ARCUS CAPITAL PARTNERS

Q2 | 2024 Market Commentary

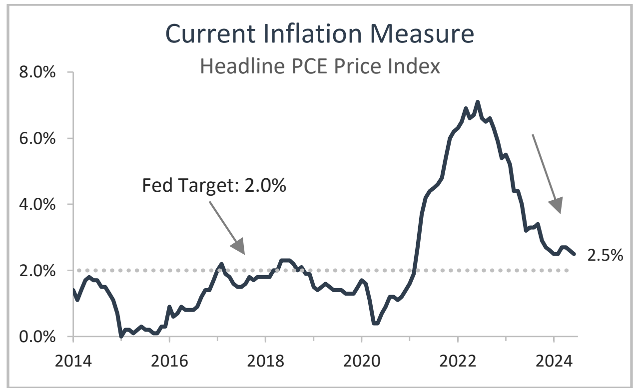
Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great summer. The second quarter brought more of the positive price action experienced during the prior three months and saw markets push to new all-time highs. Resilient economic growth, strong corporate earnings, and the continued hope of Federal Reserve (Fed) rate cuts acted as tailwinds. Interest rates bounced around and ended the quarter nearly unchanged. Lastly, commodities were modestly higher, even as global crude oil prices were flat. We maintain a positive view of equities but expect higher volatility and more modest returns during the back half of the year. Within fixed income, we still prefer private credit to public markets but think interest rates could decline and benefit rate-sensitive bond prices. Finally, we suggest investors keep a long-term perspective and focus on adding to positions on material weakness.

I. Market & Economic Overview

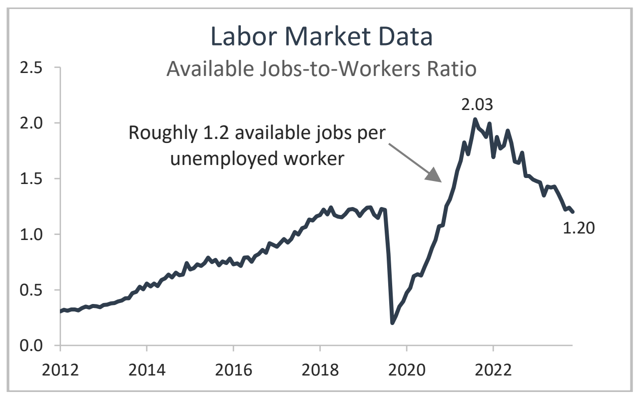
US stocks remained in gear and registered new all-time highs during the quarter. Similar to Q1, solid domestic growth (helped by fiscal spending) and expectations for Federal Reserve interest rate cuts (albeit fewer) supported higher stock prices and robust earnings growth. In fact, the Fed's preferred inflation measure is back in the vicinity of their 2% target, and the labor market has normalized back to pre-covid levels (Charts 1-2). These factors should lead to interest rate cuts during the second half of the year (Chart 3). The total number of cuts will depend on the upcoming data releases – the Fed will emphasize inflation readings (e.g. PCE) and the labor market numbers (e.g. unemployment rate). Assuming no major cracks form, the market expects 1-2 cuts by the end of the year (note: as of early August, the market began pricing roughly four cuts due to a weak labor report – more below).

Chart 1



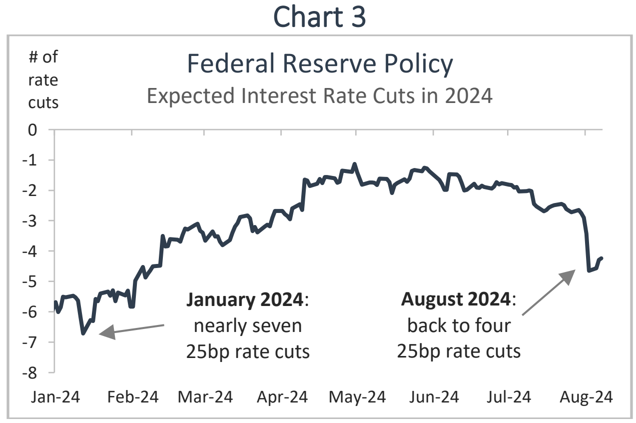
Source: Bloomberg; Arcus Capital Partners; PCE or Personal Consumption Expenditure.

