NorthCoast
Asset Management

Quarterly Client Update

Q3 2021

September 30, 2021

"There's two buttons I never like to hit: that's panic and snooze."

~ Ted Lasso

Ted Lasso has become a family favorite in my house. I love it not only because it strikes a great balance between laugh-out-loud funny and tugging at heart strings, but also because it's been hard to find a show my family can all watch together given our ages and interests (my wife and I are 50 and the kids are 22, 20, and 16). If you're not familiar, the series follows Ted Lasso, an American college football coach who is hired to coach an English premier league soccer team in an attempt by its owner to spite her ex-husband. During the beginning of season two, it's not looking good for Ted's team, which has a streak of eight straight ties. But Lasso isn't panicking, telling a press conference, "There's two buttons I never like to hit: that's panic and snooze."

That sentiment struck me as we enter the fourth quarter where we currently are in the equity markets. As I mentioned in previous letters inflation is a concern and is clearly more present -- the consumer price index rose 5.3% percent for the 12 months ending August 2021. Everything is more expensive and near ten-year highs – food, cotton, lumber, employees and energy prices (the most volatile) rose 25%. What was odd the last time I wrote you in June was that despite some inflation, the ten-year bond wouldn't budge from 1.2%, reflecting the Fed's view that these prices were "transitory." Now though, the 10-year is beginning to move – rising from a 1.17% yield on 7/19 to a 1.55% today. Bond prices, of course, move the opposite way and investors holding many longer-term issues are starting to see losses mount on those positions. However, inflation is my number one concern for equities as input prices increase. Companies either have to raise prices for end consumers to maintain their margin or (for those without pricing power) deal with a cycle of lower earnings growth. I don't think there is reason to panic (and Julia delves deeper into why in her fixed income quarterly) but we are not snoozing either. Equity positions such as DVN, EOG, and ADM were added to benefit from this environment in the second and third quarter and are now paying off. In fact as I write this, we have started to sell DVN and are realizing a near 100% profit since April. Our models are currently indicating things have moved a little too fast in the oil and gas sector.

Devon Energy Corp. (DVN)

Source: Bloomberg

Amazon.com Inc. (AMZN)

Source: Bloomberg

In our tactical portfolios you will probably continue to see moves like this throughout the fourth quarter as we attempt to take advantage of

overbought and oversold positions in individual stocks based on the market's tendency to overshoot one way or the other. Technology shares like ADBE and AMZN only now are beginning to trigger some buy recommendations for us as they work through -15% corrections. For most of this year, we have been underweight big technology issues because they were too expensive vs. other parts of the market – namely industrials, financials, and energy. But that is changing as our models adapt to current conditions.

So we are optimistic about the market and expect to benefit from stock selection in the months ahead. With elevated inflation levels creating volatility and opportunity, we hopefully will continue to benefit from shorter term (3-6 month) positioning in stocks while the longer-term market grinds higher with a backdrop of higher earnings, more fiscal stimulus, and a continued economic reopening as the Delta variant subsides.

If you choose to give *Ted Lasso* a try or if you are already watching you may remember a great line in episode #1 that Ted delivers as he arrives in London saying, "I do love a locker room. Smells like potential." That line resonates with me as well because I love the combined implication of team, hard work and aspiration. I've seen it first-hand here at NorthCoast for 17 years and now I'm equally excited for our next chapter as part of Focus Financial. I wrote you a letter a few weeks ago about us joining the Focus team. First, thank you for the overwhelmingly positive feedback we've received. As many of you understand, we will serve you better. Following are a few examples that recently come to mind:

- A client that has been with us for 14 years couldn't get a mortgage to buy a condo in Florida because traditional banks wanted to see income (despite a sizeable net worth): we will be able to help with credit services such as a mortgage.
- Another long-term, retired client had a problem finding a trustworthy Trustee for his estate plan: we will now be able to offer Trust services.
- Clients sometimes need help with whole life insurance in estate plans and tax services, especially in the context of large blocks of concentrated stocks. In the past we could only speak to the pros and cons but not offer real solutions: now we can provide the help you need.

