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Quarterly Client Update

Q4 2021

December 31, 2021

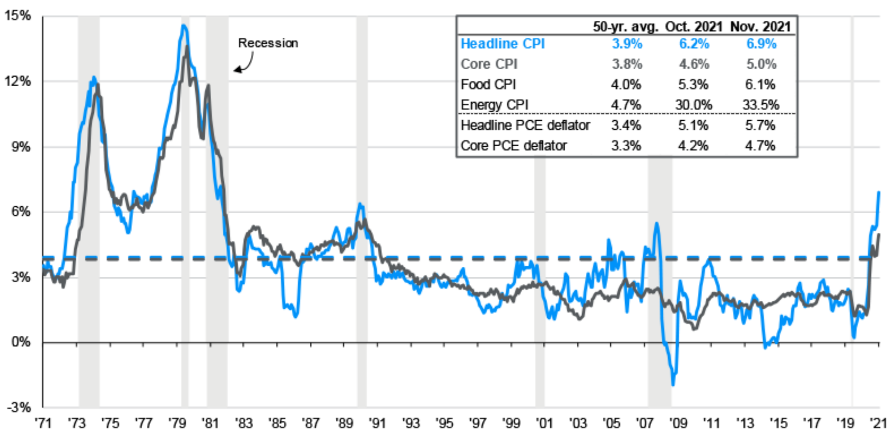
"I'm a health nut. My favorite food is hot dogs with French fries. And my exercise: I have a two-story house and a very bad memory, so I'm up and down those stairs."

~ Betty White

Typically, the quotes I choose to start my quarterly letters directly correlate with my thoughts on current market conditions. Not this time. There is no relationship between the market and my quote this quarter. Just an homage to an amazing person. There is, however, still a nod to a market timeline. Thirty years ago (1988-1991) was the height of The Golden Girls – one of Betty White's career peaks. That coincides with the last time we saw core consumer price inflation rise above 3% (see Exhibit 1).

Exhibit 1: CPI and Core CPI

% change vs. prior year, seasonally adjusted



Source: BLS, FactSet, J.P. Morgan Asset Management.
Notes: CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations. Guide to the Markets – U.S. Data are as of December 31, 2021.

Inflation is not only higher prices – it's a loss of purchasing power over time. Rising inflation means your dollar will not go as far tomorrow as it did today.

The Consumer Price Index (CPI) measures the cost of things consumers buy out of pocket. The other measure in this graph is the Personal Consumption Expenditures index (PCE), representing more of a lagging indicator that also measures things people consume, but including things they do not pay for directly — notably health care (a cost that insurance and government benefits help cover).

The Federal Reserve, America's central bank and the institution in charge of keeping prices from increasing too rapidly, targets 2% annual increases in the PCE index on average over time. They have determined that this level is generally healthy because it allows companies and individuals to gradually adapt to pricing and wages in a way that doesn't create market booms or busts.

In the short term, high inflation can be the result of a hot economy — one in which consumers have a lot of surplus cash or are accessing a lot of credit and want to spend. If consumers are buying goods and services eagerly enough, businesses may need to raise prices because they lack adequate supply. Companies may also choose to charge more because they realize they can raise prices and improve their profit margin without losing customers. However, inflation can also rise based on developments that have little to do with economic conditions. Limited oil production or supply chain issues can keep goods in short supply, pushing up prices.

In the longer term, high inflation can become entrenched if workers begin to expect it and can successfully negotiate wage increases to cover their climbing costs. Companies that are facing these higher labor costs may decide to pass the costs onto consumers — and voilà! You now have a situation where pay and prices push one another steadily upward over time.

When we're talking about effects on the market, very high inflation can spell trouble for stocks because investors need to make higher returns to break even. While it might have been attractive to invest money for a 3% annual payback before an inflationary rise, once inflation has taken off to 4%, your investment would actually be declining in terms of real-world purchasing power. Plus, inflation can be tough on the underlying business. Companies that lack pricing power — meaning that they cannot easily pass costs on to customers — suffer the worst, sometimes forced to absorb input cost increases by taking a hit to their profit margin.

