NorthCoast

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Quarterly Client Update

Q2 2022

June 30, 2022

"History doesn't repeat itself, but it often rhymes."

~ Mark Twain

At midyear, the United States economy is sliding into a recession. Unemployment, which reached 5% of the labor force in May, almost certainly will climb higher in June. With hundreds of thousands of young people entering the job market at a time when employers are laying off workers, unemployment will go higher this summer and threatens to hit 6% by the end of the year. The most disturbing aspect of the immediate economic outlook is the sag in spending on industrial and commercial construction and on inventories. A further fall in business investment would turn this mild slump into something more serious. And look at the market – the first six months of the year were down over 20%.

Businesses are trimming their plans for spending on new plant and equipment order to conserve cash. With orders down, manufacturers are operating below 80 per cent of capacity. The economy could be facing a period of sluggish growth lasting years rather than months. With all the downward pressure on the economy, the first signs of a slowing of inflation seem to be appearing. Some sensitive commodity price indexes are down; the over-all wholesale price index is rising at a slightly slower rate. But consumer prices have thus far scarcely been affected. Service costs still are skyrocketing. And wage pressures have not yet abated.

The Nixon Administration has been forced to make the agonizing decision whether to fight recession or inflation. The President has concluded that it has already done enough to stop inflation and will let the momentum of the downward trend finish the job. "It's a little like trying to bring a boat into a dock," said Mr. Nixon. "You turn down the power well before you get the dock and let the boat coast in." One can only hope that this tricky maneuver works to end the slump while stopping the inflation. And we have not even begun to discuss the stress on the country due to the ongoing war in Vietnam.

Wait. Nixon, Vietnam?

S&P 500 Performance

July 1969-June 1970

Source: Investor's Business Daily, Bloomberg.

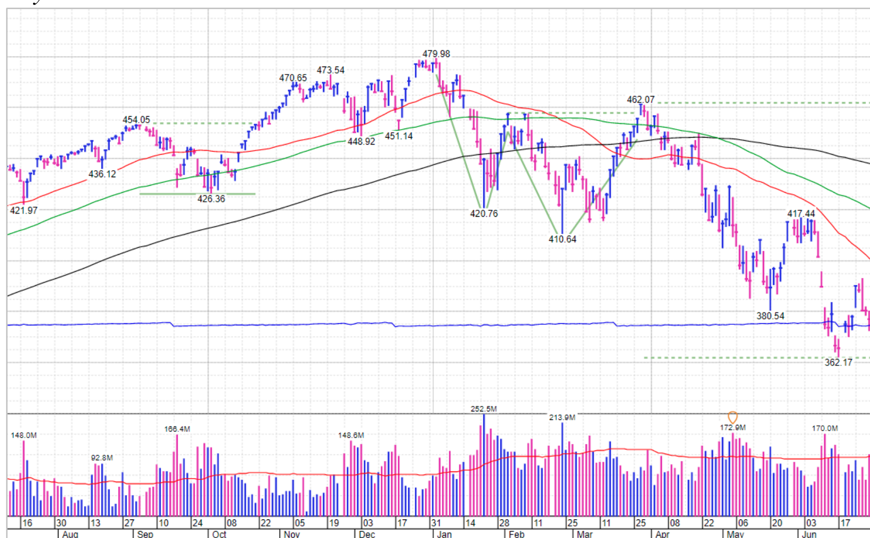
Oh right, that was 1970. In fact, the first three paragraphs are paraphrased from the *New York Times* and the *Wall Street Journal*, both dated July 1, 1970. It is amazing how history rhymes. I am always curious as to why people act like we have not seen this before. Today, everyone again is talking about inflation, but I am starting to wonder why. Last year, it was transitory and now it is permanent? From the highs, steel is down over 50%, copper 25%, lumber 50%, U.S. natural gas 40%, aluminum 35% and wheat 40%. Gasoline prices have declined $0.75 per gallon. Retail inventories are bloated which will reduce order levels – alleviating supply chain bottlenecks and shortages. Inflation expectations have dropped from over 3.75% to 2.50% in 5-6 weeks. Retailers are discounting to clear excess inventory which will curtail inflation. Computer chip demand appears to be in decline based on Micron's recent commentary (June 30), which should help industries like the auto sector facing part shortages. Over 60% of CEOs are expecting a recession and small business owner confidence is in free-fall. Many companies are announcing layoffs which should also curb wage inflation. Used car prices are in decline. Housing demand has declined

sharply due to higher mortgage rates. The actions by the Federal Reserve have materially impacted both the housing and the stock markets, which comprise a substantial portion of household wealth. This will also serve to effectively curb spending. But the above effects are occurring as year-over-year inflation levels are high, which makes the numbers easier to improve going forward. If the Federal Reserve can impact inflation this quickly, how long before they take a pause as recessionary concerns mount?

