NorthCoast Asset Management

Quarterly Client Update

Q2 2024

June 30, 2024

"Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria."

~ Sir John Templeton

As we enter a new quarter in an election year, it seems appropriate to reflect on the dynamic interplay between political events and market behavior, which is very much like the symbiotic relationship between voter participation and election outcomes. Just as every vote counts in shaping the political landscape, every market participant's decision contributes to the overall valuation of the stock market.

Political elections are a quintessential demonstration of collective sentiment. Voter turnout reflects the public's engagement and confidence in the political process, much like investor activity mirrors trust in and outlook on market conditions. High voter participation typically signals a robust democratic process, similar to how increased trading volumes can indicate a healthy, liquid market.

A recent example is the recent political swings observed in the French elections. Initial expectations pointed towards a far-right majority, but a record voter turnout resulted in a left-leaning divided government for the second round. Such political shifts create periods of volatility and adjustment as markets react to new policy directions and economic strategies.

Similarly, recent US election events have thrown a curveball into the election outlook, adding another layer of uncertainty to an already unusual year of worldwide political events. These highlight the intricate connections between political developments and market behavior, as investors adjust their strategies based on anticipated policy changes and economic impacts.

Recently, we've observed a notable decline in the trading volume of SPY (the SPDR S&P 500 ETF), indicating a period of reduced investor activity and engagement. This decrease in volume can be interpreted as a sign of market participants adopting a wait-and-see approach, possibly due to uncertainties in the macroeconomic environment or in anticipation of future political developments.

Moreover, the current US market rally is extremely narrow, dominated by a handful of high-profile stocks and not representative of the overall market health and breadth. This phenomenon is particularly concerning in a slowing late-cycle economy, where broader market participation is crucial for sustained growth and stability. Stocks like NVIDIA (NVDA) have shown remarkable performance, yet their success underscores the disparity between leading stocks and the general market conditions.

As we move into the third quarter, understanding some of these parallels can offer deeper insights into market movements. By appreciating the connections between trading volumes, individual stock performances, and market valuation, we can better anticipate and respond to the multifaceted forces shaping our investment landscape.

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: A Narrow and Negative Quarter

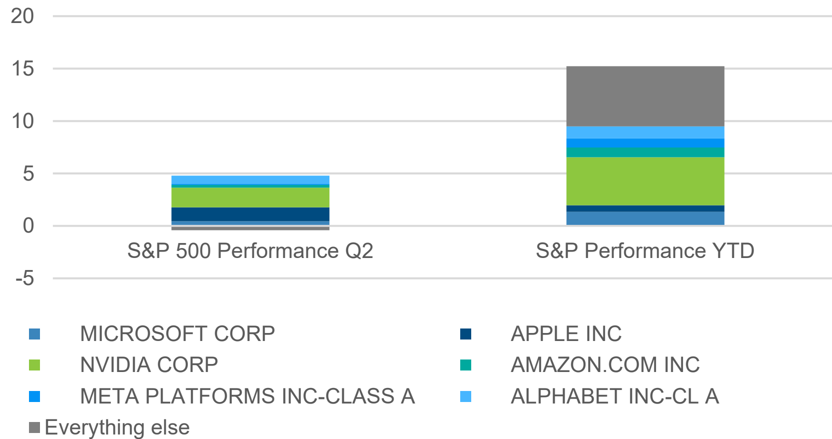
Last quarter we discussed the magnitude of the distortion of index returns caused by the artificial intelligence gold rush and some technology stocks. This quarter is confirming the trend, with potential signs of cooling off.

A few year-to-date statistics: the S&P 500 Index is up 15.05% at the end of second quarter, with 38% of its stocks having negative returns and less than 25% of its stocks beating the index. This is on pace to be a record low when looking at the past 40 years (the next two lowest years are 1998 and 2023). The average stock return is 5.2% while the top six names (Microsoft, Apple,

Nvidia, Amazon, Meta, Alphabet) disproportionately accounted for almost 10% of the 15.05% return YTD (almost two-thirds of the performance).

Now looking at the second quarter the index is up 4.18%, more than entirely attributable to the same six names, while the average stock in the index was down 2.5%, with 58% of the stocks having negative returns (Exhibit 1).

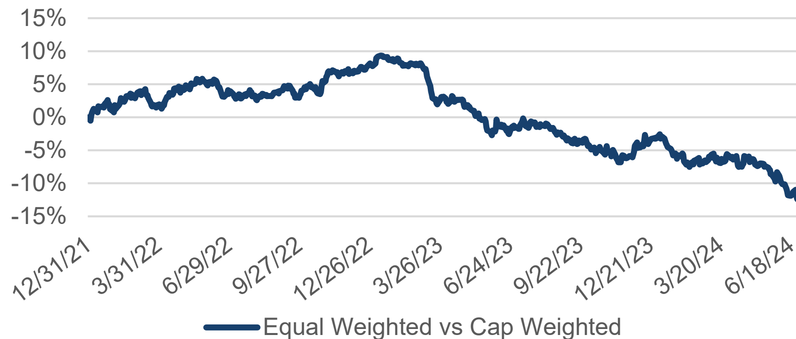
Exhibit 1: S&P Performance Q2 and YTD



Source: Bloomberg.