Our advisors will be able to help clients in all facets of their financial life, continuing to provide services as a fiduciary and recommending only what is in your best interest. So whether we serve as a tactical sleeve in your portfolio or offer a holistic solution within a full financial plan, we will be better. We will also continue to do business as NorthCoast Asset Management – the same hardworking, aspirational team. This partnership within Focus Financial feels like we were promoted to the premier league, and we are ready and excited to reach for our potential.

As always, thank you for your business. The fourth quarter also brings about the Holidays, and it's an important one as many families reconnect. So this is also an early wish for nothing but the happiest and healthiest of Holiday seasons for you and your family.

Warm regards,

Dan Kraninger
President & CEO

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Lingering Factors and the Long-Term View

Julia Zhu
Senior Vice President, Market and Security Research

During the majority of the third quarter, Treasury yields remained well below what many market participants expected earlier in the year, partially due to concerns over the Delta variant, Chinese regulatory clampdowns, and peaking economic growth. However, the approaching wind-down of the Fed's asset purchases and moderately hawkish interest rate projections helped push the yields notably higher in the last seven trading days of the quarter. The yield on the benchmark 10-year U.S. Treasury note spiked by 20bps and settled at 1.49%. Real yields (up 11bps) and inflation expectations (up 9bps) both contributed to the move.

Over the past few months, investors seem to have become less anxious about any dramatic shift in monetary policy given the frequent communications and increased transparency from the Fed. Nevertheless, the September FOMC meeting was viewed as mildly hawkish. Policymakers sent a strong signal on tapering the central bank's $120 billion monthly asset purchases, and expect the process to end by mid-2022. At the same time, the pace of the tightening revealed by the September FOMC dot plot[1] is slightly faster than previously penciled, with half of the participants expecting at least one rate hike by the end of next year. The median projection is now for the Fed funds rate to be 1% in 2023 and 1.75% in 2024. We now expect the Fed will likely announce its formal tapering timeline in November and begin its first cut in December. We believe Treasury bond yields will move modestly higher as the Fed looks to taper, but do not anticipate a massive sell-off. Given the sufficient advance notice of tapering and the carefully crafted language of the Fed's communications, we believe that global markets will not have a violent taper-tantrum this time as they did in 2013.

One threat to our benign view of long-term yields comes from the upside inflation pressure, which we expect will be alleviated next year. Despite very high points this year, CPI inflation eased in the recent two months as some of the temporary factors behind the past surge are fading. Average prices for airfare and hotels, as well as new and used vehicles, declined in August (see Figure 1). While short-term inflation expectations remain elevated relative to pre-pandemic levels, the longer-term expectations (measured by both the survey and market-derived data) do not show signs that the market is worried about a structural overshoot of the Fed's target (see Figure 2). One critical type of inflation that would concern the Fed is wage inflation, as it usually is more structural and could cause long-term inflation expectations to rise. Our nominal wage index, a combination of multiple wage measures including the employment cost index, Atlanta Fed Wage Growth Tracker, and average hourly earnings, was up 3.7% YOY in August, with the growth rate only slightly higher than pre-pandemic levels. Given the amount of slack still in the labor market and the potential easing of labor supply constraints with the receding Delta variant wave, we believe the wage inflation will likely be kept in check. Overall, our view is that inflation risks are to the upside in the short-run largely due to supply-chain issues, but high inflation will not become a long-term structural concern given its unsustainability due to nominal wage growth, low velocity of money, and an aging population.

Fixed income investors face obstacles to building robust portfolios in the current environment, with lingering inflationary pressure and continued historically low yields coupled with elevated market volatility. At NorthCoast, we continue to look for opportunities that deliver attractive income as well as strong risk-adjusted returns by combining top-down research, rigorous ETF selection models and flexible duration management tools. Since December 31, 2020, our Tactical Income strategy has returned 3.4% (estimate) net of fees, outperforming the U.S. Aggregate Bond Index and the Global Aggregated Bond Index by 5.0% and 7.5% respectively.

