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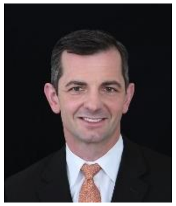
Quarterly Client Update

Q3 2022

September 30, 2022



"Patience wins the race."

~ Bernard Barton

When taking a break from the markets on the weekends, I race cars. It's one of my favorite pastimes. Once at the end of a particular race, a fellow racer told me, "I cannot believe it. You waited 20 laps before making your move. You're so patient!" This unusual compliment struck me as quite insightful, and since that day I remind myself that good old patience can be a highly valuable virtue in stressful and time-sensitive situations.

Without going too deep into race craft, current market conditions "drive" me to elaborate on that point. Twenty laps with about ten corners each means that 200 times in a row I made the conscious decision to "do nothing" with a pack of wolves in tow. More inexperienced racers tend to be swayed by the intense pressure and the adrenaline rush, leading them to become aggressive too soon and too often, making costly mistakes along the way.

What matters, in racing and in portfolio management, is to cross the finish line in the best position, not necessarily race in the front for as long as possible. How can you maximize your chance of winning if making a pass is both difficult and risky? One approach is to keep pace with the pack and let other impatient racers make mistakes. Then analyze the weaknesses of others, position yourself accordingly, and execute the pass with conviction.

Smart portfolio management uses the same approach. First, we try to avoid making mistakes out of impatience despite the constant flow of news and events. It is tricky – headlines affect your mind and emotions, and so many conversations will gravitate toward market turmoil and exacerbate the feeling that you need to do something. The solution we implement is to instead analyze the data and identify opportunities based on data not drama. We then position the portfolio to attempt to capitalize on those opportunities, while remaining vigilant when observing data trends and changes.

A CIO's View

Several topics come up regularly during my conversations with clients. While headlines do not drive our portfolio decisions, the quantifiable effects of these macroeconomic factors can influence investment positions. Following are my brief thoughts on each and how the associated data points may continue to affect the markets. As a reminder, we regularly cover these topics in our monthly Navigator.

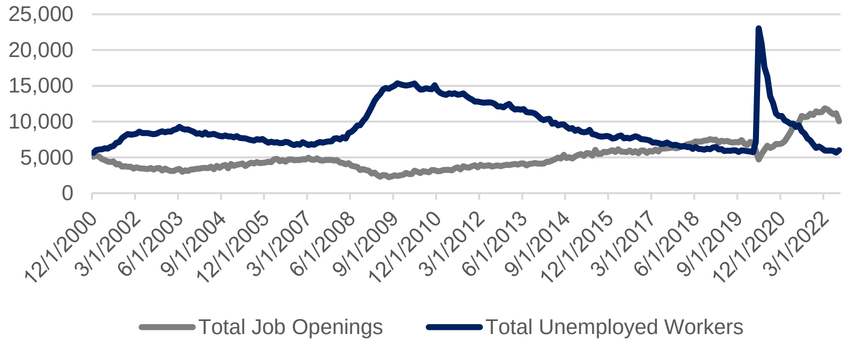
COVID continues to take its toll across the globe via different mutations. Now a more quantifiable risk, the global confirmed new case level was muted at 610,461 as of 9/22, and the China Stringency Index[1] sits at a high of 73.61. COVID no longer makes headlines but still has some effect on global markets due to continued supply chain effects.

Russia invaded Ukraine on February 24, causing to date an estimated 30,000 deaths and US$350 billion in property damage[2]. Last week's destruction of the Nordstream pipeline and the mobilization announcement with threats of nuclear escalation further increased the likelihood of a drawn-out conflict. The anti-war protests in Russia, some successful European efforts to diversify away from Russian gas, and some diplomatic setbacks are increasing non-military pressure on Putin.

