%, while other metrics were up 0.4%: vehicles, services, tenants' rent. Medical care service prices ticked higher with a 0.7% increase last month.

Core inflation above 3% for the remainder of 2024 is a scenario which would trigger hawkish actions from the Federal Reserve such as a delay in interest rate cuts as inflation could be more persistent than predicted.

Exhibit 3: US/Europe Core Inflation Rates

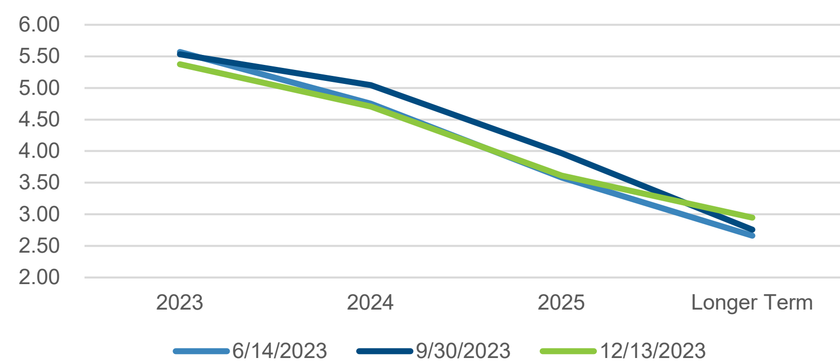


Source: Bloomberg.

Federal Reserve actions: Pause with some cuts signaled.

In December, the FOMC continued to pause and maintain its policy rate within 5.25% and 5.5%. The tone was more dovish, with the consideration of 75 bps of interest rate cuts in 2024, and the acknowledgement of an economic slowdown and inflation easing. The dot plot is now lower, at a similar level as June 2023.

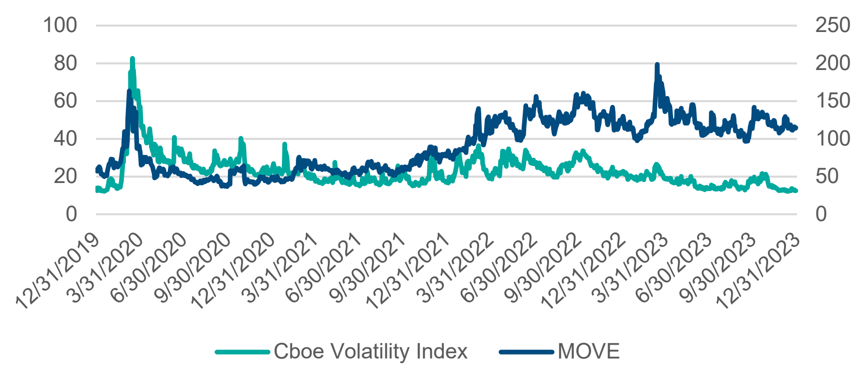
Exhibit 4: FOMC Dot Plots continue to signal high rates for longer



Source: Bloomberg.

The interest rate uncertainty is still high, as can be seen in Exhibit 5: the MOVE Index (implied volatility of a basket of OTC options on US interest rate swaps) illustrates the uncertain environment we are in, while the VIX Index is at a new low along with tight credit spreads, reflecting the optimism on the economic situation.

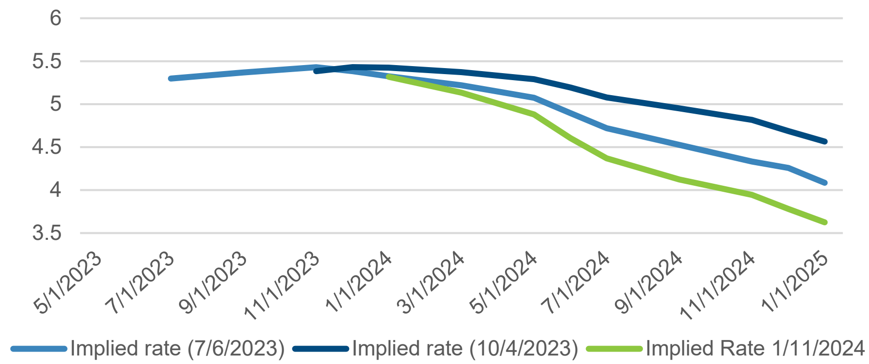
Exhibit 5: The VIX Volatility Index reflects a more benign environment while the MOVE Index indicates greater uncertainty in fixed income



Source: Bloomberg.