We like to measure the notion of market breadth by comparing the performance of the equal-weighted S&P 500 Index versus the cap-weighted index performance. You can see below that after a difficult 2023 and Q1 2024, the race between those two indices has gotten even worse over the past few months (Exhibit 2).

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

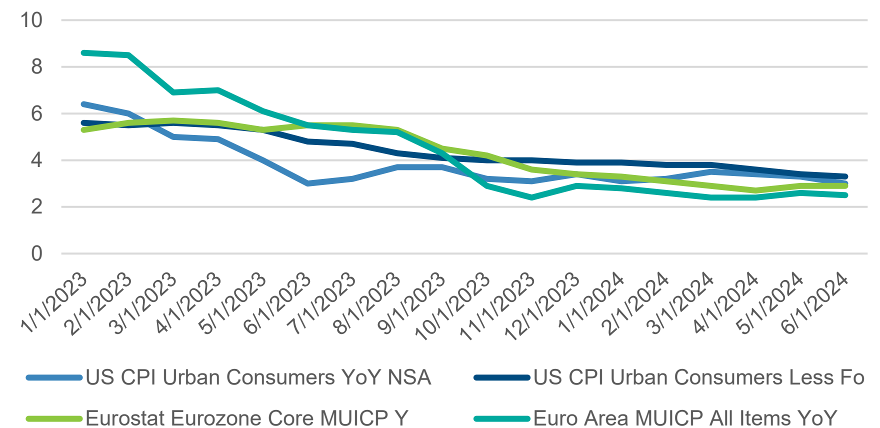


Source: Bloomberg.

Inflation: Improvements so far but resilience ahead

Core inflation has continued to abate but is now doing so slower (Exhibit 3). Core inflation now stands at 3.3%, and headline inflation has now declined to 3%, both declining by 0.5%. While the trend continues to be in the right direction, the pace in inflation moderation is slower than previous quarters and slower than the market anticipated. This quarter the decline was mostly caused by gasoline prices, which tend to be more volatile. We have highlighted in our previous commentaries that possibility and see it becoming the base case for the moment. The markets seem to have integrated this scenario as the new consensus.

Exhibit 3: US/Europe Core Inflation Rates

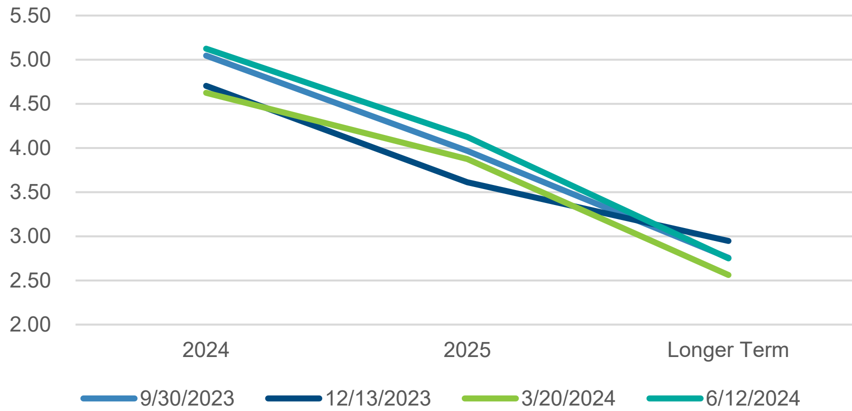


Source: Bloomberg.

Federal Reserve Actions: A First Cut in September?

In May and June, the FOMC continued to pause and maintain its policy rate within 5.25% and 5.5%. While acknowledging the encouraging data, they indicated they're looking for additional data confirmation before taking any action. The tone was to pause, reiterating the 2% inflation target and the need to stay higher for longer, while assessing the strength of the economy and the labor market. The dot plot is now higher than the last one for all horizons (Exhibit 4).

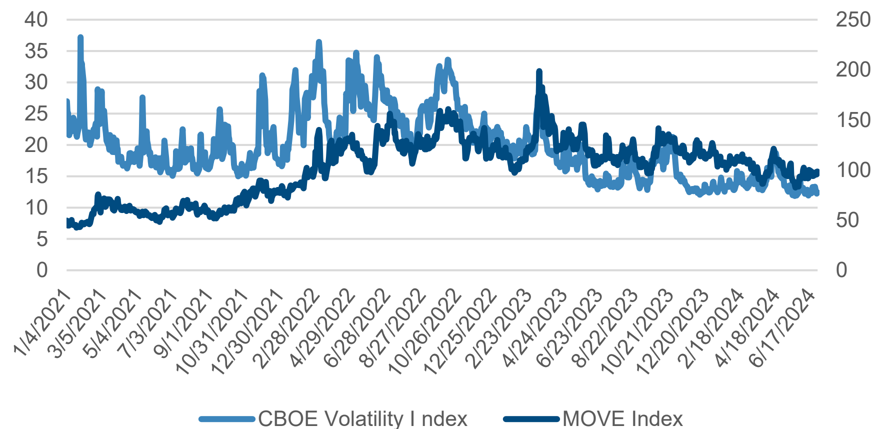
Exhibit 4: FOMC Dot Plots continue to signal high rates for longer



Source: Bloomberg.