Inflation as measured by the US CPI YOY Index has been above 4% since April 2021, and above 8% since March 2022. The World Economy weighted inflation YOY index has been above 4% since June 2021, and above 9% since June 2022, forcing global central banks into a coordinated effort of monetary tightening. The US Federal Funds Target rate has increased since March 2022 with rate hikes of 25 bps, then 50bps, then 3 successive 75 bps hikes. This is an unprecedented pace in tightening not seen in the past 40 years.

Fed Fund Target Rate hikes have negatively impacted both the equity markets (the S&P 500 Index is down 20.7% YTD, the Nasdaq 100 Index is down 32.3% YTD the MSCI ACWI ex USA Index is down 25.6% YTD) and the bond markets (the US Aggregate Bond index is down 14.6% YTD, the Global Aggregate bond Index is down 19.9%). Several Fed officials have spoken out publicly, reiterating this hawkish stance. To break the cycle of inflation the Fed must be very public with the message that inflation needs to come down and it may cause economic pain, unemployment, a recession, and margin compression. We are optimistic that the Fed's strategy will show results before year-end. Already the JOLTS Job opening report was below consensus with 10,053k opening versus 11,088k expected (Exhibit 1).

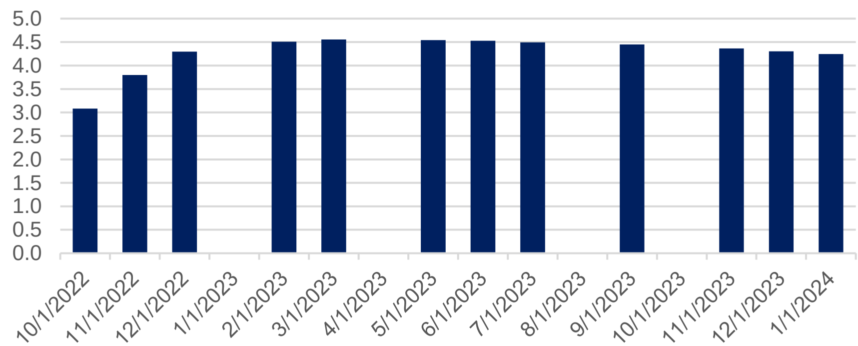
Exhibit 1: Job Openings Fell Again in August



Source: Bloomberg.

The strengthening dollar is a consequence of tighter monetary policy at home (Exhibit 2). This policy creates an inflationary effect for our exports (assuming the main invoicing currency is the US dollar), which is a way to export our inflation and help us lower it here. International pressure against the US is likely to resurface forcing the Fed to step back from these policies.

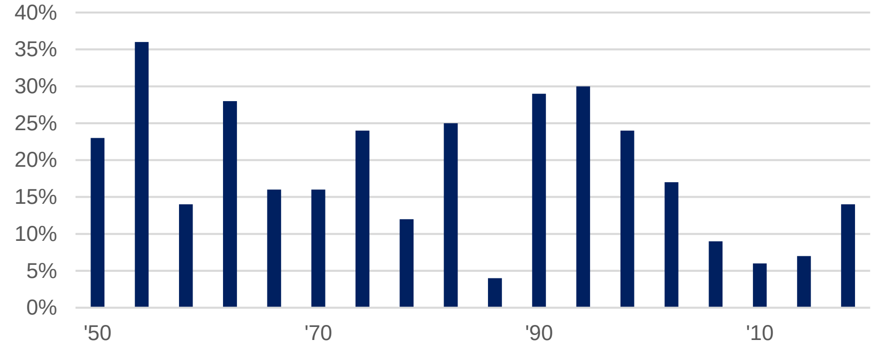
Exhibit 2: Implied Policy Rate (%)



Source: Investor's Business Daily, Bloomberg.

Mid-term elections are less than two months away, creating further political uncertainty and soon to be a new front page recurring topic. History has generally shown a market rebound around US midterm elections (Exhibit 3).

Exhibit 3: S&P 500 One-Year Performance After Midterm Elections



Source: Forbes.