The market has reacted to this information and incorporated most but not all the data (Exhibit 6). During Q4, the prevailing thesis of a perfect soft landing, allowing central banks to cut rates toward the neutral stance fueled risk appetites, with implied rates reverting the increase of Q3 and more. The recent CPI data point might be challenging to that thesis, making risk assets seem overbought and exposing vulnerabilities in equities especially at multiples of 22x-23x. Rate cuts can be expected in June, with the possibility of them coming earlier: March or May. However Fed Presidents' recent language indicated that there is not yet a compelling case for earlier cuts and significant developments would be needed to make such a case.

Exhibit 6: Implied Rates have significantly decreased in Q4

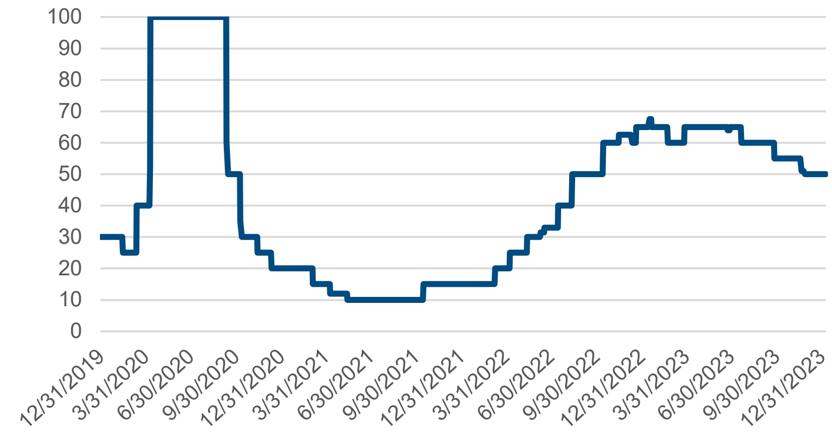


Source: Bloomberg.

Recession: Slightly lower likelihood, with clouds on the horizon

Recession risks have continued to inch lower however more recently recession probability has improved slightly to an elevated 50% (Exhibit 7). Since the economy has shown some resilience with some softening, this may embolden the FOMC to continue its restrictive actions and stay higher for longer.

Exhibit 7: Probability of a U.S. Recession (remains at 50%)



Source: Bloomberg.

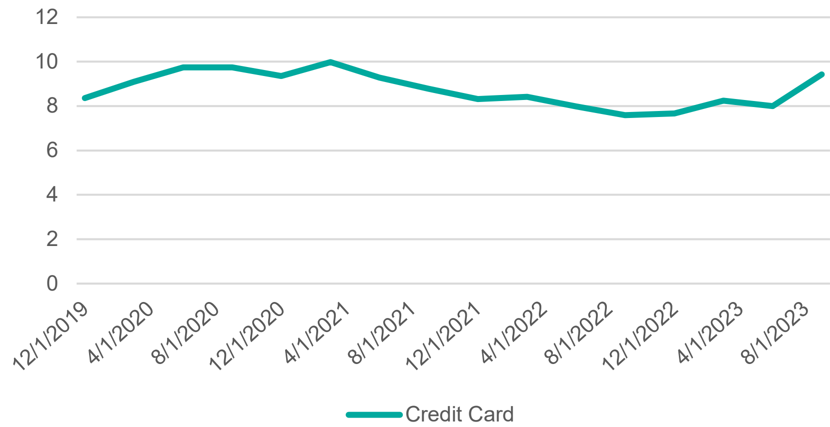
Economy: Resilient with some cracks

The economy in 2023 proved surprisingly resilient despite "bank-rupcies," geopolitical turmoil and unprecedented, restrictive monetary policy. This resiliency can be explained by quick government intervention to avoid systematic financial contagion, corporate margins continuing their trend on the back of past inflation, and labor supply increasing while the unemployment rate stayed exceptionally low. The soft-landing scenario has prevailed and has become the overwhelming consensus for Q4 2023.