I suspect the market will focus on this issue in the coming months and could change its tune to something more welcoming. The Russell 2000 was higher in 2018 than it is today and since then earnings have grown 70%! Excluding technology, the S&P 500 trades at a 12.5x P/E. Given the current extremely bearish sentiment, if we have a mild recession or start to see a recovery in the second half of this year as inflation moderates, the bearish consensus could prove absurdly short-sighted.

S&P 500 Performance

July 2021-June 2022



Source: Investor's Business Daily, Bloomberg.

Just want to note that the NorthCoast tactical portfolios are hedged with 50% cash and we remain aware of the case for a bear market. The most concerning observation is that earnings estimates will likely prove too optimistic. For now, it does seem early to declare a bottom. However, things do change quickly, and we will be monitoring if the opportunity set improves. Historically markets do improve before the headlines. And as we saw in 1970, the headlines were pretty nasty on July 1, and this was right in the face of a decidedly better second half for investors as the market rallied +26%. In fact, the market closed 1970 completely flat! Funny how every headline talks about 2022 as the worst market half since 1970, without mentioning what happened in the second half of that year.

S&P 500 Performance

July 1969-Dec 1970

Source: Investor's Business Daily, Bloomberg.

Regarding your portfolio, I would encourage you to take time to discuss it with your advisor. Our most satisfied clients have three things in common: (1) they have a suitable investment, (2) they understand our investment process, and (3) they allow it time to work. We have a good foundation to help our clients succeed in markets such as these, and that happens with quality interactions between you and our advisors. Our defined outcome strategies are doing well this year (essentially using index options to better balance certainty and risk) and many of those strategies were designed with more difficult bond markets in mind. The US bond market is down over 10% this year so far, and though a respite is perhaps warranted in the second half I would expect bigger bond allocations to have headwinds over the next several years. This is a good time to discuss alternative approaches.

I hope this letter finds you and your family happy, healthy, and enjoying the summer days. We look forward to continuing the march toward your financial goals, and as always thank you for your business.

Warm regards,

Dan Kraninger
President & CEO

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Data sources: NorthCoast Asset Management, Bloomberg.

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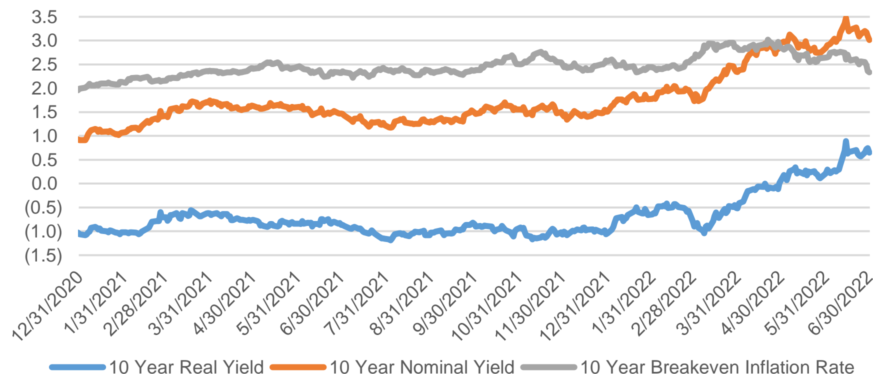
Glass Half Empty or Half Full?

Julia Zhu
Senior Vice President, Market and Security Research

Half Empty: Worst first half year for bonds in decades

The second quarter of 2022 continued to witness significant yield volatility driven by stubbornly high inflation and a hawkish Fed. U.S. nominal 10-year Treasury bond yields spiked by 1.14%, from 2.34% at the end of the first quarter to 3.47% on 6/14, but slipped in the second half of June amid fears that the Fed's aggressive tightening to tame inflation might eventually tip the U.S. economy into a recession. Real yield contributed primarily to the move (up by 1.17%) while the inflation breakeven rate dropped slightly by 51bps to 2.33% (see Exhibit 1). Rising interest rates has been the main driver of poor fixed-income performance for 2022, with the Bloomberg Treasury Index and U.S. Aggregate Bond Index experiencing one of their worst half-years in 40 years, losing 9.1% and 10.4%, respectively.

Exhibit 1: Treasury yields rose considerably in the first quarter of 2022



Source: NorthCoast Asset Management; Bloomberg.

