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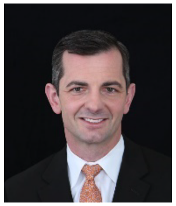
Quarterly Client Update

Q4 2022

December 31, 2022



"Prediction is very difficult, especially if it is about the future."

~ Niels Bohr

Every four years the most prestigious soccer competition in the world takes place, hosting 32 national teams for a month-long tournament. As a French native, this world cup particularly spoke to me: France was the defending champion, making it to the final round in Qatar's latest AC stadiums, facing Argentina where the game is more than a sport – it's part of your identity. Each team had arguably one of the top players in the world: Lionel Messi and Kylian Mbappe, who are teammates on the Paris Saint-Germain team.

On December 18, I was expecting a clash of the titans, both at the team level and at the star player level. The reality had almost nothing to do with my expectations. And even though France lost, the match was far more entertaining than expected, leaving me with the memory of the best soccer match I can remember. The event was a wild roller coaster with the strongest swings in momentum: Argentina dominated the first half with a 2-0 lead. The statistical odds were abysmal: France did not stand a chance.

But in the second half within 33 seconds of game time, Kylian Mbappe scored twice, stunning the Argentinian team, and turning the previous momentum and match domination on its head. In overtime, both stars led the charge, scoring an additional goal each. My heart rate soared while watching it all play out on the edge of my seat. In the end, Argentina won by settling the 3-3 match with penalty kicks.

As a financial professional, I could not help but consider the parallel with investing. The experience is not unlike facing the inherent difficulty of predicting the outcome of a volatile market, while simultaneously experiencing the attendant emotional roller coaster. And as in all sports, there are many alternate scenarios that could have materialized. What about a very marginal referee call?

When investing, there are many similar "matches" going on at the same time between strong forces like France vs. Argentina: Fed vs. Inflation, Recession vs. Soft Landing, Russia vs. Ukraine, Covid vs. Vaccine, Bulls vs. Bears. Each battle is wild and unpredictable. Each outcome can have a disproportionate impact on your individual life savings and your financial future, and yet you must find a way to stay invested to give your portfolio a chance to appreciate. "Finding the way" is one of the most important strategies that NorthCoast offers. But let's first go over those current matchups.

A CIO's View

We regularly cover these topics in our monthly Navigator. Here are some quick takes on each, all monitored daily by our models:

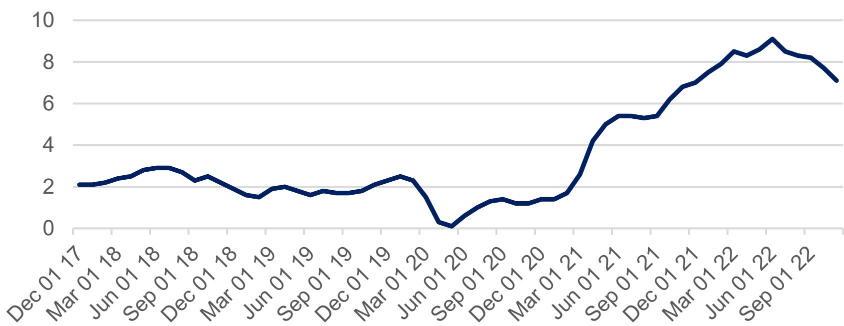
Covid is switching from a pandemic to an endemic in many economies where vaccination rates are high, and hospitalizations remain below previous peaks. Following lockdown protests, after spending 1,016 days closed to the outside world, China reopened its borders on January 8, abandoning the elusive safety of a "zero-covid" policy, and catching up with several waves of the pandemic.

China reopening: While we immediately think about the healthcare consequences of this reopening and any bumpiness along the way, there are other ramifications for the global economy and inflation. First, the stock market has witnessed a risk rally anticipating the reopening, and second, the FTSE China Net Total Return Index is up 53.39% from 10/31/2022 to 1/9/23. Other impacts will be higher commodity demand along with supply-chain issues.