For 2024, we see some further signs of slowdown which could grow more substantial: personal savings buffers are lower than post-pandemic which could diminish consumer strength, fiscal policy is looking contractionary with the lapsing of past policies, the additional labor participation rate looks more challenging, the delayed impact of variable rate debt is likely to be seen in more corners of the economy, US election uncertainty, and geopolitical tensions in the Middle East could create additional headwinds.

Looking at the data, we see some evidence of this slowdown, first with credit card delinquencies rising to levels equivalent to the 2020 recession. This can be seen as a sign of normalization from the past low levels of previous years and a digestion of the riskier lending. Corporate bankruptcies have also been rising while they are still below pre-pandemic levels. Commercial real estate does look problematic, but accounts for only 2-3% of bank loan portfolios, which should avoid a repeat of the 2008 episode.

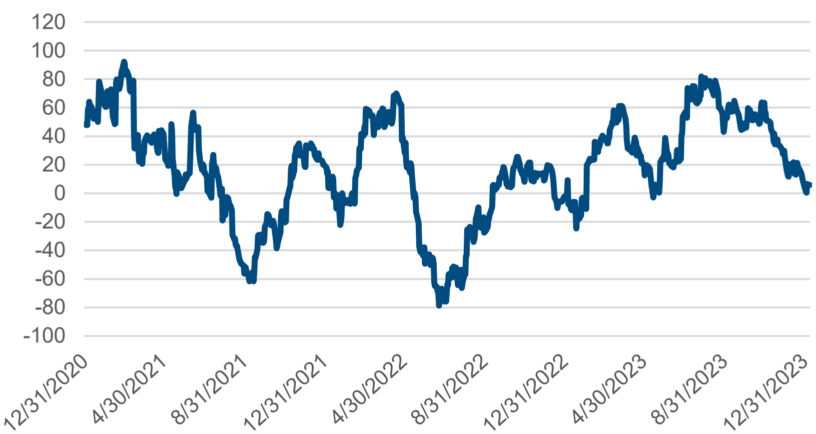
Exhibit 8: Credit Card Delinquencies starting to rise (% of balance delinquent 30+ days)



Source: Bloomberg

Next, the Citigroup Economic Surprise Index has declined over the past quarter, indicating that while still resilient, the US economy is no longer posting as many positive surprises as the majority of 2023. While the indicator is in neutral territory, it is not displaying a sharply negative trend like the one of 2022. (Exhibit 9).

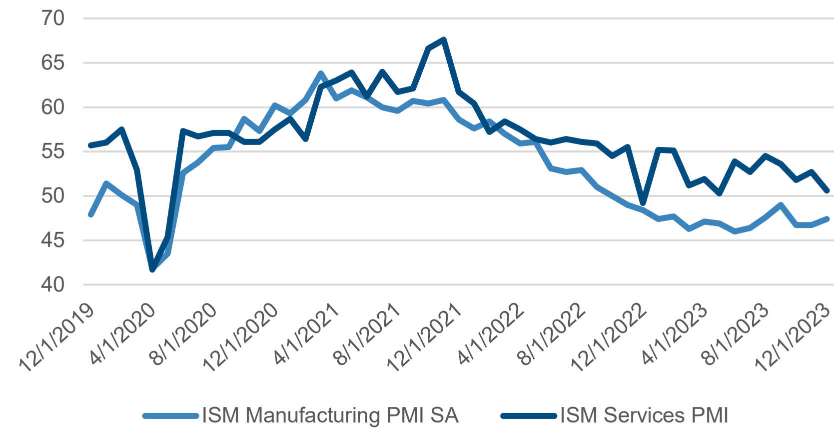
Exhibit 9: The Citigroup Economic Surprise Index indicates how economic data compares with consensus estimates



Source: Bloomberg, Citigroup.

Further signs of slowdown can be seen in the leading indicators of the PMI ISM surveys. Both indices are close to or below the neutral 50 level. While the declines seem to have stabilized, they have not yet shown any clear signs of improvement over the past six months.

Exhibit 10: ISM Manufacturing and Services Indices are still at a low



Source: Bloomberg.

Geopolitical risks: The Red Sea situation could trigger supply chain disruptions.