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. With a continuation of the positive trend this quarter, that uncertainty is a little lower than it used to be, indicating that the "higher for longer" scenario might be sinking in. Meanwhile the VIX (Volatility) Index continues at its lows along with tight credit spreads, reflecting the optimism in the economic situation.

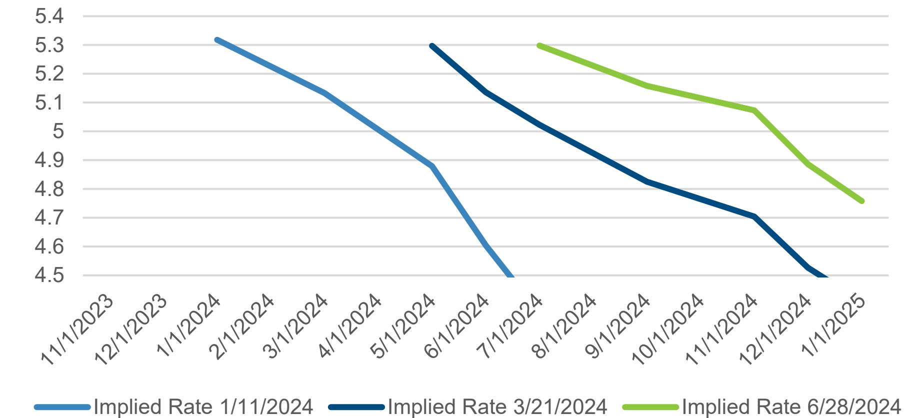
Exhibit 4: The MOVE Index indicate moderating uncertainty in interest rates, while the VIX Index indicates a constructive investment narrative.



Source: Bloomberg.

The rates markets have incorporated this information (Exhibit 6) and are pricing in higher rates for longer, showing an implied rate curve higher than the ones of the last two quarters.

Exhibit 6: Implied Rates have significantly decreased in Q4



Source: Bloomberg.

We continue to see US equities trading at multiples of 24X-27X with some signs of economic slowdown in combination with resilient inflation. The prudent thesis makes risk assets seem overbought, exposing vulnerabilities in US equities. The Shiller CAPE (cyclically adjusted price-earnings ratio) is 36, near the highs of the dotcom bubble. In contrast, the Euro Stoxx 50 is trading at 13X-15X multiples, the FTSE 100 Index trades at 12X-14X, the S&P TSX Index trades at 16-17X, offering viable competing alternatives to US equities. Yield spreads continue to compress and are low by historical standards both in corporate and high yield segments.

Economy: Resilient with a Moderate Slowdown

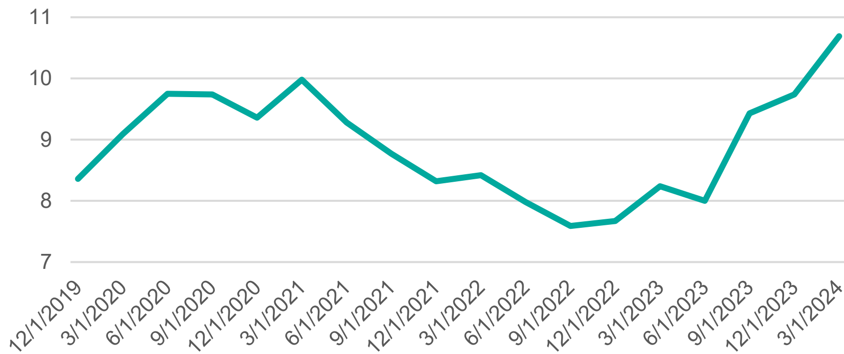
Recession risks have continued to inch lower however more recently recession probability has decreased slightly to a moderate 30%.

For 2024, we are continuing to 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.

Credit card delinquencies are rising to levels now higher than the 2020 recession (Exhibit 7).