Russia/Ukraine conflict: This situation continues to develop and seems to be reaching a stalemate on the battlefield thanks to the technological ingenuity of Ukraine using smartphones and Starlink satellite communications. All this while Ukraine reaches new levels off the battlefield with the help of a combination of sanctions and political influence. A cease fire attempt to allow Orthodox Christians to celebrate Christmas was offered by Russian President Vladimir Putin but met with doubt by Ukrainian officials. Hopefully this is a sign of a long-lasting cease fire in the future.

Inflation as measured by the US CPI YOY Index has been above 4% since April 2021, and above 7% since March 2022 with a peak at 9.05% in June 2022.The World Economy weighted inflation YOY index has been above 4% since June 2021, and above 9% since June 2022, with a peak at 10.42% on 11/04/2022. Global central banks entered into a coordinated effort of monetary tightening which seems to be getting results over the past few months. One component is now in focus: the tight labor market. Fortunately, this also seems to be loosening at the margin while staying fundamentally strong, which can be taken as a sign that the economy is still robust and can withstand further hikes.

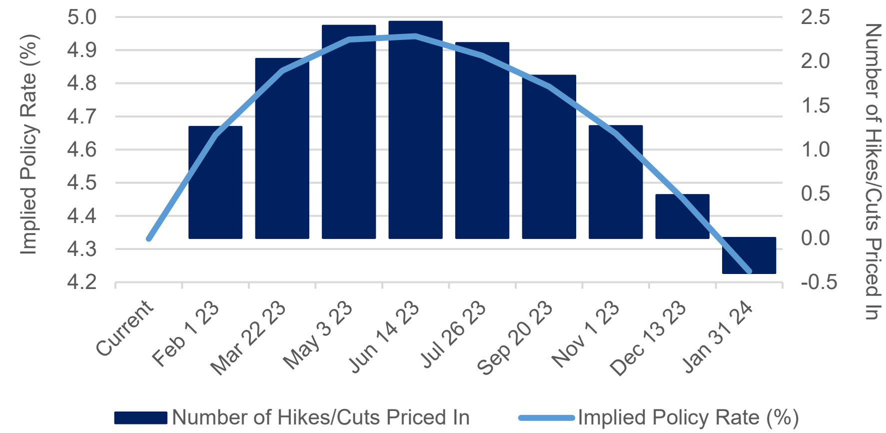
Exhibit 1: US CPI YOY Index



Source: Bloomberg.

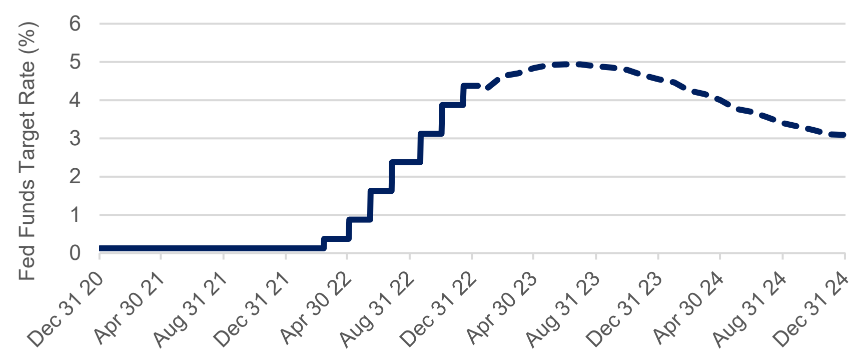
Fed Fund Target Rate: A series of interest rate hikes was one of the main factors for equity and bond indices correcting in 2022. The S&P 500 Index was down 18.55% and the US Aggregate Bond index was down 13.01% in 2022. The terminal Fed Funds rate has gradually moved from 3% to 5%, creating further downward pressure on risky assets. This strategy has started to show some results lately with the US CPI Urban Consumer Index YoY decreasing from a high of 9.1% to 7.1%, creating a short-lived relief rally. Expectations have started forming that central banks could signal an end to interest rate hikes and even rate cuts as early as mid-2023. This potential Fed pivot could have a positive impact on risky assets in 2023, and subsequently for the economy. Note that inflation has been historically difficult to influence, which is why the market has tended to swing on fresh inflationary data.