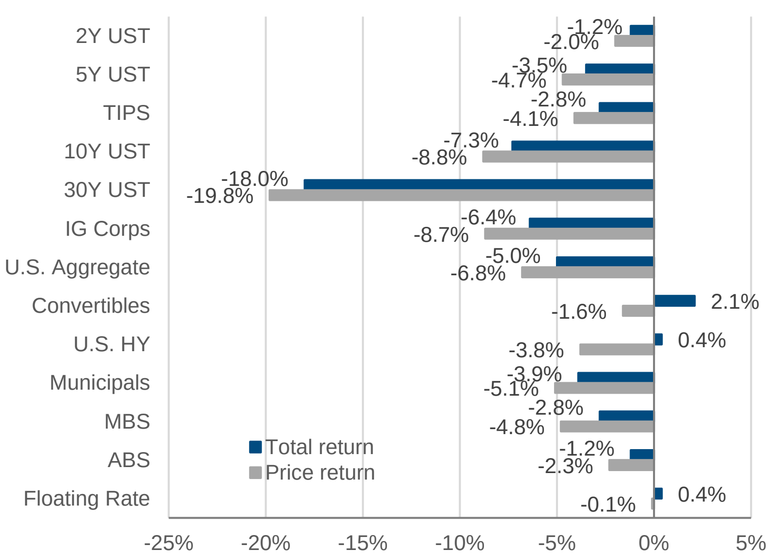
High inflation can also spur the Federal Reserve to increase interest rates as it tries to cool off the economy and slow demand. If the central bank does so drastically, it could even plunge the economy into a recession, which would also be bad for stocks — along with everyone else.

Which leads to the most important questions for me this year: Will 2022 see the current inflation spike ebb as supply chain disruptions ease and Omicron slows the pace of spending? Or are we entering a new, long-term inflationary period (which can be especially tough for people on fixed incomes like retirees)?

Our models have already started making adjustments, regardless of the answer. Specifically, during tightening regimes (1986, 1994, 2004, and 2014 when the Fed funds rate started to rise amid tapering) pharma, healthcare equipment, semi's, food, and tech hardware led the market. As such, in our equity portfolios you can see these sectors represented with stocks including ABBV, Archer Daniels, DELL, Qualcomm, Stryker, Pfizer, and Thermo-Fisher. In our ETF portfolios you can see inflation-hedged bonds and near zero exposure to traditional US bonds. Why? Because as inflation and yields climb, bond prices decline. 2021 saw the bond market decline -1.5% — the first negative bond market in nearly a decade. If this trend were to continue, you can see below the impact on traditional income producing assets (Exhibit 2).

Exhibit 2: Impact of a 1% Rise in Interest Rates

Assumes a parallel shift in the yield curve



Source: Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management.
Notes: Sectors shown are provided by Bloomberg unless otherwise noted and are represented by – U.S. Aggregate; MBS: U.S. Aggregate Securitized – MBS; ABS: J.P. Morgan ABS Index; Corporates: U.S. Corporates; Municipals: Muni Bond; High Yield: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); U.S. Floating rate index; Convertibles: U.S. Convertibles Composite. Convertibles yield is as of November 2021 due to data availability. Yield and return information base don bellwethers for Treasury securities. Sector yields reflect yield-to-worst. Convertibles yield is based on U.S. portion of Bloomberg Global Convertibles. Correlations are based on 15-years of monthly returns for all sectors. Past performance is not indicative of future results. Guide to the Markets – U.S. Data are as of December 31, 2021.

Despite the above uncertainties, we feel well-suited to enter this market phase. 2021 was a banner year for our strategy performance and we feel we are prepared for what's ahead. CAN SLIM performance at +19% was a leading hedged equity return as it outperformed its tactical category by 10%. Tactical Income at +4.2% beat the US bond aggregate by 5.5%. Our All-Cap Growth strategy, a buy and hold equity portfolio, gained 31%.