Inflation, Fed and recession risk

High inflation, Fed tightening, and recession risks remained the dominating themes in the markets throughout the second quarter and have involved magnitudes not seen in decades. U.S. consumer price inflation has surprised on the upside lately and increased 8.6% on a year-ago basis in May, the highest pace in 40 years. The Federal Reserve responded by hiking its target range by 150bp over just three meetings through June, including the most recent 75pbs hike which was the first 75-basis point increase since 1994. 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.

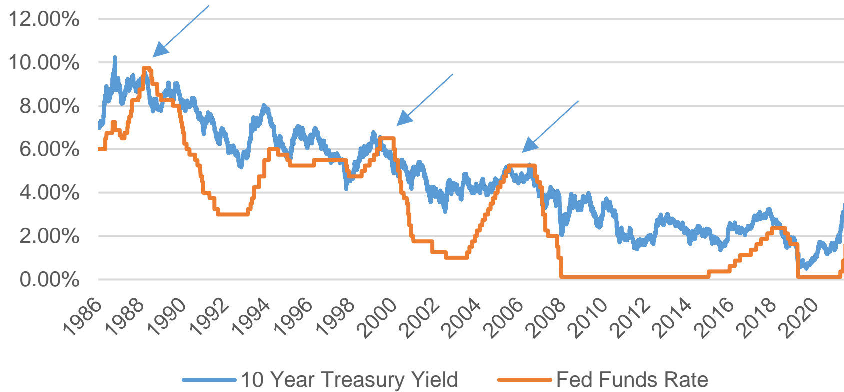
Accelerated monetary policy tightening has weighed on risk appetite, and the market has priced in reduced odds of a soft landing and a higher probability of recession. Weak economic data recently have fueled those concerns further, including signs of sharp cooling in the housing sector, a slowdown in consumer spending, record low consumer sentiment indexes, and worse-than-expected GDP estimates. As of June 30, the Federal Reserve Bank of Atlanta's GDPNow tool estimates that real GDP growth in the second quarter is -1.0%.

Half Full: Is the worst over?

While persistently high inflation and the fast pace of central bank tightening will still put upward pressure on yields (glass half empty), we also see several reasons for an improved outlook.

First, we expect less volatility going forward as it appears that the bulk of the move to higher rates is possibly behind us. Historical data indicates that the 10-year Treasury yields tend to peak near the peak level of the fed funds rate in a hiking cycle (see Exhibit 2). The futures market now looks to be pricing in a steep path for the fed funds rate to reach about 3.5% by Q1 2023 and a higher probability of rate cuts in late 2023 and 2024. With the 10-year yield rising 3.47% in mid-June, there seems to be limited scope for it to move much higher. Also, the rising probability of recession risk implies that at some point down the road, the Fed might need to shift its focus from inflation back to growth, leading to the possibility that the Fed ultimately will not go that high. That said, we believe it is still a bit early to call the peak in Treasury yields as yields usually peak when it is closer to the final hike in a cycle. Risks remain that the Fed might hike rates more than what markets have priced in if inflation turns out to be less manageable.

Exhibit 2: 10yr Treasury yields tend to peak close to the peak of the fed funds rate



Source: NorthCoast Asset Management; Bloomberg. Data from 12/31/1986-6/30/2022.

Second, while the worst performance of the bond market in several decades occurred in the first half of the year, yields (yields move in the opposite direction of bond prices) have now increased across fixed income sectors (see Table 1). Rising yields mean increasing return potential for bond investors over time. Although there may well be more pitfalls down the road, we are beginning to see levels representing more reasonable long-term valuations as yields approach 3%.

Table 1: More attractive yields in fixed income markets

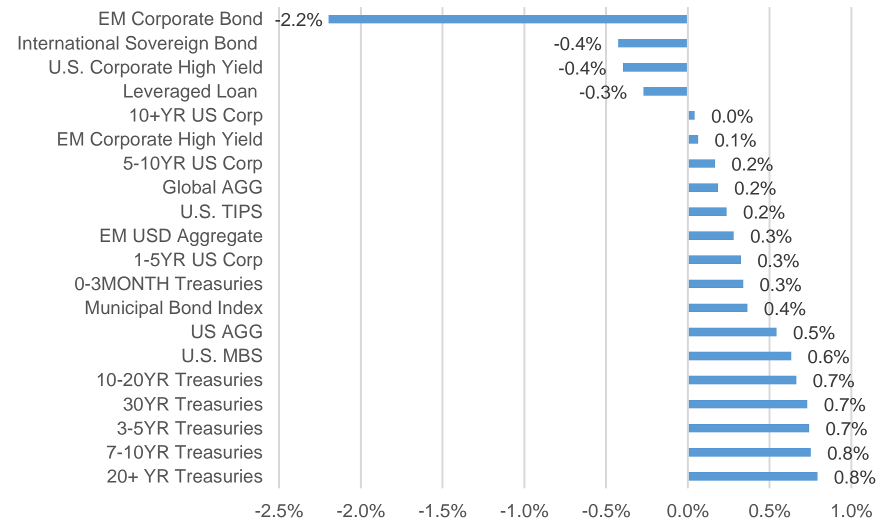
Yields of Main Fixed Income Market Sectors (%)