Exhibit 2: Implied Overnight Rate + Number of Hikes/Cuts



Source: Bloomberg.

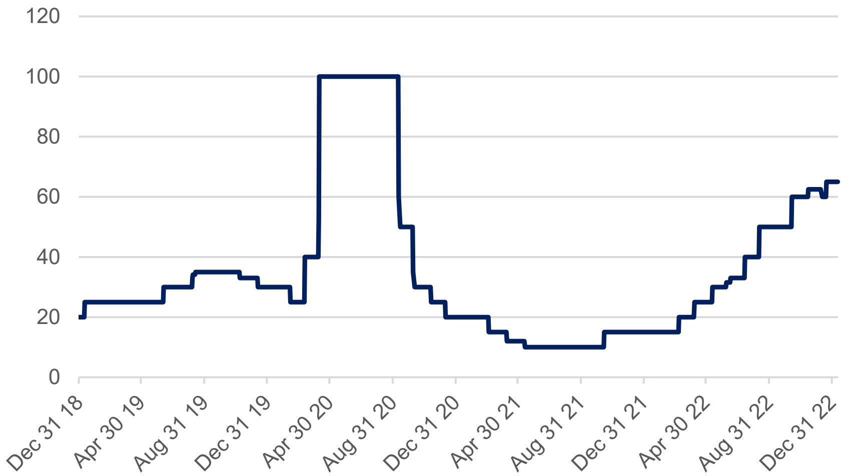
Exhibit 3: Fed Funds Target Rate with Futures



Source: Federal Reserve, Bloomberg, Credit Suisse.

Soft landing versus full-blown recession: This is the million-dollar question on everyone’s mind. While we have seen the valuation reset caused by the soaring rates, the earnings have not receded much yet. Inflation tends to have a positive impact on earnings and profitability because of the operating leverage. A combination of decreasing inflation and increasing rates can have quite a negative impact on earnings. This is one of the reasons why our portfolios are still positioned defensively. Markets do tend to anticipate recessions and recoveries, as well as future rate hikes based on the guidance of the Fed. The one year ahead recession probability forecast standing at 65% is already priced into the markets. These odds have worsened over 2022, but they could improve with the latest data. A match difficult to predict: on the one hand the strength of the labor market hints at the economic resilience; on the other, it also indicates that the Fed might not feel the need to cut rates and reverse course. This is all a balancing act for Fed Chairman Jerome Powell.

Exhibit 4: US Recession Probability Forecast



Source: Bloomberg.

Equity markets tend to anticipate future economic activity and corporate profitability. The ISM Manufacturing PMI continues to deteriorate and is now below 50, indicating a slowdown in activity which might transfer to a decline in pricing power. Margins could be at risk with a tight employment market and sticky wages, along with inventory acquired during this high inflationary period and supply chain issues. In other words, inflation slowing down might be better for rates, but worse for earnings and maybe worse for the stock market.

Speculative assets and stock picking: We have witnessed in 2022 the more speculative segments (Bitcoin, Crypto, NFT, SPACS) correcting heavily, and to top it off, the FTX debacle. “It's only when the tide goes out that you learn who has been swimming naked.” as Warren Buffet would say. Private assets (debt, equity, real estate) have not corrected and have even appreciated in this environment, forcing us to pause our enthusiasm for these asset classes. During this time, our stock picking model has been working quite effectively (further evidenced by the number of benchmark-beating returns). Value versus growth is still trading at a discount, a potential sign that there is more to come, giving us confidence that stock picking and active management could continue to be in favor in 2023.