More importantly, going forward our market exposure and security (bond and stock) selection models remain programmed to assess the inflation risk daily. Given what may be a new tightening regime and a more confident Fed approach, we expect corrections and volatility this year to be harder to stomach than the relatively steady climb of the last 20 months. These pockets, however, create opportunity for more sophisticated investors. Choppy and at times downright scary but still productive.

Further, you should know that our team of talented advisors have never before been armed with better technology and investment solutions to help you navigate the road ahead. During our last team meeting in December, we reviewed the new planning software, loan services, insurance solutions and estate planning capabilities now available to our clients. These expanded capabilities have a breadth and depth that we are excited to demonstrate to you.

In closing, thank you for your business. In what was obviously a challenging year for so many, we hope this letter finds you and your family safe and sound. And although we moved into 2022 without Betty White and her buoyant wisdom, our wish for you as always is her brand of joy, happiness and prosperity. Welcome 2022!

Warm regards,

Dan Kraninger
President & CEO

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Inflation as a Short-Term Challenge

Julia Zhu
Senior Vice President, Market and Security Research

Inflation was one of the most widely discussed economic trends in 2021, with the Consumer Price Index posting the largest gain since the early 1980's. Headline (0.8% m/m) and core (0.5% m/m) CPI for November registered more robust increases. Inflation seemed to be more transitory earlier this year, driven mostly by supply chain issues and other reopening-related categories. However, in recent months inflation pressures have broadened beyond COVID reopening effects as some more structural economic components, including rising shelter costs, began to contribute to elevated pricing levels.

During the fourth quarter, yields initially increased when inflation readings came in higher than expected, and the central bank took a decidedly more hawkish tone. Yields then decreased as headlines surrounding the rapid spread of the Omicron variant flamed concerns about global growth and weakened investor risk appetite in the market. The nominal 10-year Treasury bond yields ended the quarter at roughly the same level as they started, with inflation expectations remaining elevated (up by 10bps) while real yield sinking further in deeply negative territory (down by 12bps). From a historical perspective, Treasury yields moved up from all-time lows reached in 2020 but stayed around the bottom of their historical range (see Exhibit 1).

While we acknowledge that the inflation risks are to the upside during the first quarter of next year, we expect inflation to begin to dissipate in the second half of 2022 and end up at a reasonably acceptable level by U.S. central bank standards, though probably higher than pre-pandemic levels. We have recently seen emerging signals that supply chain issues may be easing, suggested by what appears to be peaking global shipping costs and a slight drop in the supplier delivery index. Meanwhile, our wage index has only increased marginally since the third quarter. We anticipate that the recent step-up in wages and ongoing recovery from the COVID-19 pandemic will likely boost participation rates and dampen some labor supply and inflationary pressures. Overall, we believe that fundamentals do not support a permanent shift to higher inflation, as evidenced by anchored longer-term inflation expectations in the survey-based and market-derived data.

Inflation pressure and continued tightening of the labor market have pushed the Federal Reserve to formalize the hawkish shift in its monetary policy. In its December meeting, the Federal Open Market Committee (FOMC) announced plans to double its pace of tapering from 15bn USD to 30bn USD per month. The expected timeline of rate hikes was also pulled forward, with the median voting member now expecting three hikes in 2022 and 2023.

The expectations of rate hikes in 2022 have made some investors anxious. However, we expect a measured and well-communicated approach from the central bank due to moderating economic growth, peaking inflation, virus uncertainty, and the Fed's desire not to disrupt the markets. Also, we want to point out that rate hikes do not necessarily lead to negative returns for all fixed income strategies.