The Fear Index (VIX, which measures market volatility) is back in the news, consistently range bound between 40 and 20 since January this year with a handful of episodes above 35 in the first three quarters of 2022. Exhibit 4 is a great chart illustrating the grinding market stress since the beginning of the year. I think we can all identify with this.

Exhibit 4: CBOE Volatility index

Source: Bloomberg.

Portfolio Management Moves

As I mentioned previously, we analyze myriad data factors going forward to determine investment decisions. We identified a worsening outlook during the third quarter, and thus increased our tactical strategies cash level by 12% from 47% to 59%, reducing market exposure to 41%. Most of the increase in cash occurred during the summer rally, generating a positive contribution to our returns.

We have rotated a few positions toward value stocks, positioning the portfolio to be further underweight technology stocks and materials (more exposed to an economic slowdown), while keeping us overweight in energy and healthcare (more resilient sectors in this environment). These actions had an additional benefit of harvesting some losses and bringing back capital gains close to neutral for 2022.

What I believe this demonstrates is that our portfolio managers rely on many simultaneous and sometimes competing factors for our daily position reviews. We look beyond the headlines to find both the concerning and opportunistic trends in the data. This daily analysis and diligence, along with a patient, non-reactive approach and thoughtful strategy positioning help us get you to your financial finish line in a positive position.

I hope this letter finds you and your family happy, healthy, enjoying fall and looking ahead to the holidays. We look forward to having end-of-year conversations about your financial goals and how we can help you get there. As always, we thank you for your business.

Warm regards,

Patrick Jamin
President & CIO

Notes:

1 The China Stringency Index (CGRTSCHN) collects publicly available information on 17 indicators of government responses. Eight of the policy indicators (C1-C8) record information on containment and closure policies, such as school closures and restrictions in movement. Four of the indicators (E1-E4) record economic policies, such as income support to citizens or provision of foreign aid, and five indicators (H1-H5) record health system policies such as the COVID-19 testing regime or emergency investments into healthcare.

2 Sources: The World Bank; Reuters.

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NorthCoast Fixed Income Outlook

Q3 2022 | September 30, 2022

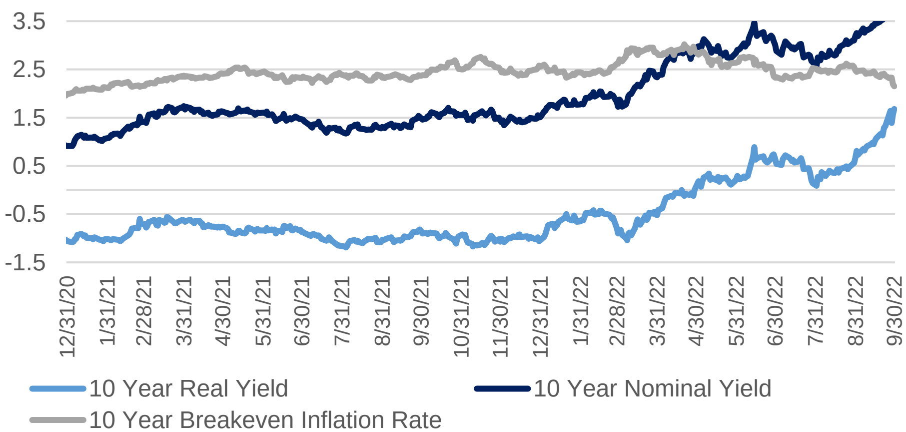
Continued Headwinds Result in Significant Yield Volatility

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

The third quarter of 2022 continued to witness significant yield volatility, with the end of summer bringing renewed weakness to global bond markets. Stubbornly high inflation, geopolitical tensions, recession risks, and the fastest pace of Fed tightening in decades are among the significant headwinds for the markets. U.S. nominal 10-year Treasury bond yields spiked from 3.01% at the end of the second quarter, briefly reaching 4% in late September and settling at 3.83% at the end of the third quarter. Real yield contributed primarily to the move (up by 1.03%) while the inflation breakeven rate dropped slightly by 18bps to 2.15% (see Exhibit 1).