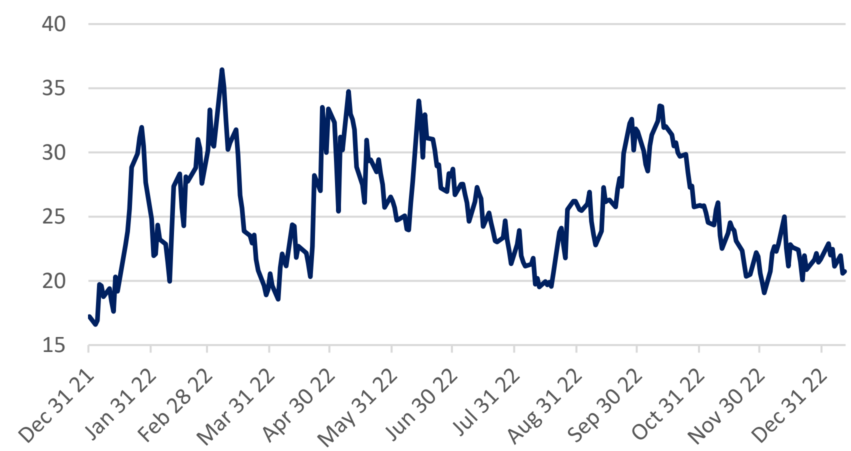
Fixed Income: The silver lining in the interest hikes is that while fixed income suffered because of the duration effect, it is more attractive now: Treasury bonds are currently at 4%+ yield. This rate is so compelling that we launched a strategy to provide clients access to such an attractive and safe treasury rate. In our more tactical strategies, we are currently holding about 65% in cash, invested in money market funds that can yield almost 4% depending on the custodian. This is much more attractive than a checking account.

We anticipate traditional fixed income to come back in vogue and play a more important role in portfolios than it had in previous years. Returns and correlations could both become more attractive for that asset class.

US policy: The chaotic election of Kevin McCarthy to US House Speaker highlights the thin margins of control in the House. A divided Congress is a potential omen of further political uncertainty in 2023 such as the votes on the US debt ceiling and government spending, which could disrupt financial markets.

The Fear Index (VIX, which measures market volatility) is back to its 2022 lows, sitting at 21.97 after an excursion above 30 at the beginning of Q422. This is indicative of a market with more hope than fear despite the matches ahead.

Exhibit 5: CBOE Volatility index



Source: Bloomberg.

Portfolio Management Remains Defensive

As we enter 2023, we continue to take a defensive position in our tactical strategies, either holding 60%+ cash in our equity portfolios or managing with a bias towards shorter duration and quality in fixed income. This all occurs while concurrently taking advantage of market relief rallies and pull backs to adjust our stance on the margin. As always, tax-loss harvesting was a year-end focus of our team. Overall, these investment decisions have positively contributed to returns pre- and post-tax. We anticipate a rotation in early 2023 with some profit-taking in our most appreciated positions (energy and defensive stocks), while continuing to take advantage of further appreciation opportunities as the year moves on.

Navigating these uncertainties can be daunting as headlines trigger emotional responses that can derail your plans. Effective investment management guides you through this challenge: a commitment to an adaptable tactical portfolio, for instance, during the ebbs and flows of market unknowns can be critical to your financial success. We have a wide range of strategies available, including tactical solutions, fixed income, defined outcome options with predefined guardrails, and long-term growth solutions that can be combined into an effective portfolio. We call this approach the “All-Weather” approach. Please reach out to your advisor to discuss your plans going into the new year.

