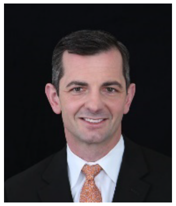


"Prediction is very difficult, especially if it is about the future."

~ 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:

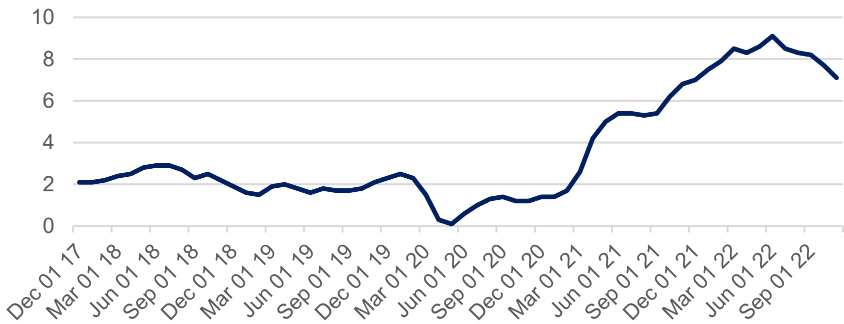
Covid is switching from a pandemic to an endemic in many economies where vaccination rates are high, and hospitalizations remain below previous peaks. Following lockdown protests, after spending 1,016 days closed to the outside world, China reopened its borders on January 8, abandoning the elusive safety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

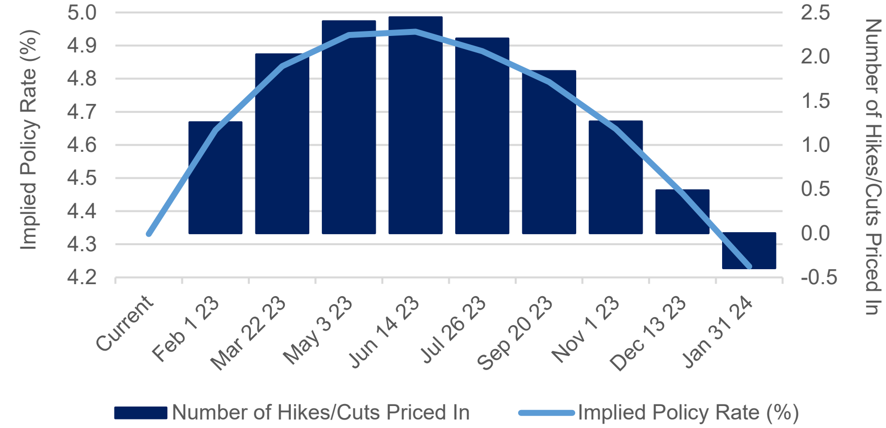
Exhibit 1: US CPI YOY Index



Source: Bloomberg.

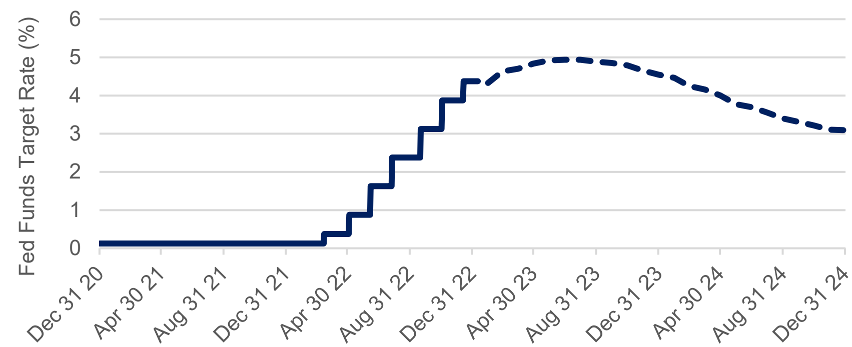
Fed Fund Target Rate: A series of interest rate hikes was one of the main factors for equity and bond indices correcting in 2022. The S&P 500 Index was down 18.55% and the US Aggregate Bond index was down 13.01% in 2022. The terminal Fed Funds rate has gradually moved from 3% to 5%, creating further 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.

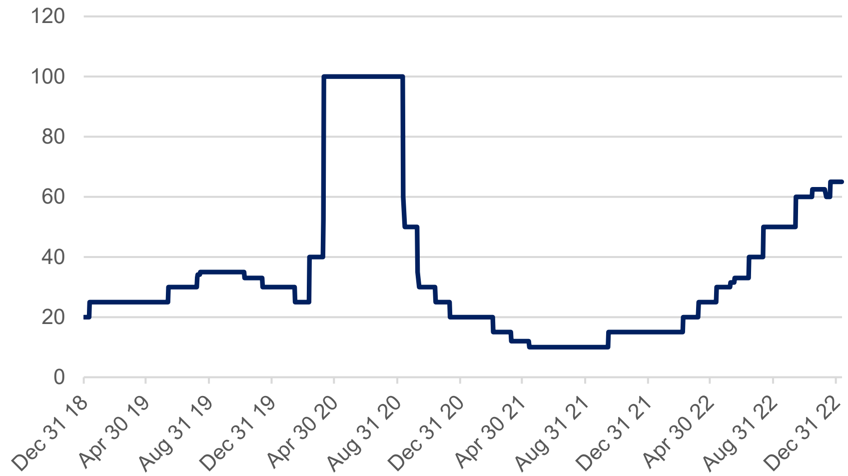
Exhibit 3: Fed Funds Target Rate with Futures



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.

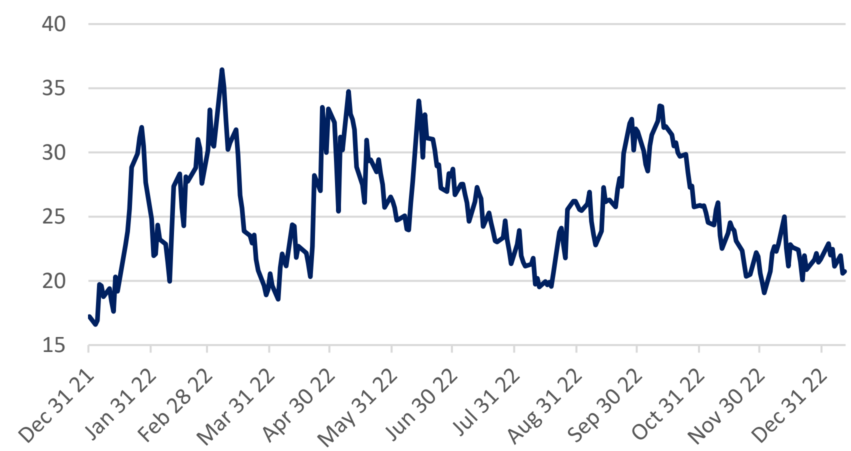
Fixed Income: The silver lining in the interest hikes is that while fixed income suffered because of the duration effect, it is more attractive now: Treasury bonds are currently at 4%+ yield. This rate is so compelling that we launched a strategy to provide clients access to such an attractive and safe 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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