NorthCoast
Asset Management

Quarterly Client Update

Q1 2021

March 31, 2021

"To everything (turn, turn, turn). There is a season (turn, turn, turn). And a time to every purpose, under heaven."

~ The Byrds

It seems appropriate to quote The Byrds given we find ourselves in the midst of so much societal and economic change worthy of discussion. How about economic growth for starters? Ronald Reagan was in the White House and *Return of the Jedi* was in theaters when economic growth hit levels that we expect to see this year if economists are correct. Those surveyed by *The Wall Street Journal* boosted their average forecast for 2021 economic growth to 6.4%, measured as the change in inflation-adjusted gross domestic product in the fourth quarter from a year earlier. If realized, that would be one of the few times in 70 years that the economy has grown so quickly. Adding fuel to this projection, Congress just approved another $1.9 trillion in fiscal support as President Biden unveiled an infrastructure investment plan to be partly financed by higher corporate taxes.

How about efforts to resurrect normal life after COVID lockdowns? While a purely digital existence has been interesting and miraculous in many ways, it's not sustainable. Humans are social animals, and we need real interaction with each other to thrive. About a third of Americans have now received at least one COVID vaccine and recent data shows 19.4% of the U.S. population is fully inoculated against COVID-19 according to the Centers for Disease Control and Prevention.[1] We're not out of the woods yet. But parts of pre-pandemic life are returning, from Hollywood movie openings (*Godzilla vs. Kong* raked in $48.5 million despite capacity limitations at most theaters) and baseball fans are returning to stadiums as MLB kicked off the season on April 1, (roughly 13,000 fans were allowed to watch the Los Angeles Angels play the Chicago White Sox on Opening Day, as Angel Stadium opened at 33% capacity).[2]

And for investors, what about all-time highs in the stock market coinciding with a historically significant rise in bond rates? The good news is your portfolio has got you feeling pretty good. The bad news is that financial assets have never been so expensive at the start of an economic recovery, and the market euphoria is increasingly turning into concern about the outlook for inflation. Stock markets are discounting machines and it's important to ask "will people buy 4 Peloton bikes?" or said another way, at what point is all that future growth already priced in? Having been quiet for much of last year, bond markets are getting more worried about inflation, and both central expectations and the inflation risk premium have started to rise. US 10-year Treasury yields are currently around 1.7% and forwards indicate they are likely to move higher. That amounts to a ~80 basis point rise in yields in three months, the sharpest move in over four years (Table A). Much of the bond market concern is centered in the US, where some fear the $1.9 trillion fiscal stimulus is too large, especially on the back of $3.1 trillion in stimulus to date, the full effects of which are yet to be felt. In addition to those factors, markets also sense that potentially very large pent-up private demand may meet significant supply constraints across economies once they fully re-open. If that wasn't enough, underneath those estimates lurk some concerning details – China's producer prices climbed in March by the most since July 2018 on surging commodity costs and the producer price index rose 4.4% from a year earlier after gaining 1.7% in February.