Sectors	Recent low	Difference	7/1/2022
U.S. aggregate	1.02	2.70	3.72
Investment-grade corporates	1.74	2.96	4.70
High-yield corporates	3.53	5.36	8.89
Emerging markets debt	4.36	3.35	7.71
Municipal bonds	0.86	2.35	3.21

Source: Bloomberg, J.P. Morgan. Data as of 6/30/2022 except emerging market debt (which is as 6/15/2022 due to availability of data). Sector yields above refer to Bloomberg U.S. Aggregate Index, Bloomberg U.S. Corporate Investment Grade Index, Bloomberg U.S. Corporate High Yield Index, 50% J.P. Morgan EMBI Global Diversified Index/50% J.P. Morgan GBI-EM Global Diversified Index blend and Bloomberg Municipal Bond Index. Dates for recent lows from top to bottom in chart shown are: 8/4/20, 12/31/20, 7/6/21, 1/4/21 and 7/27/21.

Third, fixed income usually performs well during recessions, and if the Fed can succeed in lowering inflation, bond investors could face a more benign environment. We see a higher recession probability in the U.S. and in other developed countries in the next two years, reflecting stubbornly high inflation, central banks' priority on fighting inflation, and geopolitical risks. In our recent study of asset class performance during stagflation periods, we define the episodes displaying stagflationary pressures as the months in which growth (PMI) was in the bottom third and inflation (CPI) was in the top third of their respective distribution. As shown in the graph below (see Exhibit 3), most fixed income benchmarks have demonstrated positive average monthly returns in the state of stagflationary pressures since 1995.

Exhibit 3: Fixed income performance in episodes of low growth and high inflation (since 1995)



Source: NorthCoast Asset Management; Bloomberg.

Investment Implications

In the face of a more uncertain environment with inflationary headwinds, tighter monetary policy, and growing recession risk, we believe it is essential to actively manage duration and build more robust asset allocation while maintaining portfolio flexibility and liquidity. For the first half of 2022, our Tactical Income strategy returned -8.5% net of fees, outperforming the U.S. Aggregate Bond Index and the Global Aggregated Bond Index by 1.8% and 5.4%, respectively.

On duration, we continue to target moderate duration underweights against upside inflation risks and the prospect of Fed tightening. At the same time, the recent selloff has brought valuation for some bond sectors more in line with expectation, which may provide an attractive entry point for investors. We slightly increased our stake in iShares MBS ETF (MBB) to start to close our underweight position, as we see much more attractive valuations in the agency mortgage-backed sector after a steep rise in mortgage rates and the

5-year Treasury yield. Meanwhile, with the peak in corporate credit quality behind us and more macro uncertainty, we decreased our credit risk in the portfolio by trimming positions in VanEck High Yield Muni ETF (HYD) and iShares Interest Rate Hedged High Yield Bond ETF (HYGH) during Q2. We continued to overweight U.S. TIPS as diversifiers in the inflationary backdrop, and selectively allocated to alternative assets such as dividends and infrastructure to hedge inflation, enhance income and further diversify the portfolio.

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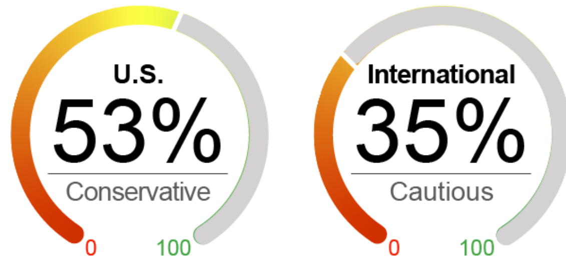
The NorthCoast Navigator is a market barometer displaying current equity outlook. The aggregate metric is determined by multiple data points across four broad dimensions including macroeconomic, sentiment, technical and valuation indicators. The daily result determines equity exposure in our tactical strategies. As of 6/30/2022. Data provided by Bloomberg, NorthCoast Asset Management.



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.

Macroeconomic

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.

Sentiment

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

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.

Valuation

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.

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