Chart 2



Source: Bloomberg; Arcus Capital Partners; data shown is the ratio of US JOLTs Job Openings and total unemployed workers.

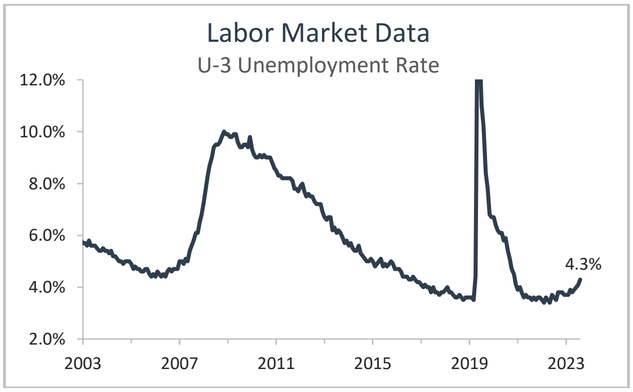
Chart 3



Source: Bloomberg; Arcus Capital Partners

As noted, recent labor reports have shown signs of weakness (Chart 4). According to many experts, the unemployment rate has reached levels consistent with past recessions. A few data points do not make a trend, but the current situation requires closer scrutiny over the coming months.

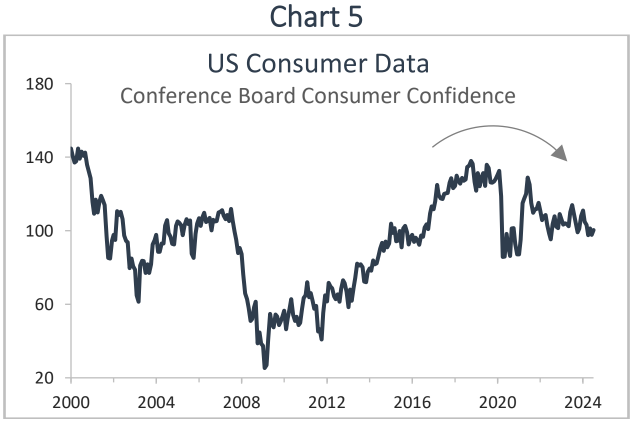
Chart 4



Source: Bloomberg; Arcus Capital Partners

The weakening consumer is another area that bears watching, as consumption drives the domestic economy (Chart 5). Consumer data have started deteriorating, and CEOs across many industries have noted a slowdown in spending, delayed purchases, and a preference for lower-cost items.

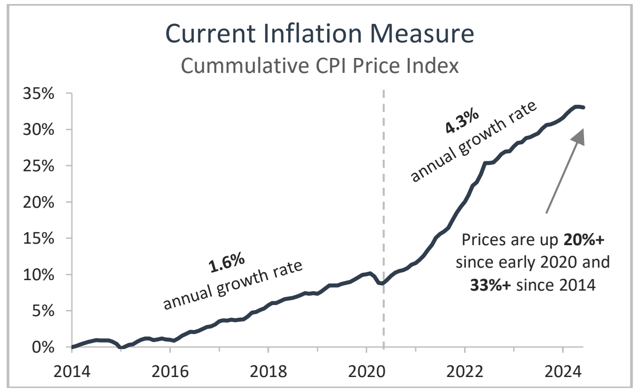
Chart 5



Source: Bloomberg; Arcus Capital Partners

It is difficult to pinpoint the exact cause of the weakness, but depleted savings, record borrowing costs, and persistently higher prices have all played a part. Although most inflation rates are moderating, they are still increasing, and prices are not falling. The basket of goods tracked by the CPI (Consumer Price Index) has risen over 20% since early 2020 after growing roughly 10% during the prior six years (Chart 6). These additional costs have put immense pressure on consumers and likely outpaced their wage increases.

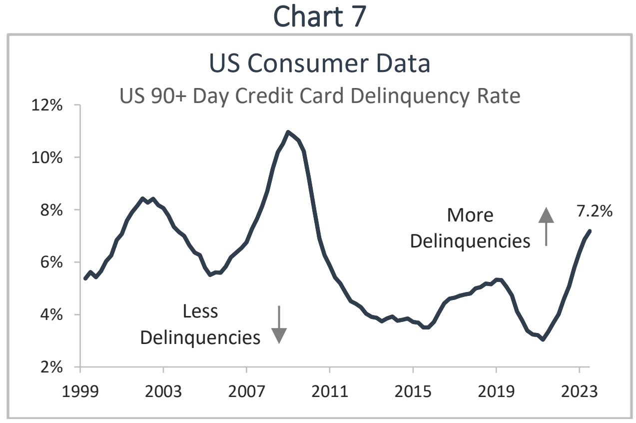
Chart 6



Source: Bloomberg; Arcus Capital Partners; CPI or Consumer Price Index.