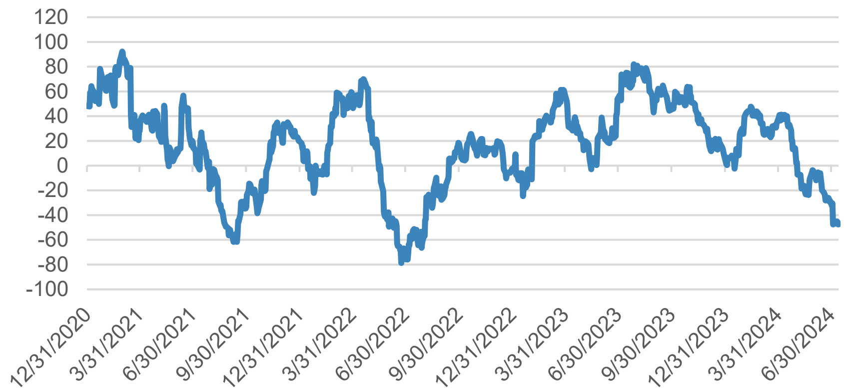
Exhibit 7: Credit Card Delinquencies starting to rise (% of balance delinquent 90+ days)



Source: Bloomberg

Another sign of economic slowdown is the Citigroup Economic Surprise Index which continued to decline over the past quarter, indicating that while still resilient, the US economy is no longer posting as many strong positive surprises as the majority of 2023. This indicator is now firmly in negative territory. (Exhibit 8).

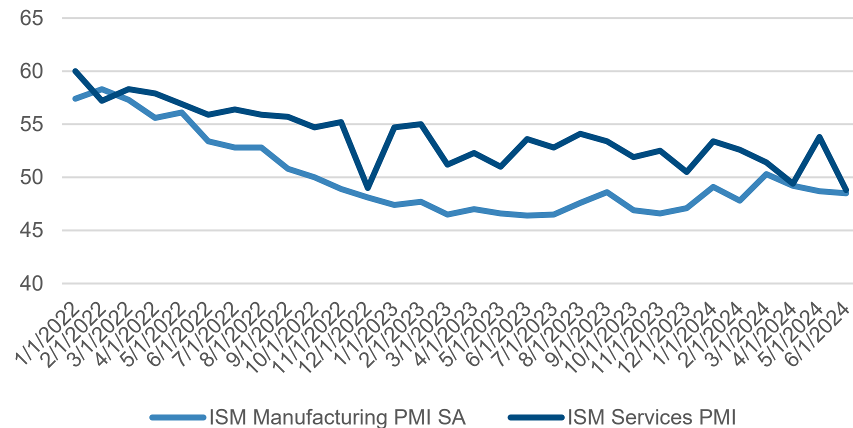
Exhibit 8: The Citigroup Economic Surprise Index indicates how economic data compares with consensus estimates



Source: Bloomberg, Citigroup.

Further signs of a moderate slowdown can be seen in the leading indicators of the PMI ISM surveys (Exhibit 9). Both indices are now at slightly below the neutral 50 level. While the declines seem to have stabilized, they have not shown any clear signs of improvement over the past six months.

Exhibit 9: ISM Manufacturing and Services Indices are in neutral territory



Source: Bloomberg.

US Elections: More uncertainty later in the year

We continue to monitor the election, with some unprecedented developments for both candidates over the past quarter. The outcome of the election could yield significant changes to regulation, fiscal policy, trade policy and foreign policy. Of particular interest are the risks of higher tariffs and increased fiscal spending which could reinvigorate inflation risks. While this aspect is dominating the news, with some uncertainty, we take comfort that 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, it seems that the focus on the Fed and its inflation fight are more of a known-unknown with a reasonable consensus, in the context of a soft landing/higher for longer scenario dominating the narrative. The focus

seems to have started shifting to the magnitude of the economic slowdown and the resilience of the economy amidst political uncertainty and a concentrated bull market fueled by the economic prospects of artificial intelligence. Any evidence of a less than perfect scenario can create vulnerabilities, and some risks of a healthy correction. While we still 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.

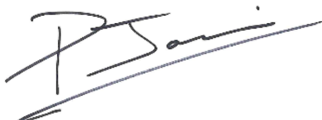
Given the current market conditions we reiterate our recommendations:

- Diversify-Diversify-Diversify: by asset class (bonds, equities, alternatives, options), by investment approach (long, tactical, premium income), by style (active, passive, defined outcome), by benchmark (equal weighted / cap weighted), by geography (US, International …): embrace other scenarios.
- Be realistic and remain cautious and opportunistic in the current environment with active risk management and tactical strategies.
- Follow a systematic and flexible approach and stick with it during episodes of volatility.

As the S&P Index breaks new records this summer and propels certain stocks to very generous levels, keep in mind the recent political gyrations and how quickly a situation which seemed quite certain can evolve.

I hope this letter finds you and your family happy, healthy, and enjoying your summer. 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 appropriate allocations and proactive financial planning. As always, we thank you for your business.