I hope this letter finds you and your family happy, healthy, and enjoying the new year. We look forward to having fruitful 2023 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

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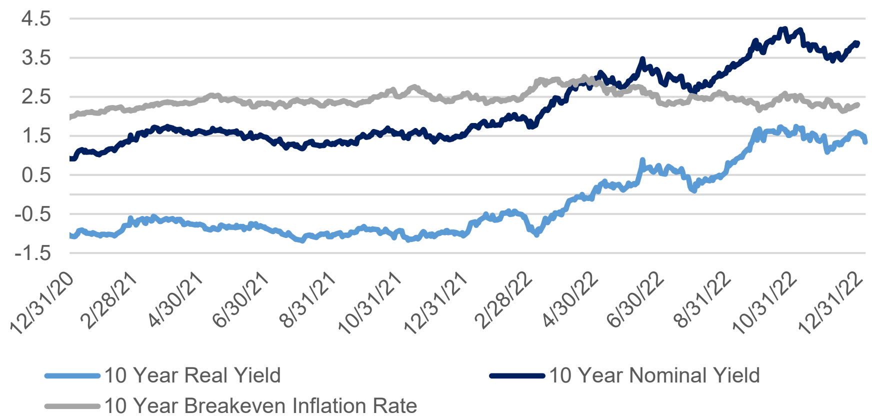
Yields Invested Bonds Rebounded

Julia Zhu
Senior Vice President, Market and Security Research

Treasury yields have fallen since the beginning of November due to a negative inflation data surprise at that time along with a dovish perception of the Fed's policy. They climbed higher in the last trading days of the year, however, when both the European Central Bank and the Bank of Japan surprised the market with hawkish policy decisions. The US nominal 10-year yields ended the quarter essentially flat at 3.87%, compared with 3.83% at the end of the third quarter. The real yield contributed negatively (down by 48bps), while inflation expectations, measured by the 10-year inflation breakeven rate, rose moderately from 2.15% to 2.30% (see Exhibit 1).

Exhibit 1: Treasury Yields ended flat in the fourth quarter of 2022

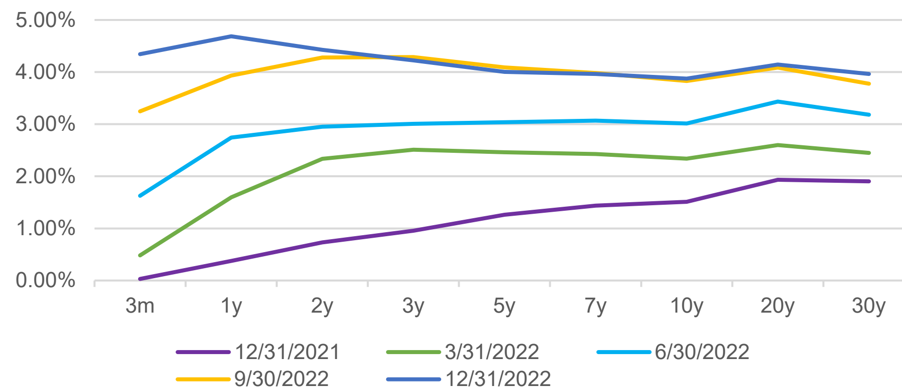


Source: Bloomberg.

After three quarters of deeply negative returns, the fourth quarter saw some rebound across different sectors in fixed income. The broad market, as represented by the Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index, returned 1.9% and 4.6%, respectively, during the quarter.

Amid a further flattening of the Treasury curve, the yield curve inversion has become deeper during the fourth quarter, with the two-year yield now almost 55 basis points above the 10-year yield. Furthermore, the aggressive interest rate hikes from the Fed drove up the 3-month rates significantly from 3.25% to 4.34%, a level that is 47bps higher than the 10-year yields (see Exhibit 2). The Probability of Recession Model from the Federal Reserve Bank of New York (which looks at the difference between 3-month rates and the 10-year yield) currently predicts a 60% recession probability in the next 12 months.

Exhibit 2: U.S. Treasury Yields Curve



Source: Bloomberg.