Credit card delinquencies are rising rapidly and hit the highest level since the GFC (Chart 7). This figure is especially concerning due to the supposed strength of the economy, recent stimulus measures (e.g. student loan forgiveness), and the number of open jobs. Most of the weakness is within the lowest age cohort (18-29), but more seasoned borrowers (30-39) have also started falling behind.[1]

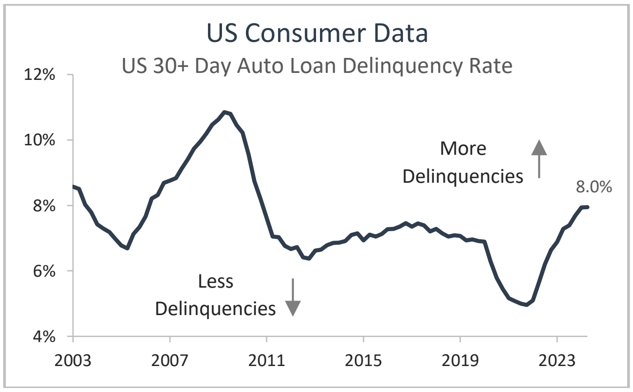
Chart 7



Source: Bloomberg; Arcus Capital Partners

Other metrics support the credit card data, including auto loan delinquencies (Chart 8). Like credit cards, borrowers younger than 39 are showing the most stress. It is also worth noting that the post-covid underwriting standards were far looser than today, and many borrowers purchased autos at record-high prices due to supply chain issues. Even so, these figures are concerning.

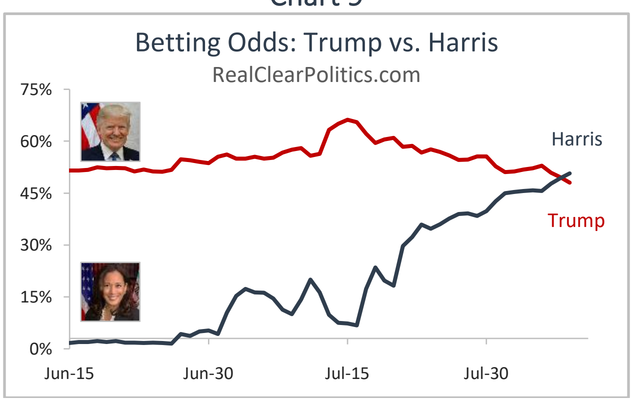
Chart 8



Source: Bloomberg; Arcus Capital Partners

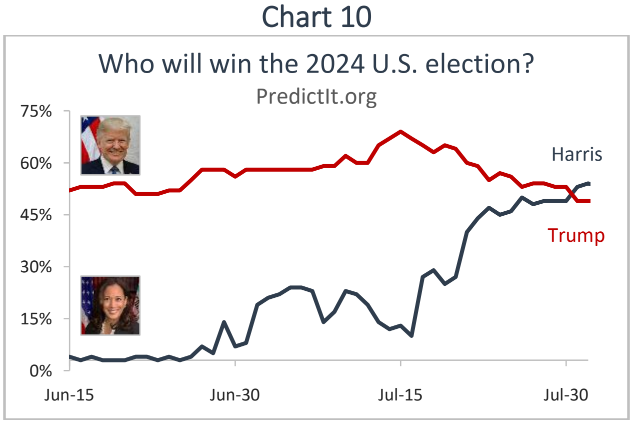
Moving away from the economy, we have entered the heart of the 2024 election cycle, and the fireworks have started. Currently, the betting odds and polls have VP Harris leading former president Trump by a slight margin (Charts 9-10). However, these measures are notoriously volatile and have a wide margin of error. Next quarter, we will dig into each candidate's proposed economic policies.