Warm regards,



Patrick Jamin
President & CIO

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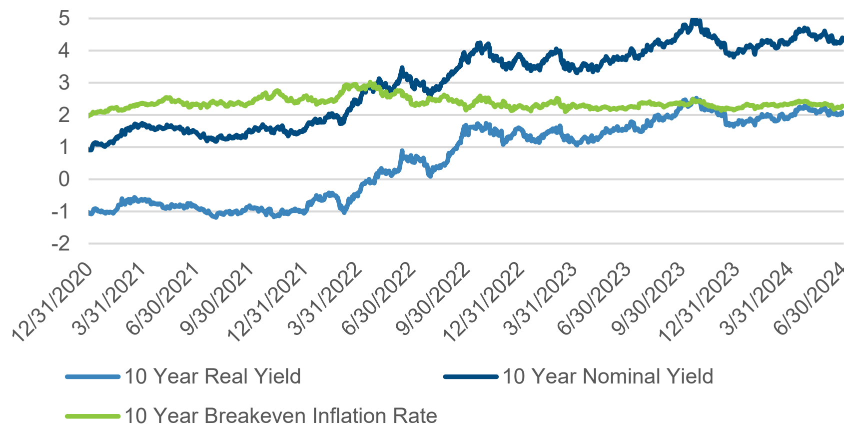
Yield Advantage and Softer Inflation Drive Fixed Income Opportunities

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

U.S. Treasury yields rose significantly in April as investors reassessed their expectations for interest rate cuts in 2024, following warmer-than-expected inflation data in the first quarter. However, treasury yields generally saw a downward trend in May and June, driven by evidence of cooling inflation, below-expectation activity and sentiment data, and renewed expectations of policy rate cuts. The nominal 10-year U.S. yields ended the quarter slightly higher at 4.40%, compared with 4.20% at the end of the previous quarter. The increase in real yield contributed primarily to the shift, with real yield up by 20 basis points for the quarter. Inflation expectations, measured by the 10-year inflation breakeven rate, saw a marginal decrease from 2.32% at the end of the first quarter to 2.28% (see Exhibit 1).

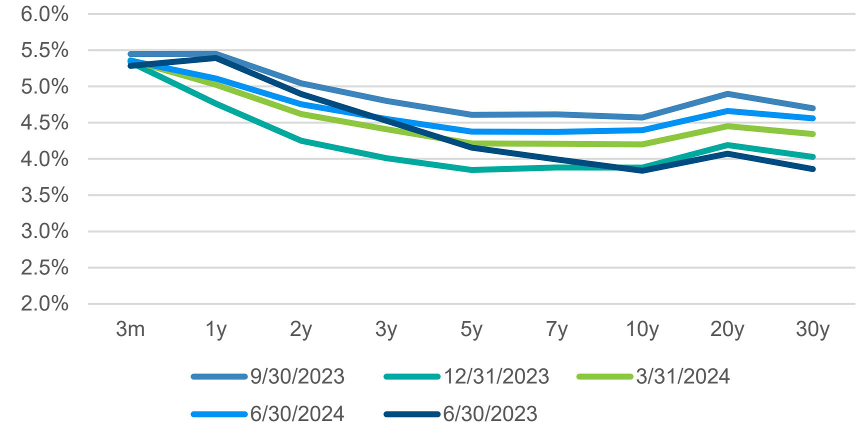
Exhibit 1: Treasury yields increased in the second quarter of 2024



Source: Bloomberg.

Treasury yields across most maturities increased for the first quarter, except for the 3-month yields, leading to a slightly less inverted yield curve. The 3-month yield decreased marginally from 5.36% to 5.35%, a level 0.96% higher than the 10-year yields (compared with 1.16% higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 10-year and 30-year bond yields increased by around 20 basis points each but remained high historically.

Exhibit 2: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

Moderating growth: In recent months, most investors have focused on the prospect of an economic slowdown, and the U.S. has seen mostly softer data in the second quarter. To some extent, bad news for the economy is becoming good news for the market, as they might enable an easing in financial conditions and increase the probability of a soft landing. U.S. manufacturing activity regressed into contraction territory in April and contracted again in May, as shown by the ISM manufacturing index dropping to 48.7 in May. Homebuilder confidence reversed the upward trend and declined in the second quarter to 43, below the 50-point neutral threshold. Higher mortgage rates were the major culprit behind the decline. On the household side, the University of Michigan consumer sentiment index has turned down for several months, decreasing to 65.6 in June, the lowest reading since November.

And yet, we found ourselves not having to change our growth forecast – we still expect moderate economic growth this year. Consider the current state

of the labor market – payroll gains averaged an impressive 249,000 per month over the last three months, and the slowdown in April is more likely an anomaly than an indicator of any imminent weakness. At the margin, the labor market has seen signs of a modest softening, as the initial jobless claims trended slightly higher in recent weeks. Consumer spending has also witnessed some weakness in recent months, but we believe spending will remain supported by a robust job market, real wage increases, and household wealth effect, with inflation-adjusted U.S. household wealth up a stunning $19.1 trillion since Covid.

Cooling inflation, but bumpy road: April and May have welcomed a more-than-anticipated moderation of inflation. May headline CPI remained unchanged from April, resulting in a decrease in the year-over-year inflation rate from 3.4% to 3.3%. Gasoline pricing (down 3.6% from a month ago) was the primary driver for the softer headline CPI in May. Core CPI (excluding food and energy) grew 0.2% in May, with year-over-year growth slowing down from 3.6% to 3.4%. Once again, shelter inflation drove most of the increase in core CPI, rising 0.4%. Also, the PPI (producer price index) unexpectedly experienced its biggest drop in seven months in May, contributing to signs that inflationary pressures are easing. The PPI for final demand decreased 0.2% in May, following a 0.5% jump in April, and bringing down the annual rate to 2.2%.