Exhibit 1: Treasury Yields Rose Considerably in the Third Quarter of 2022



Source: NorthCoast Asset Management; Bloomberg.

The Bloomberg U.S. Aggregate bond index and the Bloomberg Global Aggregate index were down 14.6% and 19.9% year-to-date, respectively, which was an unprecedented drawdown for both indexes. In the meantime, the U.S. Treasury yield curve flattened further and moved to the top end of its range over the past 10 years. The US yield curve is now inverted with two-year yields above ten-year yields.

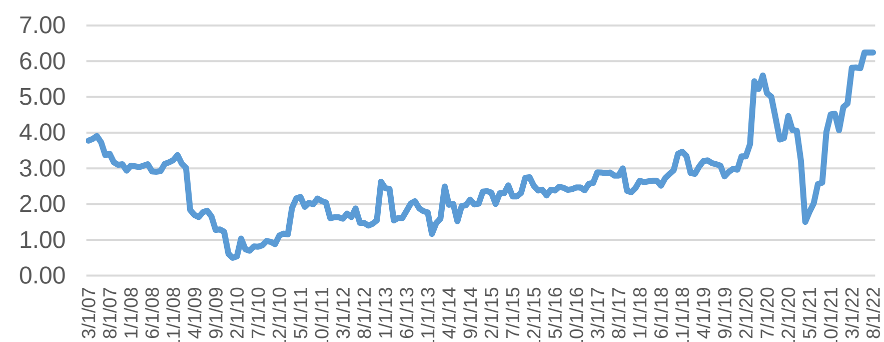
In this newsletter, we highlight three key developments that inform our outlook:

1. Core inflation could take time to subside

U.S. core inflation rates now appear more entrenched and may take longer to subside, though headline inflation is likely to moderate over the cyclical horizon. Despite falling gasoline prices from mid-June (by more than 20%) and tentative easing of supply-chain stress, rising inflation has broadened to include elements of the CPI basket that tend to be relatively inflexible, or “sticky,” including shelter, service, and wage growth.

Accounting for about 32% of the CPI index, rising shelter prices are likely to contribute to entrenched core inflation. While growth in owners’ equivalent rent is expected to moderate in the longer term with the cooling housing market, it affects core inflation with a lag given how the measure is calculated. More importantly, a tight labor market has pushed up wages in a wide range of occupations. According to our wage index (a combination of multiple wage measures including the employment cost index, the Atlanta Fed Wage Growth Tracker, and average hourly earnings), wage inflation is running at a blistering 6.2% YOY in August as compared with around 3.7% before the pandemic (see Exhibit 2). Wages are a “sticky” driver of inflation, and the Fed will likely want nominal wage growth closer to 3.5%.

Exhibit 2: The Wage Index showed no sign of deceleration



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

On the positive side, measures of longer-term inflation expectations have been trending lower over the past quarter, indicated by both survey-based and market-implied measures. In the University of Michigan survey, five-year-ahead inflation expectations dipped down to 2.7%, its lowest level since April 2021.

2. Fed policy: tighter for longer

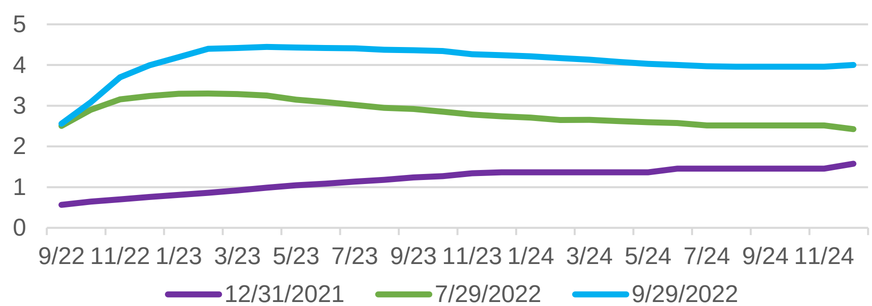
Despite signals of decelerating growth, we believe the Fed will continue to stay the course in tightening. The target rates will be at a restrictive level and remain there for longer. A few points that stand out to us:

First, the central banks have become increasingly more hawkish over the quarter as they squarely prioritized bringing down inflation over supporting growth. In the U.S., after the Fed delivered 150 basis points in interest rate hikes over three months, the median "dots" of the policy rate rose more than the consensus expected. The median estimate for Fed Funds rates at the end of 2022 was pushed to 4.4%, 1% higher than the projection in June, while the median estimate for 2023 is now 4.6%, up from 3.8% from last quarter.

Second, the Fed's quarterly Summary of Economic Projects indicated a downward revision to real GDP estimates and upward revisions to the unemployment rate projections to 4.4% (0.9% above the post-Covid lows). The sharp uptick in the unemployment rate projection sends a clear message that the Fed will likely see a need for substantial tightening until more labor market softening emerges. Moreover, the Fed seems to look beyond the unemployment rate as a measure of labor market slack and pay more attention to job vacancies and quit rate, with the latter two measures currently indicating a significantly tighter labor market.

Third, the good news is that much of the Fed aggressiveness has been priced into the market. Bond markets have ratcheted up their expectations for this cycle's terminal interest rate from 3.3% at the end of July to 4.5% at the end of September (see Exhibit 3).

Exhibit 3: Market Implied US Overnight Lending Rate (%) (based on Fed funds futures)



Source: NorthCoast Asset Management; Bloomberg as of September 29, 2022.

3. Attractive yields bring back bonds

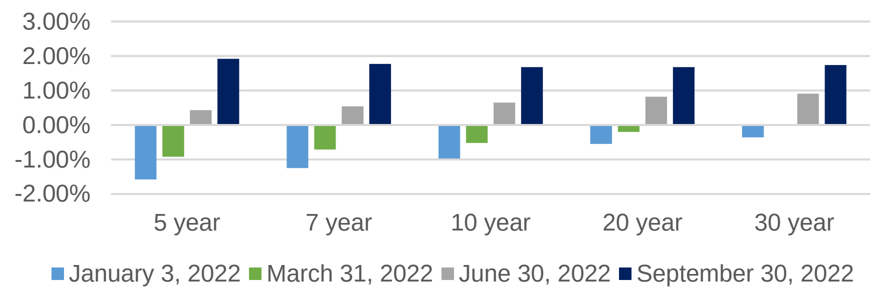
While we believe this is a time for caution in fixed-income portfolios, the return potential in the bond market is now more compelling as higher yields are adding to the attractiveness of bonds across maturities and sectors (Exhibit 4). Investors can potentially earn higher income amid volatile markets as positive real yields now exist, with bond yields higher than expected inflation over the longer term (Exhibit 5).

Exhibit 4: Yields of Key Fixed Income Markets

Treasuries	9/30/2022	12/31/2021	Difference
2-Year	4.2%	0.7%	3.5%
5-Year	4.1%	1.3%	2.8%
TIPS	1.7%	-1.0%	2.7%
10-Year	3.8%	1.5%	2.3%
30-Year	3.8%	1.9%	1.9%
Sectors			
U.S. Aggregate	4.8%	1.8%	3.0%
IG Corps	5.7%	2.3%	3.4%
Convertibles	7.1%	3.7%	3.5%
U.S. HY	9.7%	4.2%	5.5%
Municipals	4.0%	1.1%	2.9%
MBS	4.8%	2.0%	2.9%
ABS	5.5%	2.0%	3.5%
Leveraged Loans	10.5%	4.6%	5.9%

Source: NorthCoast Asset Management, Bloomberg.