Chart 9



Source: RealClearPolitics; Bloomberg; Arcus Capital Partners

Chart 10

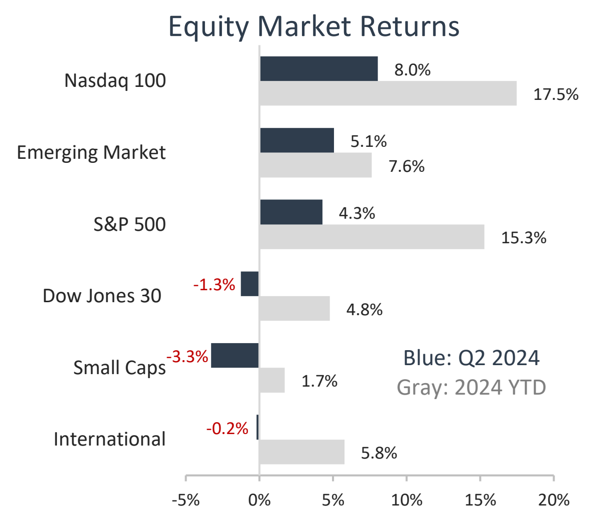


Source: PredictIt; Bloomberg; Arcus Capital Partners

For the first time in several quarters, the macro backdrop has started showing cracks in the façade. The labor market has normalized to pre-covid levels but may be weaker than expected. At the same time, the US consumer appears to be tapped out and is falling behind on their debt obligations. The Fed will likely cut rates this year, which should provide some relief; however, executing the mythical soft landing is nearly impossible and it may be too late. The back half of the year is sure to see a pick-up in volatility and will require investors to be very attentive as many potential potholes are quickly approaching.

II. Global Equities

Global equities continued their march higher, and several indexes made fresh all-time highs. Volatility remained low, and investors experienced minimal movement toward the downside.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q2 24; gray = 2024 YTD.

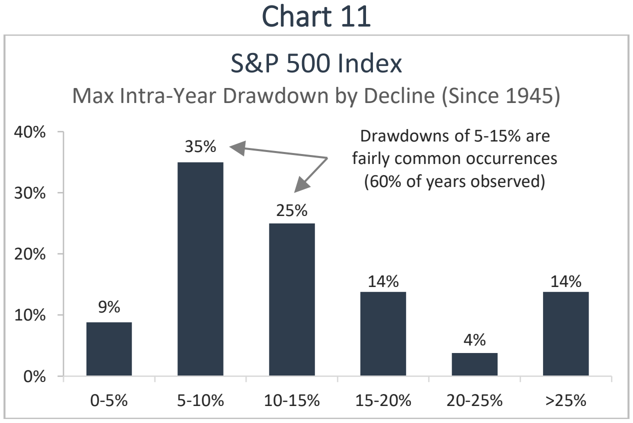
The second quarter returned to the 2023 playbook as growth-oriented large-cap sectors outpaced everything else. Technology (e.g. NVIDIA) and communications (e.g. Google) stocks rallied and drove the broad market higher. The strong performance of the biggest companies once again pushed the concentration of the S&P 500's Top-10 weightings to new highs. High concentration is not a reason to get bearish, but it is worth watching.

The S&P 500 finished up **4.3%** for the quarter – here are some interesting performance stats[2,3]:

- Top 7 index weightings (e.g. MSFT): **+14.9%**
- Remaining 493 names: **-0.7%**
- Best Sector: Technology **+13.8%**
- Worst Sector: Materials **-4.5%**
- Best stock: NVIDIA (NVDA) **+37%**
- Worst stock: Walgreens (WBA) **-43%**
- Days the market ended up over 2%: **0 days**
- Days the market ended down over 2%: **0 days**

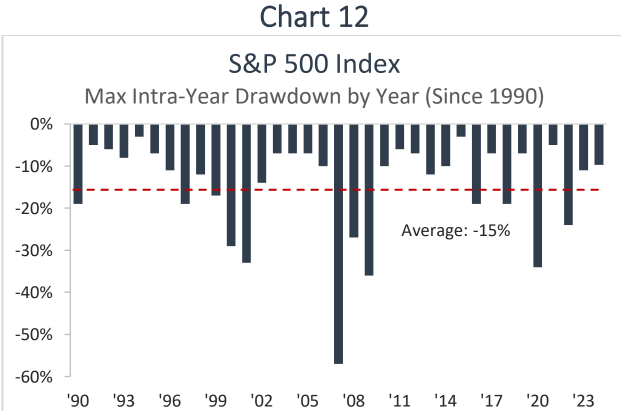
Volatility remained subdued during the quarter as the market went another three months without a 2% advance/decline. Furthermore, as of the end of July, the S&P 500 hadn't closed down by 2%+ since early 2023, a rare feat (note: this streak was broken in early August).[4] Historically, the market has declined by at least 15% in roughly 70% of years since 1945 (Chart 11). That is also the average peak-to-trough drawdown since 1990 (Chart 12).