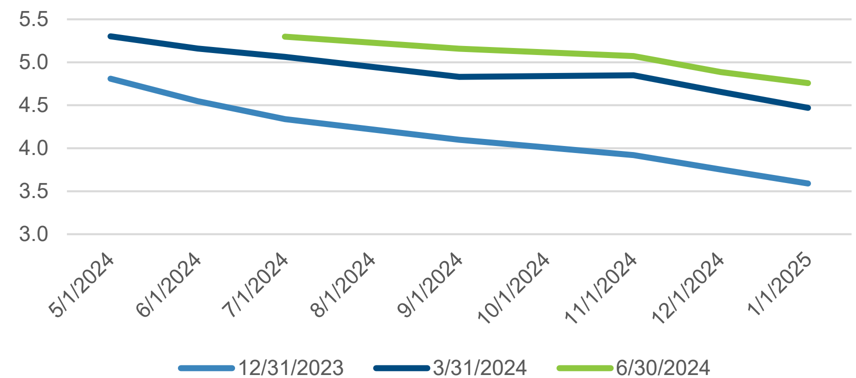
We anticipate a bumpy road in the "last mile" on inflation until inflation is sustainably at 2%. While May appears promising in this fight, extrapolating individual inflation reports is tricky, and a single print is unlikely to change the Fed's immediate-term strategy. For example, 11 bps out of the 13 bps drop in core CPI were due to transportation service, which is not sustainable, and we should expect some payback next month. Furthermore, year-over-year CPI comparisons will be a bit difficult in the second half of the year, given the relatively low inflation in the second half of 2023.

Fed policy: As widely expected, the Federal Open Market Committee left the Fed funds rate unchanged at 5.25% to 5.5% in its May and June meetings. However, the market's interpretation of the committee's latest Summary of Economic Projections was slightly hawkish as June's median projection showed just one cut this year, compared with three cuts forecasted in its March meeting. Although the Fed's data-dependence approach suggests that we can't put much weight on its policy signals in one meeting, one theme stays consistent – Chairman Powell reiterated that the committee was not confident enough that inflation was consistently on track back to its 2% target, despite the moderating May CPI.

We believe that we are in a higher-for-longer interest rate environment and expect a shallow path for rate cuts, given the prospects of moderate economic growth and a bumpy road towards slower inflation. The Fed has maintained a cautious stance and has been slowly coming to terms with the idea that rates will need to stay high for longer – both in the short and long term. That's highlighted by the gradual increase of its estimate of long-run rates, with FOMC's longer-term dot now up to 2.75%.

Market expectations have adapted accordingly. Since the beginning of the year, market expectations about the Fed's schedule for policy easing have been pushed back significantly (See Exhibit 3). As of 6/30/2024, the Fed funds futures market indicated a total of 50bps in rate cuts by the Fed in 2024, compared with 150bps cuts estimated at the end of last year.

Exhibit 3: Fed Funds Rate Implied by the Futures Market



Source: Bloomberg.

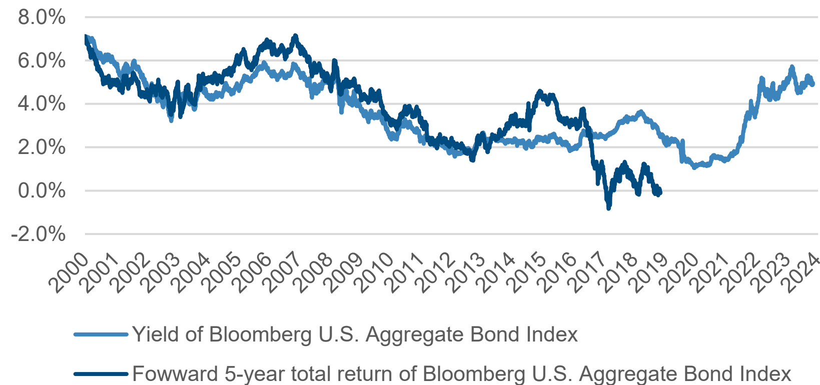
Fixed Income Outlook

Given today's high yields, a moderating inflation outlook, and growth uncertainty, we view fixed income investments as appealing to investors seeking attractive income, downside protection, and diversification through reduced correlation with equity markets. Following we discuss three themes:

1. Starting yields still look attractive,
2. The expected yield curve normalization,
3. The differentiation in monetary policies and less synchronized business cycles across countries/regions.

First, starting yields, which proved to be highly correlated with returns by empirical evidence, are still among the highest levels over a decade. Current high starting yields can boost potential bond returns and act as a buffer against downside risks. As shown in Exhibit 4, starting yields are good predictors for forward bond returns (with 90% of correlations). The yields on the Bloomberg U.S. Aggregate stood high at about 5.3% as of June 30, 2024.