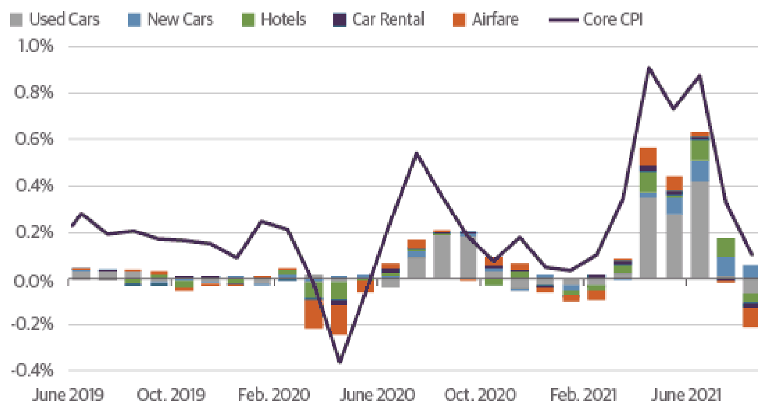
We continue to maintain our underweight positions in U.S. Treasuries as we see a gradual rise in nominal yields with the Fed poised to start tapering, especially if it appears that the Fed is on track to meet its dual targets of employment and inflation. In credit, we prefer interest rate hedged corporate and high yield bonds for less portfolio duration exposure. Year-to-date, the interest hedged IGBH and HYGH have

outperformed their unhedged counterparties IGLB and HYG by 5.4% and 1.6% respectively. At the same time, our top-down model still holds a constructive view for risky assets given resilient global growth and ongoing negative real interest rates, leading to our overweight exposure to the alternative asset class vs. the benchmarks. However, our over-weighted position was slightly trimmed in September as we observed some softness in recent data and believe that a more selective approach will benefit as further gains in some of the alternative assets are limited with stretched valuation.

Figure 1

Transitory factors fading in Core CPI in July and August 2021

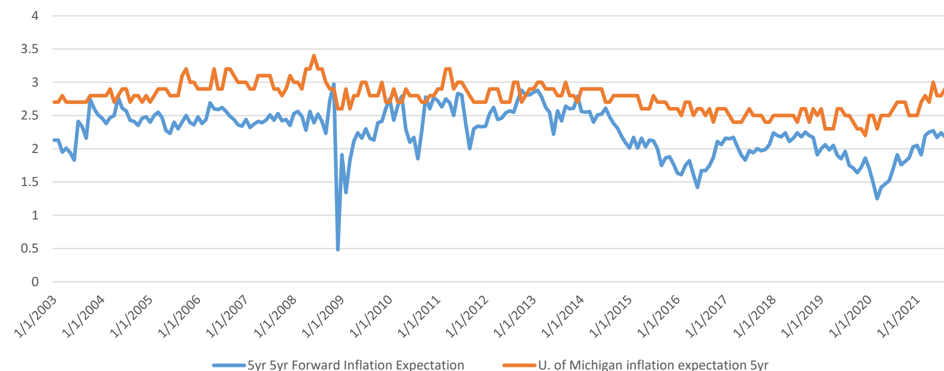
Core CPI, Contribution to MoM% Change



Source: Bloomberg, NorthCoast Asset Management.

Figure 2

Long-run U.S. Inflation Expectations Remain Anchored



Source: Bloomberg, NorthCoast Asset Management.

Note: 1 The U.S. Federal Reserve dot plot is a chart that summarizes the Federal Open Market Committee's (FOMC) outlook for the federal funds rate. Each of the 12 members of the committee is represented by a single dot, but each dot is anonymous.

Data from Bloomberg, NorthCoast Asset Management.

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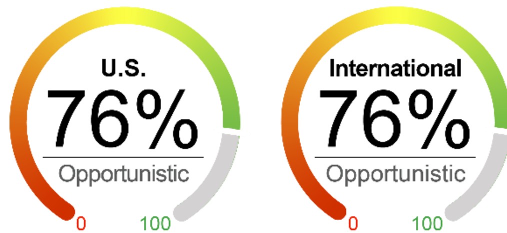
The NorthCoast Navigator is a market barometer displaying current equity outlook. The aggregate metric is determined by multiple data points across four broad dimensions including macroeconomic, sentiment, technical and valuation indicators. The daily result determines equity exposure in our tactical strategies. As of 9/30/2021. Data provided by Bloomberg, NorthCoast Asset Management.