Table A: Upward cycles for the US 10-year Treasury Yield and S&P 500 returns

Start of rise in US 10-year yield	End of rise in US 10-year yield	Duration in years	Yield low	Yield peak	Change in yield	Change in yield per year	Change in S&P 500	Change in SPX per year (CAGR)	US Recession
6/30/1931	1/31/1932	0.6	3.13%	4.26%	1.13%	1.92%	-46.86%	-	Aug 29-Sep 33
11/30/1945	10/31/1948	2.9	1.55%	2.20%	0.65%	0.22%	-4.01%	-1.36%	Nov 48-Oct 49
12/31/1949	6/30/1953	3.5	1.80%	3.11%	1.31%	0.37%	43.78%	10.66%	Jul 53-May 54
4/30/1954	10/31/1957	3.5	2.29%	3.97%	1.68%	0.48%	45.29%	10.99%	Aug 57-Apr 58
4/30/1958	1/31/1960	1.8	2.88%	4.72%	1.84%	1.05%	28.02%	14.42%	Apr 60-Feb 61
5/31/1961	8/31/1966	5.3	3.71%	5.36%	1.65%	0.31%	15.84%	2.79%	
3/31/1967	5/31/1970	3.2	4.50%	7.95%	3.45%	1.09%	-15.13%	-4.92%	Dec 69-Nov70
3/31/1971	9/30/1975	4.5	5.53%	8.48%	2.95%	0.65%	-16.39%	-3.83%	Nov 73-Mar 75
12/31/1976	2/29/1980	3.2	6.81%	12.72%	5.91%	1.87%	5.77%	1.74%	Jan 80-Jul 80
6/30/1980	9/30/1981	1.3	10.09%	15.84%	5.75%	4.59%	1.70%	1.27%	Jul 81-Nov 82
2/28/1983	5/31/1984	1.3	10.27%	13.91%	3.64%	2.90%	1.68%	1.26%	
8/31/1986	9/30/1987	1.1	6.95%	9.63%	2.68%	2.48%	27.24%	22.94%	
9/30/1993	11/30/1994	1.2	5.40%	7.91%	2.51%	2.15%	-1.14%	-0.91%	
9/30/1998	1/31/2000	1.3	4.44%	6.68%	2.24%	1.68%	37.11%	24.96%	Mar 01-Nov 01
5/31/2003	6/30/2006	3.1	3.37%	5.15%	1.78%	0.58%	31.82%	9.12%	
12/31/2008	12/31/2009	1.0	2.25%	3.85%	1.60%	1.60%	23.45%	21.47%	Dec 07-Jun 09
7/31/2012	12/31/2013	1.4	1.51%	3.04%	1.53%	1.08%	34.01%	21.55%	
7/31/2016	10/31/2018	2.3	1.46%	3.15%	1.69%	0.75%	24.76%	9.94%	
7/31/2020	2/28/2021	0.6	0.55%	1.44%	0.89%	1.53%	16.51%	-	Feb 20 to ??
	Average	2.3	4.13%	6.49%	2.36%	1.44%	13.34%	8.36%	
	Median	1.8	3.37%	5.15%	1.78%	1.09%	16.51%	9.12%	
	Minimum	0.6	0.55%	1.44%	0.65%	0.22%	-46.86%	-4.92%	
	Maximum	5.3	10.27%	15.84%	5.91%	4.59%	45.29%	24.96%	
	Percentage of Time Up						73.68%		

Source: BofA Global Research, Bloomberg Global Financial Data (GFD).

So what does that mean going forward? In our mind stocks continue to be good assets to own. We do expect further gains this year but with much more volatility. Second quarter earnings between now and the end of May are important because the S&P 500 is trading at 22.6 times its projected earnings over the next 12 months, above the five-year average of 18.14[3]. Higher valuation measures don't lead to bear markets alone and too many other positive market metrics (technical, macro-economic and business sentiment in particular) still make the market attractive. But I would expect at least one pretty good scare during the summer. Volumes are lower at that time, which can exacerbate some corrections. My guess is inflation concerns will probably be the culprit as it becomes more difficult for the biggest and most expensive stocks to withstand the pressure of long duration valuation measures. But corrections are inevitable and shouldn't matter to investors with at least a three-year outlook. By the time people start reacting to it, it will probably be over.

The climate on inflation and rates warrants some additional detail, and I asked Julia Zhu, who manages our tactical income portfolio, to share her thoughts on the bond market in this newsletter. For those of you who own large bond allocations (especially with longer dated maturities) this is an important topic to monitor, and a quick 30-minute check-in with your advisor to plan ahead will be time well spent. We have a number of good ideas to help you generate income from your portfolio with a mix of conventional and non-conventional approaches using options.

On a personal note, as we *turn* into this next season and with my first COVID vaccine appointment behind me, I look forward to reconnecting with friends and family, and even planning a summer getaway. My hope is that you and your family are also looking forward with hope and promise of greater things to come, this summer and beyond.

Warm regards,

Dan Kraninger
President & CEO

Notes:
1 Source: Centers for Disease Control COVID-19 statistics.
2 Source: ESPN.
3 Source: FactSet

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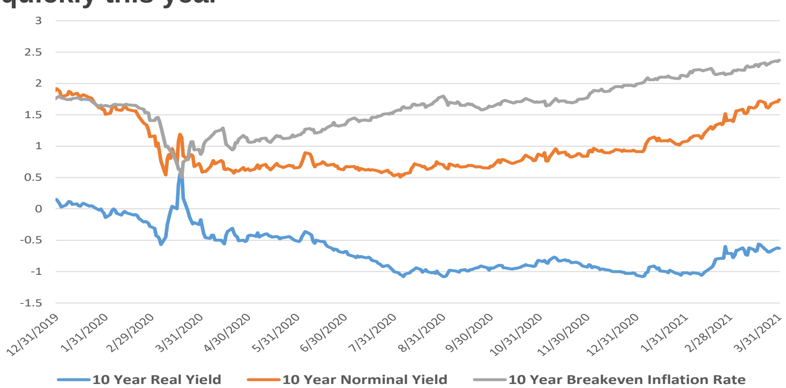
Growth > Policy

Julia Zhu
Senior Vice President, Market and Security Research

As the economy gradually reopens and recovers, there are clear hallmarks of improved economic and sentiment indicators. Record high PMI index, surging payroll employment as well as other continuously improving high-frequency data support our continued cautiously bullish outlook for the market. We believe that the resiliency this economy is demonstrating is largely a function of two key developments: 1) the swift development and distribution of COVID vaccines and 2) the combination of accommodative monetary policy and supportive fiscal measures. We continue to maintain a positive outlook in these areas into the second quarter.