Macro volatility may have peaked but is set to remain high

The bond market continues to be driven by expectations of inflation and Fed policy changes. We believe headline inflation has peaked for this cycle, but it remains uncertain how quickly and how low inflation might go in 2023. We have seen core goods disinflation and expect shelter inflation to decelerate as the housing market continues to cool down. However, core service inflation excluding shelter will be highly sensitive to labor market tightness and wage growth. We expect inflation to fall further in 2023 but will likely stay above pre-2020 levels for the foreseeable future.

Major central banks worldwide, except for the Bank of Japan and the People's Bank of China, have carried out their efforts to tame stubbornly high inflation. In the U.S., the Fed announced its fourth consecutive rate hike of 75 basis points in its November meeting, followed by a 50-basis point rate hike in December, bringing the Federal funds rate to a range of 4.25% to 4.5%. Despite the slower pace of rate hikes, we see central banks live with persistently above-target (above 2%) inflation, and unable to cut rates as quickly as some investors might have expected.

Bonds are Back

After a year of deeply negative returns, we believe that fixed income will likely deliver better performance in 2023.

First, we see compelling opportunities in fixed income, given higher yields across maturities and sectors (see Exhibit 3). Investors can earn higher income amid volatile markets as positive real yields now exist, with bond yields higher than expected inflation over the longer term. Also, compared with the equity earnings yield, bond yields have moved much higher during 2022. At the end of 2021, only asset classes such as leveraged loans and emerging market debt generated yields comparable with the S&P 500. An investor can now earn a higher yield without moving farther up the risk spectrum, with U.S. investment grade bonds yields higher than equities.

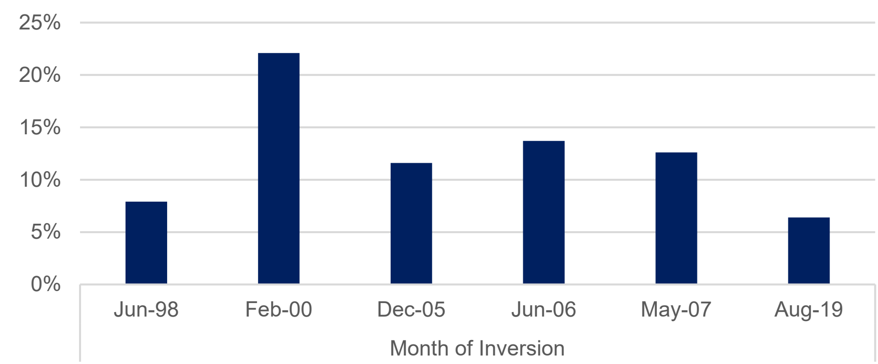
Exhibit 3: Yields of Key Fixed Income Markets

Treasuries	12/31/2022	12/31/2021	Difference
2-Year	4.4%	0.7%	3.7%
5-Year	4.0%	1.3%	2.7%
TIPS	1.6%	-1.0%	2.6%
10-Year	3.9%	1.5%	2.4%
30-Year	4.0%	1.9%	2.1%
Sectors			
U.S. Aggregate	4.7%	1.8%	2.9%
IG Corps	5.4%	2.3%	3.1%
Convertibles	7.1%	3.7%	3.4%
U.S. HY	9.0%	4.2%	4.8%
Municipals	3.6%	1.1%	2.4%
MBS	4.7%	2.0%	2.7%
ABS	5.9%	2.0%	3.9%
Leveraged Loans	11.4%	4.6%	6.8%
SPX	5.4%	4.4%	1.0%

Source: Bloomberg.

Second, in addition to more attractive yield potential, fixed income also looks more appealing given the current macroeconomic uncertainty – bonds tend to hold value better in a recession. We anticipate that when the economy continues to weaken and earnings estimates are cut, the traditional negative correlation between stocks and bonds will resume, and higher-quality fixed income should play its role as reliable hedging against risky assets. This year, we have witnessed a flattening of the Treasury curve with the inversion between the 2-year and 10-year yields triggering recession concerns. Empirical data has shown that bonds delivered good performance two years after the 2-year and 10-year U.S. treasury yields were inverted (see Exhibit 4).