The Middle East conflict is starting to have supply chain ramifications as some shipping companies have started re-routing via the Cape of Good Hope, creating delays and additional costs which could increase inflation or make it more resilient. These risks could be exacerbated by the closure of some factories for the Chinese New Year.

US-China relationships and competition are likely to intensify, in particular with the strategic interest in Artificial Intelligence and associated enabling technologies. US restrictions have started to be enacted, likely to trigger more reactions from China and the increasing de-globalization trend which is inflationary.

US Elections: More uncertainty later in the year

While this aspect is dominating the news, it has not yet seemed to impact the markets. We anticipate some volatility as the year progresses and the agendas become more clearly defined between the candidates on fiscal, trade and regulatory policies.

Investment Implications

Looking forward, we cannot help but notice that the markets have anticipated a perfectly soft landing scenario: lower inflation and resilient economic growth and profits, leading to equity multiples appearing overbought. Any evidence of a less than perfect scenario can create vulnerabilities and some pull back. While we do not see any major risks to the upside or the downside, the current return/risk environment does not appear the most favorable, thus our cautious stance and willingness to embrace any trading weaknesses to capitalize on future opportunities.

In summary, I have a few considerations for your portfolio given market conditions:

- Remain cautious and opportunistic in the current environment with active and tactical strategies.
- Diversify your investments: not only per asset class (bonds, equities, alternatives, options), but also per investment approach (long, tactical, defined outcome, premium income).
- Consider active risk management and equal-weighted approaches to differentiate from the current consensus and embrace other scenarios.
- Allocate to fixed income which is looking increasingly attractive with higher yields in quality fixed income while the yield curve is normalizing.

Remember that forecasting is a very uncertain exercise and positioning for several alternative scenarios will more likely result in a positive long-term outcome. If you have any questions about your portfolio or would like to discuss your current positioning, please contact your advisor at any time. Our team always has your interest at heart and stands ready to help meet your goals with the proper allocations and financial planning.

I hope this letter finds you and your family happy and healthy in the new year. As always, we thank you for your business.

Happy New Year and wishing you a healthy and prosperous 2024!

Warm regards,

Patrick Jamin
President & CIO

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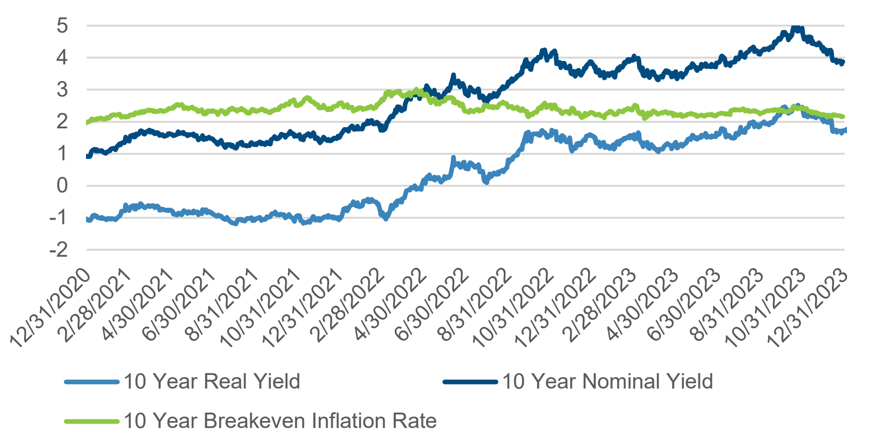
Why it Might be Time to Invest in Bonds Despite Recent US Treasury Volatility

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

In the fourth quarter, we witnessed unprecedented volatility in the U.S. Treasury market. In October, the 10-year yields rose sharply to almost 5% amid resilient economic data, and then retreated significantly in November and December with lower-than-expected inflation data and speculations that the Fed will be able to pull off a soft landing. The nominal 10-year U.S. yields ended the quarter at 3.88%, down from 4.57% at the end of the previous quarter. The primary factor behind this shift was the decrease in real yield (by 52 basis points), while inflation expectations, measured by the 10-year inflation breakeven rate, saw a slight decline from 2.35% at the end of the third quarter to 2.16% (see Exhibit 1).