Chart 11



Source: Strategas; Arcus Capital Partners

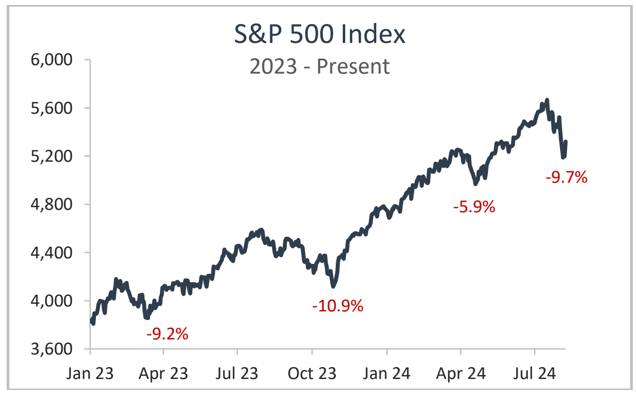
Chart 12



Source: Strategas; Arcus Capital Partners

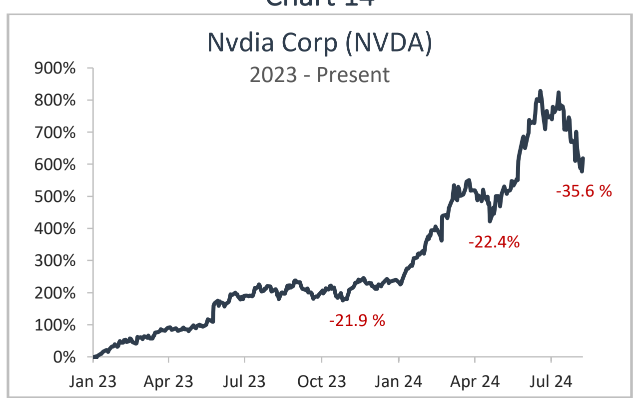
Conversely, the historical data points also show that equities typically continue rising after posting solid first-half performance, which is the case this year.[5] This suggests that although the period of compressed volatility could finally end during the coming quarters, market participants may consider buying into weakness, which could continue to pay off for investors. As of early August, the market and many bellwether stocks had declined off their recent all-time highs (Charts 13-14).