Exhibit 4: Returns of the Bloomberg U.S. Aggregate Bond Index two years after 2-year and 10-year U.S Treasury yields invested



Source: Bloomberg.

Thirdly, the new regime of higher rates, a slower economy, and elevated market volatility requires us to take more granular views by actively allocating among sectors and sub-asset classes rather than depending on broad exposures. We favor a more cautious approach, allocating to higher-quality assets that tend to be less sensitive to economic downturns. We favor high-grade credit as we think it can hold up better in a recession than equities. In addition, corporate balance sheets are relatively healthy, with companies having already refinanced their debt at lower yields. Valuation for mortgage-backed securities also looks attractive as its spread increased to the widest levels in more than ten years, except during the liquidity crisis in 2020 at the beginning of the pandemic.

Investment Implications

In the wake of central bank tightening, stubbornly 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 December 31, 2022, our Tactical Income strategy returned -9.8% net of fees, outperforming the U.S.

Aggregate Bond Index and the Global Aggregated Bond Index by 3.2% and 6.5%, respectively.

On duration, we remain moderately underweight to counter for policy risk and have moved closer to neutral in less tactical portfolios. For credit risk, we believe this is an environment where we make active decisions to balance near-term caution and a long-term focus on high-quality assets. We added short-term (IGSB) and intermediate-term (IGIB) investment-grade corporate bond ETFs to our more tactical portfolios. We've also added iShares Interest Rate Hedged Long-Term Corporate Bond ETF (IGBH) since last quarter as it provides exposure to long-term corporate U.S. investment grade corporate bonds with significantly less interest rate risk (effective duration: 0.02)

We believe that investing in a wide variety of assets can further help investors meet their income needs in this environment. We bought iShares U.S. Infrastructure ETF (IFRA) during the quarter as IFRA has 95% exposure to U.S. companies and is a relatively safe equity play as it invested in many super core regulated utility assets.

Important Disclosure Information

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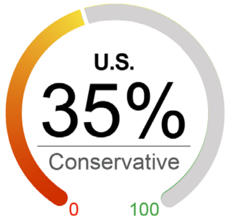
NorthCoast Navigator

Q4 2022 | December 31, 2022

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 12/31/2022. Data provided by Bloomberg, NorthCoast Asset Management.



Equity Markets Still Under Pressure from Rising Interest Rates

Equity markets were under selling pressure in December, fighting headwinds from rising interest rates and a looming economic downturn. The S&P 500 finished the month down 5.8%, and the Dow lost 4.1%. The tech-heavy Nasdaq lagged significantly, losing 8.7% for the month. Within the S&P 500, the typically defensive sectors, including health care, utilities, and consumer staples fared best, while weakness in Tesla weighed heavily on the consumer discretionary sector.

During December, inflation and monetary policy continued to be the key macro factor driving asset markets. Investors got more relief on the inflation front this month. The Consumer Price Index (CPI) rose 0.1%, slightly less than the consensus forecast, bringing the year-over-year CPI down to 7.1%. More encouragingly, the core CPI rose 0.2%, the weakest monthly gain this year, with a 6.0% year-over-year increase. The deceleration in the core CPI was attributable to declines in the prices of used vehicles, medical care services, and transportation.

Despite the welcome downside surprise of the recent two months' CPI data, it remains uncertain how quickly and how low inflation might go in 2023. We have seen core goods disinflation as consumers shifted their spending from goods to services and the supply-chain issues continued to ease. We also expect shelter inflation (40% of the core CPI) to decelerate meaningfully around mid-2023 as the housing market continues to cool down. However, the category of core service inflation excluding shelter encompasses many labor-intensive sectors and will be highly sensitive to labor market tightness and wage growth. Despite some weakness in certain industries, the labor market remains resilient, with the November payroll beating expectations by a large margin. At the same time, average hourly earnings accelerated for the third consecutive month, increasing YOY earnings by 5.1%. High wage growth could be worrisome for the Fed as it might make inflation much harder to control.