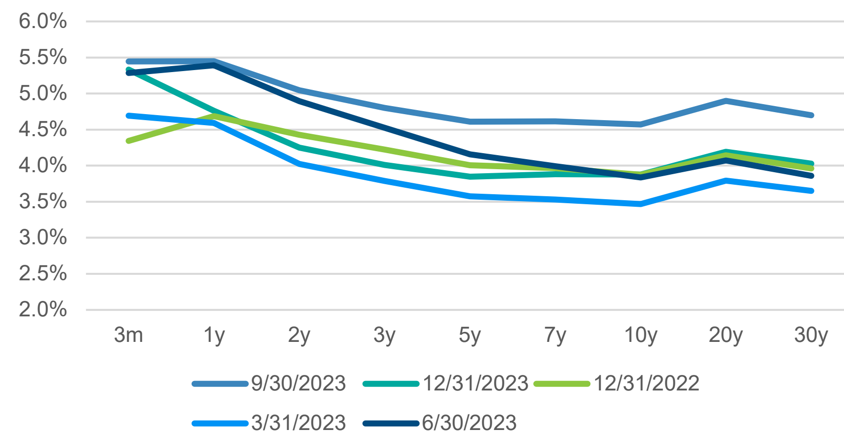
Exhibit 1: Treasury yields declined significantly in the fourth quarter of 2023



Source: Bloomberg.

Treasury yields across all maturities decreased for the fourth quarter, with 3-month yields moving down the least, leading to a more inverted yield curve. The 3-month yield decreased marginally from 5.45% to 5.33%, a level 1.45% higher than the 10-year yields (compared with 87 bps higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 10-year and 30-year bond yields decreased by around 70 basis points each but remained high historically.

Exhibit 2: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

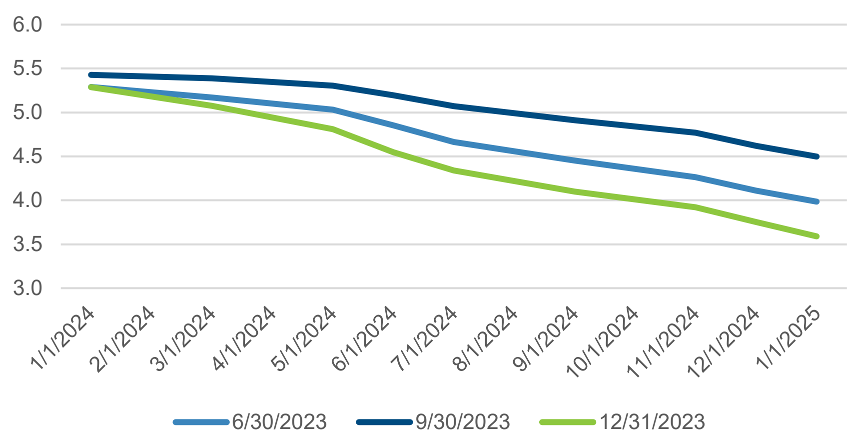
Growth Prospects: This year, a series of positive economic data has lifted market sentiments, and markets seemed to price out near-term recession risk, becoming increasingly confident about a soft landing. Digging more carefully into individual signals, however, we believe that uncertainty is still elevated, and we expect a slowdown in the economy in the coming year. The PMI index was in negative territory in 2023, suggesting that the U.S. manufacturing industry continued to face strong headwinds with a downbeat outlook. The Conference Board's Leading Economic indicator continued to decline, indicating cautionary signals that the economy is heading for a slowdown. The labor market has also shown signs of cooling this quarter.

We believe that the tailwinds that have supported the economic strength this year will likely fade, including robust consumer strength, a tight job market driven by a mismatch of labor supply and demand, and a huge fiscal stimulus. Recent household liquidity statistics showed that 80% of excess consumer savings from the Covid period have been depleted. Also, delinquencies in credit card and auto loans, as well as Chapter 11 filings, are increasing. We expect the headwinds from tight monetary policy and credit stress will be more evident in 2024, leading to a slowing economy and moderating inflation. Other risks including geopolitical uncertainty and the resumption of student loan payments could also weigh on the markets.