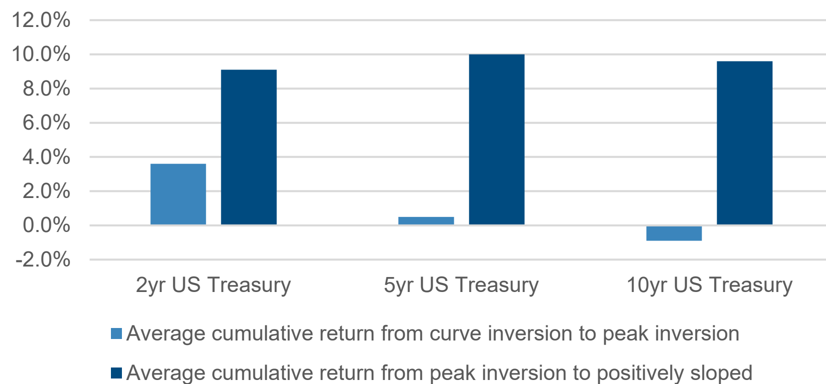
Exhibit 4: Bloomberg U.S. Aggregate Bond Index Yield and Forward 5-year Return



Source: Bloomberg.

Second, while we believe that the yield curve is likely to remain inverted in the near term, we anticipate it to steepen as fed funds rates eventually decrease, and bonds tend to outperform during the curve steeping period. The current U.S. yield curve remains inverted, and June marks the 23rd consecutive month of inverted yield curve without a recession, the longest period in history. However, once interest rate cuts appear more imminent, the curve should steepen with declining short-term rates. As shown in Exhibit 5, initial inversion and subsequent flattening of the yield curve due to tightening policy presents a challenging environment for bonds, especially the longer-duration exposure. However, bonds generally perform better as the curve steepens to positively sloped.

Exhibit 5: Bonds tend to outperform when yield curve steepens



Source: Bloomberg.

Third, global fixed income markets provide more opportunities for active management as monetary policies and business cycles are less synchronized across regions, leading to lower correlation across different regions/countries. While the Fed has held its finger on the pause button, the ECB started its easing cycle in June. The Bank of Japan, on the other hand, has considered raising interest rates further due to inflationary pressure in its June meeting. These divergent monetary policies across regions create distinctive opportunities for diversification and return enhancement through country/region selection.

Investment Implications

Against the backdrop of a moderating economic outlook, a cooling but bumpy road for inflation, and the expectation of the Fed's easing later this year, we favor a balanced approach in the current investment climate to take advantage of the broad-based opportunities across fixed income sectors. Our allocation among these sectors remains up-in-quality, while also preparing to take advantage of opportunities in other sectors as prices adjust to reflect changes in underlying fundamentals. We are neutral in duration in our more static portfolio and slightly underweight duration in our more dynamic portfolios. For YTD as of June 30, 2024, our Tactical Income strategy returned 1.2% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 4.3% and 1.9%, respectively. In the second quarter, we focused on several key themes in our strategies, outlined below:

- **Slightly extended duration:** We favor intermediate-term U.S. Treasuries as they are less affected by the high volatility of long-term rates and the reinvestment risk associated with the very short-term end of the yield curve with rate cut prospects. At the same time, we slightly added duration exposure during the second quarter to lock in yields and to protect against any unexpected economic disruptions.
- **Investment grade credit:** Given moderate economic growth and the Fed's on hold stance, the fundamentals of the investment grade credit sector remain relatively steady. Looking forward, we believe investment-grade credit spreads are likely to be within a stable range, driven by strong technical factors and attractive yields.
- **Continuing to hold bank loans and high-quality CLO:** With the markets' shifting expectation of delayed rate cuts, leveraged loans have continued to outperform high yield credit, driven by elevated rates and their lack of duration. In our portfolio, we have slightly added our exposure to the Invesco Senior Loan ETF (BKLN) from 5% to 7%, generating a YTD return of 3.6% as of 06/30/2024. Regarding collateralized loan obligations (CLOs), we prefer senior CLO tranches

due to their appealing carry and higher credit ratings. We maintained a 5% position of the BlackRock AAA CLO ETF (CLOA), which primarily invests (87%) in AAA-rated tranches and currently offers a yield of 6.0%.

- **Emerging Market Debt:** Emerging market bonds offer attractive yields of about 7% and longer duration, positioning them to benefit from a rally in rates with potential central banks rate cuts. Emerging market inflation continued to moderate, and we see country fundamentals remain relatively strong. We have a modest exposure (2%) to iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB).

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NorthCoast Navigator

Q2 2024 | June 30, 2024

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 6/30/2024. Data provided by Bloomberg, NorthCoast Asset Management.