Exhibit 5: Treasury Real Yields Turned Positive Across Maturities



Source: NorthCoast Asset Management; Federal Reserve Economic Data. Treasury real yields are referred to as "Real Constant Maturity Treasury Rates", which are estimated using pricing on Treasury Inflation-Protected Securities (TIPs).

Also, high yields can enhance the hedging characteristics of high-quality fixed income. After spending most of the year correlated with riskier assets, bonds will likely provide the potential for capital gains in the event of economic recession or more pronounced equity drawdowns.

Investment Implications

In the wake of more aggressive central bank tightening, continued elevated inflation and growing recession risks, we believe it is essential to actively manage duration and build more robust asset allocation while maintaining portfolio flexibility and liquidity. For YTD ending September 30, 2022, our Tactical Income strategy returned -12.3% net of fees, outperforming the U.S. Aggregate Bond Index and the Global Aggregated Bond Index by 2.3% and 7.6%, respectively.

On duration, we move from significantly underweight to moderately underweight, and expect to be closer to neutral in less tactical portfolios. We now see duration as broadly fair. Also, we expect the yield curve to flatten further amid recession risks, thus the longer-tenor yields, despite the current curve inversion, are better priced for potential risks that could later be priced in next year.

For credit risk, we believe that this is an environment where we take active decisions to slightly reduce risks and seek a balance between near-term caution and long-term focus on high-quality assets. We trimmed positions in VanEck High Yield Muni ETF (HYD) and closed out of the SPDR Blackstone Senior Loan ETF (SRLN) during Q2. We added the Invesco Senior Loan ETF (BKLN) position as its floating-rate is attractive in a rising-rate environment, and it has moderately better credit ratings.

We believe that investing in a wide variety of assets can further help investors meet their income needs. We invested in the iShares Preferred and Income Securities ETF (PFF) during the quarter as the bank preferred market looks historically attractive, with banks posting strong capital ratios. We also kept a modest allocation to U.S. TIPS as we believe that shorter-dated U.S. Treasury Inflation-Protected Securities (TIPS) can help hedge inflation at reasonable valuations.

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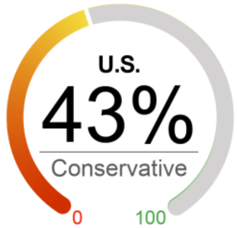
The NorthCoast Navigator is a market barometer displaying current equity outlook. The aggregate metric is determined by multiple data points across four broad dimensions including macroeconomic, sentiment, technical and valuation indicators. The daily result determines equity exposure in our tactical strategies. As of 9/30/2022. Data provided by Bloomberg, NorthCoast Asset Management.



Stubborn Inflation and Hawkish Fed Causing Market Turbulence

Market volatility reemerged in the second half of September, most notably after the last FOMC meeting. The S&P 500 fell 9.2%, breaking its mid-June lows and returning to November 2020 levels. The Nasdaq tumbled 10.4% while the Dow lost 8.8%.

Major macro catalysts for the downward market trend in September were stubbornly high inflation and the Federal Reserve reasserting that monetary policy will be tighter for a longer period. U.S. inflation was surprisingly firm in August despite a sharp decline in gasoline prices and an easing in global supply chains. In particular, the acceleration in the core CPI (up 6.3% on a year-ago basis) and strong wage growth supported by a resilient labor market did not sit well with the central bank.

The September FOMC meeting reinforced the Fed's hawkish tone and sent a strong message that the target rates would be at a restrictive level and remain there for a longer period. The Committee delivered a 75bp hike as expected in the meeting, taking the Fed funds target range to 3.00-3.25%, its highest level in almost 15 years. While there is little change to the policy statement, the upward revision to the policy rate projections (the "dot plot") made headlines: the median estimate for Fed Funds rates at the end of 2022 was pushed to 4.4%, 1% higher than the projection in June; while the median estimate for 2023 is now 4.6%, up from 3.8% from last quarter. Also, the quarterly Summary of Economic Projects (SEP) indicated a downward revision to real GDP estimates as well as upward revisions to the unemployment rate projections. The market now expects the FOMC to continue hiking into next year and has priced in increased challenges for a soft landing.