Fed Policy: During its December meeting, the Federal Open Market Committee (FOMC) again chose to maintain its policy rate at a range of 5.25% to 5.5%. The markets viewed December's meeting as the most dovish since the tightening cycle, as the committee signaled that it would likely cut interest rates by 75 basis points next year (compared with 50bps in September's projection). Also, for the first time, the post-meeting statement acknowledged that "growth of economic activity has slowed" and "inflation has eased." More encouraging is that December's Summary of Economic Projections indicated that the Fed expects a soft landing, with projections for real GDP and the unemployment rate little changed.

Market outlook on the possible paths of monetary policy in the US has seen significant shifts during the last quarter (See Exhibit 3). The Fed funds futures market is currently indicating a total of 150bps in rate cuts by the Fed in 2024.

Exhibit 3: Fed Funds Rate Implied by the Futures Market



Source: Bloomberg.

Inflation surprised on the downside: The most recent inflation data continued its descent, bringing the year-over-year headline CPI and core CPI in November to 3.1% and 4.0%, respectively. More encouragingly, core PCE (personal consumption expenditure), the Fed's preferred inflation measure, rose marginally by 0.1% in November, while the headline PCE index fell 0.1%, marking its first monthly decline since April 2020. Inflation expectations also improved dramatically in December, according to the University of Michigan survey, with 1-year inflation expectations plummeting from 4.5% to 3.1% and five-year expectations dipping from 3.2% to 2.9%.

We expect inflation to continue to fall for the following reasons: 1) Although the CPI for shelter (about 40% of core CPI) remained a significant contributor to inflation recently, we believe that the current inflation data has not fully reflected the slowdown in rents due to a lagging effect. 2) We expect the CPI for core services excluding shelter - a key metric referred to by the Fed as "supercore" to continue its downward trend. This inflation component is most sensitive to the labor market, with wage inflation playing a key role. Our wage index has declined to 3.9% YOY in November, down from its 6.0% peak in July 2022. Recent labor market data has shown signs of decelerating job growth and quit rates have fallen back to their pre-Covid level.

Why it Might be Time to Invest in Bonds

With high nominal yields, declining inflation and the Fed reaching the end of its rate hikes cycle, we believe that we are entering an optimal time for fixed income investments, in which bonds offer significantly more value, both in terms of total returns and as diversification within a balanced portfolio.

Although the initial levels of bond yields are not always a perfect indicator, they have been highly correlated with bond future returns. Despite a decrease in yields during the fourth quarter, nominal yields for high quality bonds remained high historically, with the yield-to-worst for the U.S. Aggregate Index at 4.6%. Empirical data shows that current yield levels have been typically followed by appealing returns from 5% to 7.5% over the next five years.

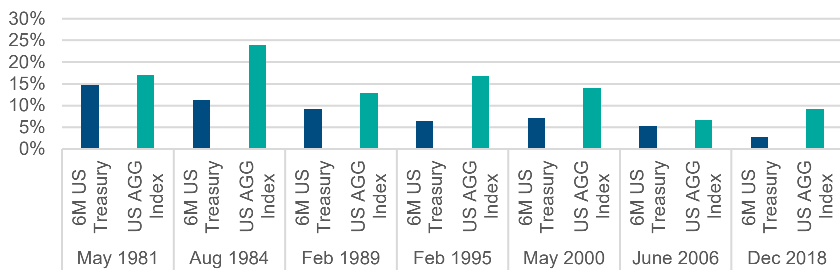
The current higher yields act as a cushion against market volatility, and ultimately, the end of the tightening cycle will also improve fixed income performance. Empirical data has shown that since the 80s, 10-year rates have consistently decreased (by an average of 1.07%) during the time periods between the last rate hike and the initial rate cut (see Exhibit 4). Not surprisingly, bonds have shown strong performance after the Fed stopped raising interest rates. Data in Exhibit 5 illustrates that bonds outperformed cash in every instance since the 80s (by an average of 6.3%) in the 12-month period after the end of hiking cycles.

Exhibit 4: Federal Reserve Rate Hike Cycle and Changes in 10-yr Yields

Last Rate Hike	First Rate Cut	Change in 10yr Yields Between Last Hike and First Cut
Feb-1989	Jun-1989	-0.95%
Feb-1995	Jul-1995	-1.48%
May-2000	Jan-2001	-1.51%
Jun-2006	Sep-2007	-0.73%
Dec-2018	Jul-2019	-0.70%

Source: Bloomberg.