A steep selloff in U.S. Treasury bonds is one of the major themes that dominated the market in the first quarter and left investors wondering about the path ahead. As of March 31, the U.S. 10 year Treasury yield rose to 1.74%, up from 0.91% at the beginning of the year. While part of the rising rates can be explained by higher inflation expectations (10 year breakeven rate rose significantly to 2.37%), real yields were a bigger driving force of the move (43bps) (Exhibit A).

Exhibit A: Treasury yields and inflation expectation have risen quickly this year



Source: Bloomberg, NorthCoast Asset Management. Data as of 3/31/21.

We believe that the recent rise of bond yield is mostly growth driven rather than policy driven. While the rate markets are now better priced for the growth and policy outlook after the bond selloff, we see potential for the 10-year rate to rise further, and believe it's not unlikely for it to reach above 2% during the remainder of the year. Notably, our economic growth outlook is leaning toward a positive surprise, as it is unclear whether the newest round of $2 trillion fiscal stimulus has been fully priced into the market.

Continued concerns about rising real yields negatively affecting equities through higher cost of capital are unsupported in the current environment, as cash flows should be boosted by a stronger economy in the meantime. In fact, in the last 90 years the S&P has traded higher 74% of the time with an average rate of 13.3% during rising cycles of the 10-year treasury yield. Since the 1990s, the only period during which the correlation was negative occurred from 1993 to 1994, when interest rates were significantly higher (above 5%), a level we have not come close to in some time. Investors should generally be more concerned when inflation rises faster than expectations, bringing the risk of an overheating economy, less accommodative monetary policy and sudden rate hikes. We are not expecting that scenario in the foreseeable future given the Fed's patient stance and flexible inflation targets. We are also still in the early stages of the recovery cycle with labor market participation well below pre-pandemic trends.

With global yields rising and markets anticipating a bumpy inflation path, we believe it matters more than ever for fixed income managers to look for tactical opportunities to protect against rising inflation, as well as to seek growth potential. Fortunately our Tactical Income strategy is well positioned, searching for risk adjusted returns in at least four additional dimensions: 1) assets that have high correlations with inflation expectations 2) assets with real yields 3) better global diversification and 4) reduction of duration risk. Since March 31, 2020, our Tactical Income strategy has returned 15.8% net of fee, significantly outperforming the U.S. Aggregate Bond Index (0.7% return) and the Global Aggregated Bond Index (4.7% return).

Specifically, we currently see opportunities in HYG and HYD owing to the continuing decrease of default rates, vast amount of policy support, and fear of tax hikes. IGF and AMLP are viewed as great recovery plays as governments worldwide crawl back to normalcy and gradually increase infrastructure spending. President Biden's $2 trillion infrastructure plan is certainly a tremendous driver for these ETFs. In the meantime, we also allocate to duration hedged fixed income ETFs: HYGH and IGBH to actively manage duration risk, and have added a 3% TIP position to better hedge against rising inflation expectations. The benefit of IGBH was substantial in the first quarter as the 10 year rate spiked, gaining 2.5% for the quarter while its unhedged counterpart IGLB lost 8.4%.

Tactical Income Strategy Allocation vs. the U.S. Aggregate Bond Index since March 31, 2020