Well-anticipated by the market, the Federal Open Market Committee increased the target range of the fed funds rate by 50 basis points in its December meeting, lifting the target range to 4.25% to 4.5%. Despite a slowdown in the pace of rate hikes, the Fed raised its projection of the peak fed funds rates in 2023 from 4.6% to 5.1% and asserted that the work to tackle stubbornly high inflation was far from over. New forward guidance also shows a worsening economic outlook from the committee, with projections for the core PCE inflation rate increasing to 3.5% (from 3.1% in September), forecasts for GDP reduced (from 1.2% to 0.5%), and the unemployment rate nudging up (from 4.4% to 4.6%).

December also witnessed a mixture of resilience and weakness in economic and sentiment data. The labor market data held up better than expected, while widespread weaknesses emerged from manufacturing and consumers in addition to the sharper cooling of the housing sector. For the first time since May 2020, U.S. manufacturing activity contracted in November, with the ISM manufacturing index falling to 49. The sub-groups of new orders, production, and employment all declined. Historically, it is unusual to see a tightening of monetary policy when the ISM manufacturing survey's new orders index is below 50. However, the Fed is acting differently this time, determined to tame inflation even at the cost of below-potential GDP growth for a period. After robust growth in October, retail sales fell more than expected in November. Consumers have mostly exhausted excess savings accumulated during the pandemic, with the savings rate falling to 2.3% in October from 7.3% a year ago. Although we expect modest sales growth, consumers are getting hit by a combination of elevated inflation, high interest rates, falling housing prices, and broadening negative wealth effects from all assets, including equities, bonds, and alternative investments.

Macroeconomic

The U.S. labor market showed signs of cooling in December but remained strong. The nonfarm employment surprised to the upside, increasing by 263,000 in November. The four-week moving average of initial jobless claims fell to 221,000 for the week ended December 24.
The headline CPI rose 0.1% in November after a gain of 0.4% in October. On a year-ago basis, the headline and core CPIs were up 7.1% and 6.0%, respectively.
Retail sales fell more than anticipated by 0.6% after strong growth in November. High inflation is eating into real income growth while rising interest rates are increasing financing costs.
U.S. industrial production fell 0.2% in November, weaker than the consensus forecast.

Sentiment

The ISM manufacturing index fell from 50.2 to 49.0 in November, indicating that U.S. manufacturing activity is contracting for the first time since May 2020. The report's details revealed that new orders, production, and employment all declined. University of Michigan consumer confidence rose in November to 59.7 from 56.8; falling gasoline prices likely contributed to the gain. The index remains strikingly low, with higher interest rates and a volatile equity market weighing on sentiment. The NAHB index fell 2 points to 31 (50 is the neutral level) in December, the lowest level since 2012. Elevated mortgage rates and worsening affordability continued to weigh on the housing market.

Technical

Technical indicators were neutral to slightly negative, with the increase of short-term reversal signals offset by momentum signals and fear indexes. The S&P 500 was 4% below its 200-day moving average, 2% below the 100-day average, and 2% below the 50-day average. The VIX index increased slightly this month and settled at 21.7 at the end of December (compared with 20.6 at the end of November). Pessimism around the outlook for equity markets and the economy amid a macro backdrop of rising interest rates and recession risks all contributed to the increase in market volatility.

Valuation

The S&P 500 lost 5.8% this month. Valuation metrics for equity improved but remained negative. P/E decreased from 19.6 at the end of November to 18.5 at the end of December. Forward P/E fell to 17.5 at the end of December from 18.6 at the end of October. Inflation-adjusted valuation metrics continued to be negative.