Exhibit 5: US Aggregate Bond Index Performance One Year After End of Rate Hike Cycle



Source: Bloomberg.

Also, current bond valuations are attractive relative to equity. One of the common measures to compare the valuation of bonds vs. equity is to use equity risk premium by taking the difference between the 10-year U.S. Treasury yield and the earrings/price ratio of the S&P 500. As shown in Exhibit 6, the equity risk premium currently stands at 0.5%, among the lowest levels in two decades, suggesting that it is probably a prime time to overweight bonds in dynamic asset allocation portfolios.

Exhibit 6: S&P 500 Equity Risk Premium

Source: Bloomberg.

Investment Implications

Looking across investment opportunities, we found fixed incomes stand out for their attractive valuation, appealing income prospects, and substantial diversification benefits in the backdrop of elevated market uncertainty, slowing economic outlook, and moderating inflation. In this time of increased uncertainty, we believe it is crucial to prioritize high-quality investment and diversification while maintaining portfolio flexibility. Thus, our allocation among fixed income sectors remains up-in-quality, while also preparing to take opportunities in other sectors as prices adjust to reflect changes in underlying fundamentals. We have started to extend the duration in our tactical portfolios and slightly overweight the duration in our less dynamic portfolios. For YTD ending December 31, 2023, our Tactical Income strategy returned 6.1% net of fees, slightly underperforming the Global Aggregated Bond Index by 0.6%, but outperforming U.S. Aggregate Bond Index by 0.3%. In the fourth quarter, we focused on several key themes in our strategies, outlined below:

- **Add duration:** While we acknowledge that current cash rates are still appealing compared with historical levels, we believe duration is expected to outperform cash with the Fed at the end of its rate hiking cycle. We prefer to move out along the yield curve and have added TLH (iShares 10-20 Year Treasury Bond ETF) and TLT (iShares 20+ Year Treasury Bond ETF) positions during the quarter.

- **Mortgage-backed securities:** We kept a significant allocation to U.S. agency mortgage-backed securities through investing in MBB (iShares MBS ETF) as we found the sector remain appealing with attractive spread of MBS, strong liquidity and government or agency guarantees.

- **Neutral in investment-grade (prefer high quality):** We kept our neutral position to investment-grade corporate bonds. We acknowledge that fundamentals remain resilient for U.S. investment-grade companies, and we expect the sector's attractiveness from a yield and duration perspective will remain intact. However, we are also aware of the risks stemming from high interest rates, wage inflation pressures and diminishing consumer demand.

- **Continued to hold bank loans:** In our portfolio, we have allocated 5% to the Invesco Senior Loan ETF (BKLN), which has generated a YTD return of 12.6% as of 12/31/2023. Looking forward, we expect bank loans to continue to offer attractive coupon rates. However, it is essential to maintain a cautious stance as we also anticipate an increase in defaults with borrowers facing high interest expenses and slower earnings growth.

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NorthCoast
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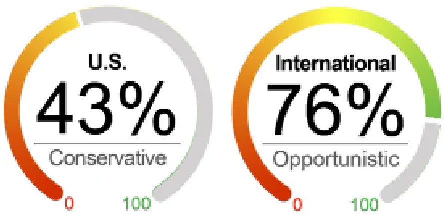
NorthCoast Navigator

Q4 2023 | December 31, 2023

The NorthCoast Navigator is a market barometer displaying current equity outlook. The aggregate metric is determined by multiple data points across four broad dimensions including macroeconomic, sentiment, technical and valuation indicators. The daily result determines equity exposure in our tactical strategies. As of 12/31/23. Data provided by Bloomberg, NorthCoast Asset Management.



Current Equity Exposure

Summary: Stocks continued their winning streak in December on lower-than-expected inflation data, market expectation of interest rate cuts early in 2024, and optimism that the U.S. economy will be able to avoid a recession. The S&P 500 and the Dow advanced 4.5% and 4.9%, respectively, while the technology-heavy Nasdaq rallied 5.6% for the month. The recent runup in equity prices is primarily due to expectations of earlier interest rate cuts, rather than a significant improvement in corporate earnings expectations. The current equity market volatility is unusually low, but we believe that market volatility will increase significantly if the Fed does not cut rates as early as the market is hoping for. Although the recession risk has certainly decreased considerably these days, we expect global growth to slow to below-potential next year. Our equity market outlook remains cautious given the continuing negative impact of high interest rates, the fading tailwinds from consumer support, rich equity multiples and lingering geopolitical risks. With this backdrop, we maintain a cautious allocation to equities and keep our U.S. equity exposure at 43% and international equity exposure around 76% during the month.