Hawkish surprises also took the stage internationally, with most major developed market central banks making it clear that they would continue to carry out more restrictive policies over the near term. The Bank of England hiked by 50 basis points to 2.25% and is expected to continue to hike at a sustained pace in coming meetings. The central banks in Indonesia and the Philippines hiked by the same amount, while the South African central bank hiked by 75bps and the Swedish Riksbank hiked by a surprise of 100 basis points. The implications of all of this: our view is that central banks will continue normalizing to bring inflation back to their targets, indicating that economic growth is likely to continue to soften across most developed markets in the near term.

Meanwhile, the European energy crisis remains a considerable challenge, and we believe it will profoundly affect growth in Europe. Since Russia invaded Ukraine, soaring energy prices have battered Europe, and its gas prices have now climbed to almost ten times their 10-year historical average. We believe that the energy crisis will exacerbate the weaker growth and higher inflation in the UK and the euro area, with industries across Europe scaling back operations due to higher energy costs. The crisis also has a spillover effect on other economies in the form of higher prices and slower growth. Fuel imports by Asian countries, including China, India, and Pakistan, have declined significantly with the fierce competition for natural gas supplies in Europe.

We remain conservative (U.S.) and cautious (International) with equity exposure, which has helped to mitigate the impact of the recent sharp sell-off. We see more volatility in the equity market down the road and believe that a cautious approach, active stock selection, and thoughtful portfolio construction can lead to more resilient portfolios. Although oversold conditions and bearish positioning could lead to a short-term technical bounce, we believe that the balance of risk in the riskier assets is still skewed to the downside.

Macroeconomic

The U.S. labor market showed signs of cooling in September but remained strong. Nonfarm employment increased by 315,000, modestly higher than the consensus forecast. The four-week moving average of initial jobless claims fell to 207,000 for the week ended September 24. The headline CPI rose 0.1% in August (stronger than consensus) compared with no change in July. On a year-ago basis, the headline and core CPIs were up 8.3% and 6.3%, respectively. Retail sales rose more than expected in August by 0.3%, with a solid gain in vehicle sales offsetting a decline in gasoline sales caused by lower prices. The robust labor market and wage growth overcame lingering low confidence and a shift from goods to service spending. U.S. industrial production declined 0.2% in August.

Sentiment

The ISM manufacturing index was unchanged in August, remaining at 52.8 (better than consensus expectation). U.S. manufacturing conditions have weakened this year, but the index remains above its recessionary threshold (closer to 48). University of Michigan consumer confidence continued to move slowly higher from its historic low and rose modestly from 58.2 to 58.6 in September, with gasoline prices falling from record highs. The NAHB index fell further below the neutral level in September to 46, with elevated mortgage rates and worsening affordability. The 30-year fixed-rate mortgage rate has soared to 6.8%, more than double the rate at the end of last year.

Technical

Technical indicators were neutral to slightly positive, with the increases in fear indexes and short-term reversal signals offset by declining momentum signals. The S&P 500 was 15% below its 200-day moving average, 10% below the 100- day average, and 11% below the 50-day average. The VIX index increased this month and settled at 31.6 at the end of September (compared with 25.9 at the end of August). With stronger than expected inflation data and a hawkish central bank, market volatility picked up considerably in the second half of September as investors positioned for interest rates to continue to rise sharply and a further slowing of the economy.

Valuation

The S&P 500 tumbled 9.2% this month, and stock valuation metrics improved but remained negative. P/E decreased from 19.3 at the end of August to 17.6 at the end of September. Forward P/E decreased to 16.1 at the end of September from 17.5 at the end of August. Inflation-adjusted valuation metrics continued to be negative.

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