NorthCoast Asset Management

NorthCoast portfolio management team reflects on 2016 and provides insight into next year

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What has been a top performing holding for 2016 in the managed ETF portfolios? What do you attribute its gains to and how do you like it heading into 2017?

Although this year has been tumultuous for equities, there have been many positive positions across the board. We found U.S. small-cap and mid-cap equities to be some of our best performing, with IJR and IJH gaining 29% and 23% YTD, respectively. We attribute the strong performance of these ETFs to a fundamentally sound U.S. economy, robust job creation, and a post-election rally which favored smaller market capitalization companies.

Heading into 2017, with the anticipation of pending government policy changes, we expect that "Corporate America" will get a profit boost from a potentially lower tax burden. Along with increased infrastructure spending, a looser regulatory environment, and a resulting increase in job growth, changes in these economic variables should administer positive supply shocks to the capital markets.

It is yet to be determined whether the new administration will pursue more restrictive international trade. Since small-cap and mid-cap companies (IJR and IJH) are less internationally oriented given their revenue streams are predominantly isolated within the U.S., the uncertainty in international trade has less impact on them. However, increasing interest rates, a potentially stronger dollar, higher commodity prices and an unknown Trump policy could mean possible risks for the U.S. equity market in 2017.

Turning attention to our Tactical Income portfolio, NorthCoast currently holds a 5% weight position of REM, iShares Mortgage Real Estate Capped ETF, which has returned 22% YTD. Mortgage REITs have benefited from the Federal Reserve's continual low interest rate environment and stable inflation. We are closely monitoring the potential interest rate hikes and managing the risk of the position.

Is there a holding currently in your portfolio that has underperformed expectations in 2016? What would you attribute that to and how do you think the holding is positioned heading into 2017?

The United Kingdom equity market has underperformed most other equity markets in 2016. We attribute the underperformance, at least in part, to economic ambiguity, a fall in consumer and business confidence -- along with an investment drop-off in the region after the Brexit vote in June.

We tactically sold our position in EWU, the iShares MSCI United Kingdom ETF, at the end of October as our score model indicated deteriorating signal strength for the United Kingdom in three out of the four signal categories: macroeconomic, technical and sentiment signals all dropped to negative territory.

We remain cautious toward the UK equity market heading into 2017. Although the third quarter GDP growth data was better than estimated and recent PMI data stayed above the neutral level of 50, we believe that it's too early to extrapolate these data points into a growing trend.

What is your outlook for mortgage-backed bonds in 2017?

Mortgage backed security performance has been largely driven by strong demand, including outsized buying by banks and non-U.S. investors.

We expect relatively higher volatility in MBB for 2017 given the potential of more Federal Reserve rate hikes. At the same time, should interest rates rise, we may see additional purchases by yield-driven investors. With the already quickly rising mortgage rates, we expect the refinancing and prepayment risk of mortgage backed bonds to be significantly curtailed.

Eurozone equities have bounced back in recent weeks. What do you attribute the move to and how do you like the region going forward?

Recent Eurozone data has been upbeat -- PMI increased to 54.9 in December from 53.7 in November, suggesting that growth may accelerate in the coming months. Employment growth also picked up to its strongest pace in over eight years. Sentiment indicators in Germany and France were both optimistic.

Also, the Eurozone Q3 real GDP expanded by 0.3%, matching the rate of second quarter expansion. Growth from a year earlier was 1.6%. The economy brushed off worries surrounding the U.K. exit vote and increased at a healthy pace in the third quarter.

We are slightly overweight EZU because our model currently indicates relatively strong macroeconomic and sentiment signals for the Eurozone and its valuation level is attractive compared with equity markets in other regions/international countries. However, we will closely monitor the risks including a potential "hard Brexit" outcome and muted profitability driven by low interest rate, etc.

When you consider varying market-capitalization positions including small-cap (IJR), mid-cap (IJH), and large-cap (IVV) U.S. equities, which one of the three stands out as being the most attractive for 2017?

Taking into account all the available data at this point, we prefer U.S. small and mid-cap equities over their large-cap counterparts.

As mentioned earlier in this publication, whether the new administration will pursue more restrictive international trade remains unknown. However, since small and mid-cap companies (IJR and IJH) are less internationally oriented and their revenue less dependent on international trade, the uncertainty in international trade has less impact on them.

One of Trump's expected priorities as president is to increase spending on U.S. infrastructure, a stimulus that would have an outsized impact on companies that focus on the domestic economy.

Real exchange rates move in tandem with inflation. Thus, the potential for interest rate hikes and a stronger U.S. dollar will have a lesser impact on small and mid-sized companies since they are more isolated from volatile foreign exchange conditions. Furthermore, as these companies are mostly importers with less sizeable revenue streams overseas, a stronger dollar will lower their costs creating positive pressure on future earnings.

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