Fed Dovish Pivot: As widely expected, the Federal Reserve kept the target range of the Fed funds rate unchanged at 5.25% to 5.5% at its December meeting. The markets viewed December's meeting as the most dovish since the tightening cycle, as the committee signaled that it will likely cut interest rates by 75 basis points next year (compared with 50bps in September's projection). Also, for the first time, the post-meeting statement acknowledged that "growth of economic activity has slowed" and "inflation has eased." More encouraging is that December's Summary of Economic Projections indicated that the Fed expects a soft landing, with projections for real GDP and unemployment rate little changed. The markets have reacted positively to the meeting, with the U.S. Treasury yields declining significantly during intraday trading and all three major U.S. equity markets closing up about 1% for the trading day.

Consumer spending outlook: As consumer spending accounts for more than two-thirds of the Gross Domestic Product (GDP), it plays a critical role in the strength of the economy. Real spending growth has fallen behind real GDP in four out of the last five quarters. At the same time, the personal savings rate in the U.S. has fallen back to around 4%, well below the long-term average of 8.9%. Moreover, we have seen a clear trend of rising delinquencies in credit cards and auto loans, as well as an increase in Chapter 11 filings. Looking forward, we believe the risks of consumer spending are skewed toward the negative side. We expect the labor market to continue to cool down with the headwinds of lagged effects of high interest rates. Ultimately, the slow real income growth will dampen consumer demand and soften economic growth.

Japanese equity outlook: Japanese equities are up 20.3% in U.S. dollar terms, and its performance in local currency was even more impressive (up 36.2% YTD). Our outlook for the Japanese equity market is positive for the following factors: 1) While most of the developed countries are fighting against stubbornly high inflation, Japan has welcomed the resurgence of inflation, with a core CPI of around 4.0% year over year in recent months. The high wage growth would imply higher consumer demand, leading to high revenue growth for consumer-oriented companies. 2) The Bank of Japan has begun its policy normalization, and the transition from negative interest rates to positive ones would be beneficial for the Japanese banking sector as banks would be able to generate interest on excess reserves and be able to charge higher interest rates on bank loans. 3) The Tokyo Stock Exchange (TSE) governance has improved, and the TSE has encouraged firms to enhance profitability and improve stock valuations by reducing excess cash and divesting underperforming businesses. We believe that Japanese equity is an attractive long-term investment opportunity given its function as a hedge against global inflation, its relatively attractive valuations, and the improved governance of the Tokyo Stock Exchange.

Macroeconomic

- Nonfarm payrolls rose by 199,000 in November, showing signs of a cooling labor market (abstracting from the impact of the UAW strike). The four-week moving average of initial jobless claims remained steady at 212,000 as of December 23.
- Retail sales improved modestly and rose 0.3% in November.
- U.S. industrial production rebounded in November, expanding 0.2% after a 0.9% contraction in October.

Sentiment

- U.S. manufacturing activity contracted for the 13th consecutive month, with the ISM manufacturing index remaining at 47.6 in November.
- The University of Michigan Consumer Confidence Index increased significantly to 69.7 in December from 61.3 in November, driven by a notable decrease in inflation expectations.
- The NAHB index increased modestly to 37 but remained well below the neutral level.

Technical

- Technical indicators were positive overall, with positive momentum and fear signals outweighing negative reversal signals.
- The S&P 500 was 10% above its 200-day moving average, 7% above the 100-day average, and 6% above the 50-day average.
- The VIX index remained low during December and settled at 12.5 at the end of the month, with improved risk sentiment and low levels of realized equity volatility.

Valuation

- Valuation metrics for equity remained negative. P/E increased from 21.9 at the end of November to 22.9 at the end of December.
- Forward P/E increased to 22.1 at the end of December from 21.1 at the end of November.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remained negative with high bond yields.