Evergrande, Interest Rate and Equity Prospects

The stock market posted its first decline since January, with the S&P 500 losing 4.8% in September. The tech-heavy Nasdaq underperformed the market and fell 5.3%, while the Dow was down by 4.3%. Energy was the only sector that enjoyed a positive return this month, boosted by soaring crude oil prices. September has witnessed a rapid rotation away from growth and technology stocks to cyclical stocks as the benchmark 10-year Treasury yields spiked to 1.5%. Financial stocks outperformed with rising yields serving as a tailwind to bank profitability, while technology stocks got hit with increased implied discount rates weighing on future earnings.

The weakness and increased volatility of the market can be attributed to several factors, including concerns around monetary policy, inflation pressure, and regulatory clampdown in China as well as stretched valuations. The September FOMC meeting sent a strong signal that the Fed will begin to taper around the end of the year. The updated dot plot was taken as a moderately hawkish signal as half of the participants expected at least one rate hike by the end of 2022. While the environment of gradually rising interest rates coupled with negative real rates is generally supportive for risk assets, we anticipate volatility along the way as markets remain sensitive to policy changes and tend to over-react after an extended bull run.

The Chinese real estate sector is also in the spotlight with fears that a possible default by Evergrande, China's second-largest property developer, might cause a global financial crisis similar to what was triggered by the collapse of Lehman Brothers 13 years ago. The Lehman parallel, in our view, is not valid. Rather than a sub-prime bubble that caused Lehman's collapse, the Evergrande crisis boils down to a liquidity crunch after the change of government policy widely known as the "Three Red Lines" – three debt metrics that real estate developers have to meet before they can borrow more. Under these new rules, Evergrande no longer has access to debt and is not able to continue its strategy of over-hoarding land and financing interest expense with new debt. Looking forward, instead of a chaotic bankruptcy, we expect Evergrande's liabilities will be restructured in a relatively well-managed way to limit broader financial disruption. A typical contagion effect to the financial system should be limited as Chinese banks are essentially owned by the government, and Evergrande's outstanding debt adds up to a negligible amount of the country's total banking assets.

Although we still stay generally constructive towards risk assets, we are slightly less optimistic and have taken a little equity risk off the table as we see some softness in data and stretched equity valuation. U.S. consumer sentiment has fallen noticeably in the last two months while Eurozone economic sentiment indicators also eased. The August U.S. payroll data disappointed the market with only 235,000 job gains. On the positive side, the PMI index was only a touch below the level of 60, supported by improvement from new orders, production, and inventory. Inflation showed some signs of deceleration as CPI rose 0.3% in August, down from the 0.5% gain in July. A more encouraging development is that the spike in coronavirus infections from the Delta variant seems to be slowing in the last two weeks. The daily average of new cases declined about 25% compared with two weeks ago, and we hope the trend continues in the coming weeks.

Macroeconomic

Payroll employment gains dropped significantly in August to 235,000, less than half of the consensus estimate. The initial jobless claims rose for three consecutive weeks, though claims remained near their lowest level since the beginning of the pandemic. However, we expect the labor market will continue to recover as more workers are able to re-enter the market with the ebbing Delta variant wave. The CPI rose 0.3% in August with both the travel sector (airfare, hotels, and rental cars) and new-and used-car sales seeing price declines in August.

Sentiment

August's PMI index reading came in stronger than anticipated, hovering around the level of 60, and marking the 15th consecutive month of expansion. The ongoing pandemic and inflation concerns continue to weigh on consumer sentiment. The University of Michigan's sentiment index remained near its lowest level since 2011. Homebuilder confidence inched up 1 point, helped by a combination of low housing supply and rising demand together with the easing pressure from building-material cost. However, the housing market still faces the challenges of affordability, supply-chain issues as well as rising rates.

Technical

Technical indicators remained positive but looked stretched. At the end of September, the S&P 500 was 4% above its 200-day moving average, 1% below the 100-day average, and 3% below the 50-day average. Volatility spiked later in the month as inflation fears, peaking growth and rising yields kept investors on edge. The VIX level settled at 23.1 at the end of the month, compared with 16.5 at the end of last month. The short-term reversal signal, however, turned positive with the recent market pullback.

Valuation

With the S&P 500 ending a seven-month winning streak and losing 4.5% in September, valuations for equity improved but are still under pressure. P/E ratios decreased to 25.8 at the end of September from 27 at the end of August. The Forward P/E ratio also declined slightly to 21.3 from 22.4. Inflation-adjusted valuation metrics continued to be negative with inflation rising.