Current Equity Exposure

Summary: Equities continued to advance in June following more evidence of cooling inflation and renewed expectations of policy rate cuts. The S&P 500 and the Dow climbed by 3.6% and 1.2%, respectively, while the technology-heavy Nasdaq outperformed by rallying 6.0% for the month. Markets seem optimistic about the outlook of easing policy, pricing in two interest rate cuts this year, while the median dots from the FOMC suggested only one cut. We believe that we are in a higher-for-longer interest rate environment and expect a shallow path for rate cuts, given our prospects for moderate economic growth and a bumpy road towards slower inflation. Also, there is an extreme level of stock concentration, with the largest 20 Stocks accounting for 75% of S&P 500 gains year to date. While we expect technology to continue fueling economic growth, we remain cautious and view this trend as unlikely to be sustained. Overall, we anticipate a bumpy process in the "last mile" on inflation, high for longer policy rate and moderating growth. With this backdrop, we maintained our allocation to U.S. equities at 48% and our international equity exposure at 69%.

Cooling Inflation: In May, inflation moderated more than anticipated, with the headline CPI remaining unchanged from April, resulting in a decrease in the year-over-year inflation rate from 3.4% to 3.3%. Gasoline price (down 3.6% from a month ago) was the primary driver for the softer headline CPI in May. Core CPI (excluding food and energy) grew 0.2% in May, with year-over-year growth slowing down from 3.6% to 3.4%. Once again, shelter inflation drove most of the increase in core CPI, rising 0.4%. Also, the PPI (producer price index) unexpectedly experienced its biggest drop in seven months, contributing to signs that inflationary pressures are easing. The PPI for final demand decreased 0.2% in May, following a 0.5% jump in April and bringing down the annual rate to 2.2%. While May appears promising in the fight against inflation, extrapolating individual inflation reports is tricky, and a single print is unlikely to change the Fed's immediate-term strategy. Furthermore, year-over-year CPI comparisons will be a bit difficult in the second half of the year, given the relatively low inflation in the second half of 2023.

Central Banks' Policy: As widely expected, the Federal Open Market Committee left the fed funds rate unchanged at 5.25% to 5.5%. However, the market's interpretation of the committee's latest Summary of Economic Projections was slightly hawkish as June's median projection showed just one cut this year, compared with three cuts forecasted in its March meeting. At the same time, the median forecast for GDP growth remained unchanged at 2.1% for 2024, despite a weak Q1 GDP of 1.3%, indicating that the committee believes that the U.S. economy will still be relatively resilient for the rest of the year. Although the Fed's data-dependent approach suggests that we cannot put much weight on its policy signals in one meeting, one theme stays consistent – Chairman Powell reiterated that the committee was not confident enough that inflation was consistently on track back to its 2% target, despite a slowing labor market and the moderating May CPI. June's FOMC meeting occurred after the Bank of Canada and the ECB (European Central Bank) both cut rates earlier this month.

Technology Sector and AI: The technology sector has seen a 28% increase YTD, nearly quadrupling the S&P 500 excluding the tech sector. The market cap-weighted S&P 500 increased by 15% this year, while the equal-weighted S&P 500 (SPW Index) was up only 5%. Since the end of 2022, the tech sector has soared 100% compared to a 24% rise in the rest of the index. Investors' preference for high-quality stocks and market focus on AI were the primary drivers for the dominance of the tech sector. AI has significantly boosted corporate earnings for tech firms. For Q1 2024, much of the earnings surprise was concentrated in Mag7 compared with the rest of S&P 493 (9.9% vs. 1.6%). However, for this momentum to persist in the second half of the year, the largest companies will likely need to consistently revise their earnings estimates higher, which could be challenging given the already high consensus for earnings growth.

Macroeconomic

- Nonfarm payrolls rose by 272,000 in May, stronger than consensus expectations. The initial jobless claims drifted upward, with the four-week moving average edging up to 236,000 as of June 22.
- Retail sales rose slightly in May by 0.1% following a weak April.
- U.S. industrial production increased sharply in May by 0.9%, far exceeding consensus expectations.

Sentiment

- U.S. manufacturing activity contracted again in May, with the ISM manufacturing index falling to 48.7 in May from 49.2 in April.
- The University of Michigan Consumer Confidence Index continued to fall in June to 69.2 from 69.1 in May, despite downward revisions of inflation expectations.
- The NAHB index declined to 43 in June, with elevated mortgage rates weighing on sentiments.

Technical

- Technical indicators were positive overall, with positive momentum and fear signals outweighing neutral reversal signals.
- The S&P 500 was 12% above its 200-day moving average, 5% above the 100-day average, and 4% below the 50-day average.
- The VIX index was relatively flat with low realized volatility and settled at 12.5 at the month-end.

Valuation

- Valuation metrics for equity remained negative. P/E increased from 24.7 at the end of May to 25.7 at the end of June.
- Forward P/E increased to 22.7 at the end of June from 21.8 at the end of May.
- Inflation-adjusted valuation metrics continued to be negative.
- Equity valuation metrics relative to bonds remained negative with high bond yields.