ETF	Description	U.S. Bond Index	Tactical Income (Avg)	ETF 1YR Performance
US Treasury Bonds		**43%**	**0%**	
SHY	1-3 years	12%	-	0.2%
IEI	3-7 years	19%	-	-1.7%
IEF	7-10 years	4%	0%	-6.2%
TLH	10-20 years	3%	-	-14.3%
TLT	20+ years	6%	-	-16.7%
ABS, Municipal, Agencies		**28%**	**17%**	
MBB	MBS	27%	12%	0.2%
MUB	Municipal	1%	5%	4.9%
Credit & High Yield Bonds		**29%**	**51%**	
JPST	Ultra-Short Income	-	7%	3.4%
IGSB	Short-Term Credit	17%	-	6.8%
IGIB	Intermediate Credit	6%	6%	10.8%
IGLB	Long-Term Credit	6%	7%	8.3%
HYG	High Yield	-	3%	18.9%
HYD	High Yield Muni	-	10%	24.0%
BKLN	Senior Loan	-	4%	11.9%
IGBH	Long-Term Credit hedged	-	8%	26.3%
HYGH	High Yield hedged	-	7%	19.9%
International Bonds		**-**	**5%**	
EMB	Emerging Market Bonds	-	5%	17.2%
Yield Alternatives		**-**	**19%**	
REM	Real Estate Mortgages	-	1%	103.6%
VNQ	Real Estate	-	1%	36.7%
IGF	Infrastructure Stocks	-	6%	35.3%
AMLP	MLP Infrastructure		1%	99.2%
DVY	U.S. Dividend Stocks	-	6%	61.3%
PFF	Preferred Shares	-	4%	26.9%

Source: Bloomberg. NorthCoast Asset Management. As of 03/31/2021. Allocations are rounded and may not add up to 100%.

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NorthCoast Navigator

Q1 2021 | March 31, 2021

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 3/31/2021. Data provided by Bloomberg, NorthCoast Asset Management.

Economic Recovery and Equity Rotation

The up-and-down Q1 2021 closed out on a positive note with U.S. equities booking gains, the S&P 500 +4.3% in March. That being said, the first quarter was not quite the return to normalcy that many had hoped for after the tumult of 2020. Right now, the story of 2021 is the changing narrative around momentum and growth stocks. At points last quarter the fervor surrounding these stocks seemed unstoppable, and even produced peculiarities such as the Game Stop saga. In mid-February the NASDAQ Composite (growth and tech-heavy) was outperforming the Dow Jones Average (more value heavy) by nearly 7%. Since then, that trend has reversed with tech and growth stocks falling while value has gained favor. One of the main drivers of growth stocks' woes has been rising yields, which generally has a negative effect on these riskier stocks. The rise in value stocks can be attributed to the same reason driving yields higher: improved economic outlook. The positive outlook has signaled a broadening of the equity market's rise, which had been concentrated in the tech sector for the past year. As it broadens, investors are rotating out of an arguably overvalued tech sector and into lagging value equities that are expected to catch up as the economy strengthens.

Equities rose in March on positive economic news regarding lower jobless claims and higher job creation. Consumer sentiment also rose after the disbursement of the most recent stimulus check and planned government spending packages. The spending packages would be aimed at projects, such as infrastructure, to further stimulate the economy, but there is an uphill battle facing these bills' passages. Regardless, the strengthening of the economy is evident at this point, and investors' rotation into value stocks is further substantiation.

In Mid-March the Federal Reserve kept interest rates anchored near zero and did not revise their forecast that rates will remain unchanged through at least 2023. They also raised their expectations for GDP growth and inflation while lowering unemployment estimates. The concerns of rising inflation still exist, and the question now is when and where inflation and yields will plateau. If inflation continues to rise past the Fed's expectations, they may need to consider raising rates prematurely. This could have an adverse effect on economic growth since it would increase borrowing costs.

At present, we are seeing more positive signals than negative. The broadening of the equity market's rise is encouraging and the technology sector's lagging behind cyclicals and value is long overdue. The economy's strength is also a major positive. Valuations are still holding back our investment levels in U.S. equities, and we remain at an opportunistic 78%. Valuations internationally remain relatively more attractive and we are 87% invested in our flagship international strategy.

Macroeconomic

Strong job numbers and rising sentiment will have hopefully had a knock-on effect of stronger consumer spending, a main driver of economic growth in the U.S. Income growth is expected to be slow for the time being, but net job growth is very encouraging. Proposed spending bills could further boost economic outlook, but their passages will be hard won in a divided Congress.

Sentiment

Sentiment is still below its pre-pandemic levels, but it is at its highest level since the pandemic's start. The University of Michigan consumer sentiment survey was up to 85 from 77 a month earlier. Stimulus and solid economic data, such as net job gains, are driving the rise.

Technical

Technical indicators remain positive. The broadening of the U.S. equity market's gains is an encouraging sign of more general momentum throughout the market. At the end of the quarter, the S&P 500 sits comfortable above its main moving averages. Currently is 12% above the 200-day moving average.

Valuation

With the rotation out of the tech and growth sectors, the relative valuation of this sector has improved slightly. Overall, however, valuations are generally still very high and equities appear overvalued. P/E ratios increased with the market rise from 30.88 at end of February to 32.43 at end of March.