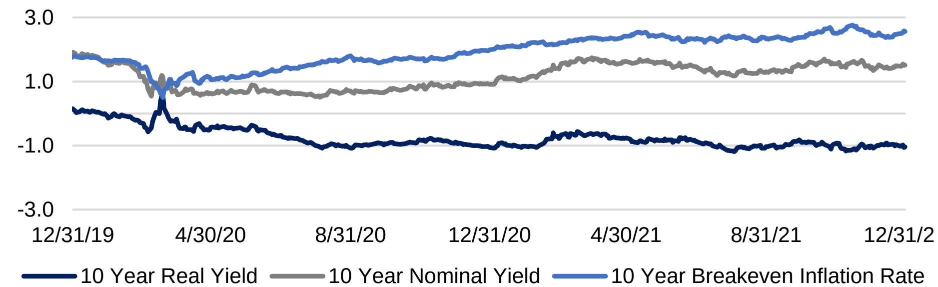
In fact, the core bond benchmark, the Bloomberg U.S. Aggregate Index, averaged a 4% return and only declined modestly in two of the last seven rate-hiking periods. The positive return can be partially explained because the Federal Reserve's action on the fed funds rate (a one-day, overnight rate) does not necessarily correlate to increasing yields across the rest of the yield curve. While raising the fed fund rate can substantially affect the short end of the treasury curve, the further out on the curve the less impact this action has. For example, the entire yield curve was actually lower by 17 to 69 basis points six months after the Fed raised the fed funds rate in December 2015. The longer-term (12 months, 18 months and 24 months after the hike) data also demonstrated that the rate hikes have less impact on longer maturity yields (see Exhibit 2).

Given the inflationary headwinds, waning stimulus, and market complexity, we believe it's essential to actively manage duration and selectively allocate to flexible income-focused strategies while balancing appropriate risk with opportunity. Since December 31, 2020, our Tactical Income strategy has returned 4.5% net of fees, outperforming the U.S. Aggregate Bond Index and the Global Aggregated Bond Index by 6.0% and 9.2%, respectively. We believe that our Tactical Income strategy is well-positioned in the following areas:

- U.S. Treasuries: Underweight. We keep our U.S. Treasuries holdings underweight with yields near lower bounds.
- Investment-Grade Credit: Slightly underweight. Valuations have soared as investors search for yields, and investors are being fairly compensated at the current credit spread level for the risk in the investment-grade market. At the same time, we believe that further spread compression will be difficult to achieve.

- High Yield: Overweight. We are forecasting below long-term average default rates for high yield bonds due to rapidly improving credit fundamentals, less distressed corporations, and wide access to capital markets. We continue to prefer interest rate hedged corporate and high yield bonds for less portfolio duration exposure.
- Municipal Bonds: Overweight. Credit quality improves in the municipal bond market due to better tax collections and massive fiscal stimulus. At the same time, the relatively low net supply of municipal bonds provides support for the valuation.
- TIPS: Overweight. We added a modest overweight position in short-term U.S. TIPS in our portfolio. Although inflation expectations have moved significantly higher, we believe that an appropriate inflation risk premium hasn't been fully priced in, given the potential of upside risk in inflation over the coming months.
- Alternative Assets: Overweight. We see opportunities across the spectrum of alternative assets, including the real estate sector, infrastructure assets and high dividend stocks, to boost income, improve return and diversify portfolios.

Exhibit 1: Nominal Yield Largely Unchanged, Real Yield Negative



Source: Bloomberg

Exhibit 2: Yield Change Across the Yield Curve after the Fed's Rate Hike in December 2015

		Yield Change (in basis points) after:			
Treasury Maturity	**Yield at "Liftoff"**	**6 months**	**12 months**	**18 months**	**24 months**
1 Year	0.69%	-17	+22	+52	+102
2 Year	0.98%	-29	+31	+37	+86
5 Year	1.71%	-61	+39	+5	+45
10 Year	2.28%	-68	+32	-12	+7
30 Year	3.00%	-57	+16	-22	-32

Source: Bloomberg

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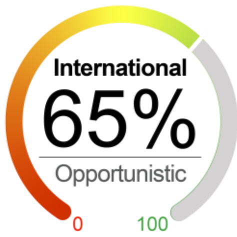
NorthCoast Navigator

Q4 2021 | December 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 12/31/2021. Data provided by Bloomberg, NorthCoast Asset Management.



Equities Rebound Despite Inflation

All three indexes finished higher in December with the S&P 500 up 4.5% and the Dow up 5.5% outperforming the tech-heavy Nasdaq up 0.8%. For 2021, the S&P 500 rose 26.9%, notching a three-year winning streak, while the Dow and Nasdaq gained 18.7% and 21.4%, respectively. Energy and real estate were the best-performing sectors in the S&P 500 in 2021, both surging more than 40%, followed by tech and financials, each rising more than 30%.

The market was volatile in the first half of December as investors weighed the impact of the Omicron variant on the global economy. However, earlier concerns were eased on signs that Omicron might not be as disruptive as initially feared. Both Moderna and Pfizer released data showing that their booster shots are effective in preventing severe infection against the new variant. Further evidence also emerged that Omicron typically results in relatively mild symptoms compared with earlier variants. While lockdowns and restrictions are imposed in some European countries, we do not anticipate major shutdowns or lockdowns in the U.S. In our view, Omicron will partially delay the global economic recovery but will not prevent it.

Inflation remained elevated in November, with the headline CPI up 6.8%, the largest gain since the early 1980s. Meanwhile, the PPI was up 0.8% in November, more than the economists' consensus anticipated. Although rising energy prices and supply-chain issues were two major driving factors behind the recent price surge, the Fed has certainly felt the pressure to address inflation. While we acknowledge that the inflation risks are to the upside in the coming months, we anticipate that prices will begin to moderate in the second half of 2022 as the supply chain issues gradually dissipate. Anticipated higher productivity in this business cycle should also help businesses absorb higher wage costs, dampening the effect of inflationary pressures.

Still, ongoing inflationary challenges and the tightening labor market have pushed the Fed to formalize the hawkish shift in its monetary policy. In its December meeting, the Federal Open Market Committee (FOMC) announced plans to double its pace of tapering from 15bn USD to 30bn USD per month beginning in January. Furthermore, the expected timeline of rate hikes was pulled forward: the median voting member now expects three hikes this year and in 2023, in sharp contrast to the forecast from its September meeting when only one hike in 2022 was anticipated. As such, we expect the Fed to kick off rate hikes this month, but also expect the effect will be gradual and relatively modest, amid the backdrops of slower but above-trend growth, peaking inflation, and virus uncertainty.

2021 has been a year of remarkable economic recovery and extraordinary equity return, and we see 2022 heralding a new regime of moderation—particularly in terms of growth, inflation, and asset returns. We anticipate volatility down the road but believe that above-trend growth, negative real yields, robust business investment, and accumulating U.S. household savings will be supportive for risky assets.

Macroeconomic

The U.S. labor market continued to tighten, with the four-week moving average of new unemployment claims falling from 206,500 to 199,250. Inflation remained high, with the headline CPI rising 6.8%, the highest level since the early 1980s. Meanwhile, the PPI increased by 0.8 percent in November, above expectations. After a healthy gain of 1.7 percent in October, industrial production in the U.S increased by 0.5% in November. With modest indicators that supply-chain concerns are no longer escalating, the picture is improving.

Sentiment

The PMI index increased from 60.8 to 61.1 in November, with supplier deliveries falling from 75.6 to 72.2, indicating a gradual alleviation of supply-chain difficulties. Despite the persistent burden of high infection rates and rising energy prices, consumer confidence in the U.S. climbed in December, according to reports from the Conference Board Consumer and the University of Michigan. The consumer confidence index of the Conference Board increased from 111.9 in November to 115.8 in December. The University of Michigan's sentiment index increased 3.2 points to 70.6, up from 67.4 in November.

Technical

Technical indicators remained optimistic but strained. The VIX level settled at 16.3 at the end of December, compared with 27.2 at the end of November. Fears over Omicron caused a rise in volatility at the start of the month. The market was calmed by signs that the Omicron might not be as disruptive as initially feared, as well as the year-end holiday influence.

Valuation

The S&P 500 rose 4.5% in December, and equity valuations remained under pressure. P/E increased from 25.03 in November to 26.21 in December; Forward P/E increased from 21.8 to 22.8. With inflation rising, inflation-adjusted valuation measures remained negative.

2021: Stocks Extend Long Recovery From Covid Shock

A fluid market saw the emergence of EV, energy and reopening stocks. But many sector moves during the year were short-lived.