Chart 13



Source: Bloomberg; Arcus Capital Partners

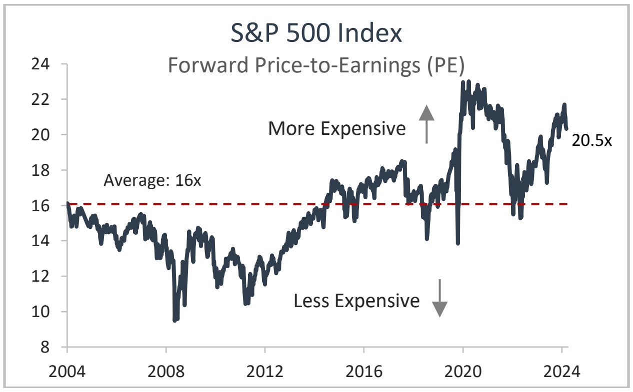
Chart 14



Source: Bloomberg; Arcus Capital Partners

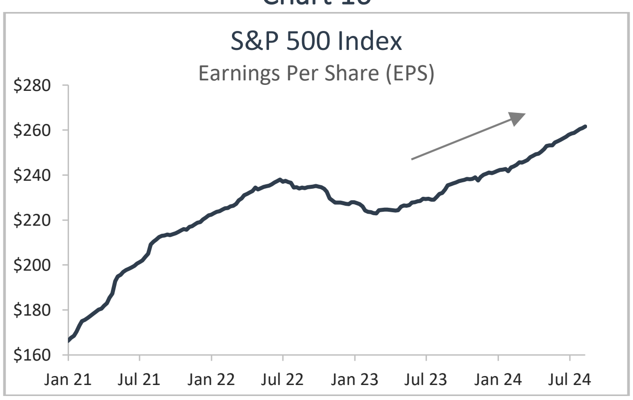
Shifting to the fundamental backdrop, the S&P 500 is expensive and trades at the upper end of its historical valuation range (Chart 15). The current P/E ratio (i.e. price-to-earnings ratio) of 20.5x next year's earnings is a demanding multiple; however, valuations are not an accurate timing tool over the short-term and can stay elevated for extended periods. Although not our forecast, a reversion back to the 20-year average P/E of 16x would require a ~20% market decline. However, analysts expect earnings to continue growing over the coming quarters, and so far this earnings season, most companies have been beating expectations (Chart 16). Additionally, falling interest rates should act as a tailwind to help support the elevated multiple.

Chart 15



Source: Bloomberg; Arcus Capital Partners. The data shown represents forward PE based on EPS estimates over the next twelve months.

Chart 16

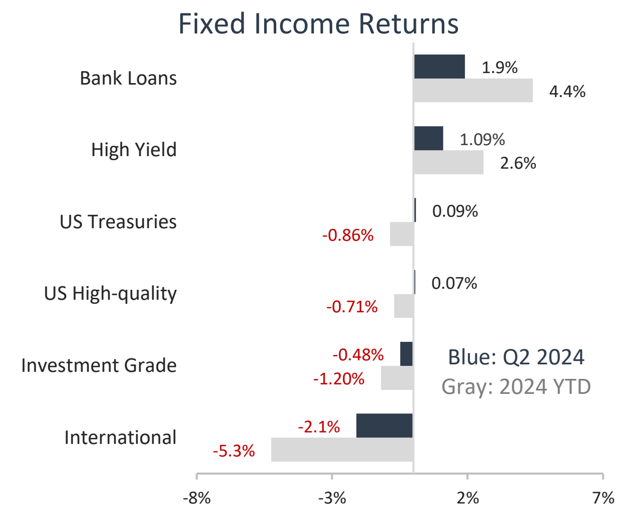


Source: Bloomberg; Arcus Capital Partners. The data shown represents forward EPS estimates over the next twelve months.

The setup for equities remains attractive, but we expect an uptick in volatility as we approach the election and seminal Fed meetings. We maintain a positive long-term outlook for US equities and would continue to add exposure on meaningful dips. Secular growth stories (e.g. A.I.) remain attractive, as do dividend-paying stocks that tend to outperform during market declines. Non-US developed and emerging market stocks continue to lag behind their US counterparts and could struggle further if the US economy slows from here.

III. Fixed Income

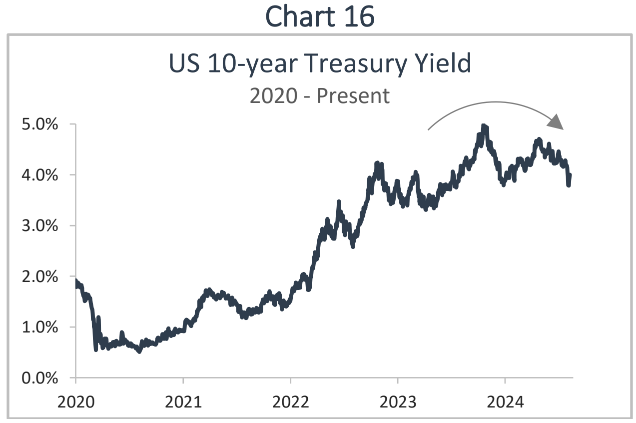
During the quarter, the US 2-year treasury yield ended slightly higher at **4.62%**, while the 10-year yield finished at **4.40%**.[6] This higher interest rate environment left rate-sensitive bonds under pressure but had little impact on credit.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q2 24; gray = 2024 YTD.

A string of firmer data releases and hotter inflation prints pushed interest rates back toward the 2023 highs during the first six months of the year, only to see rates retrace the entire move after the second quarter ended (Chart 16). As previously noted, recent weak employment data releases and other cooling growth measures quickly forced the market to rethink its current economic view.

Chart 16

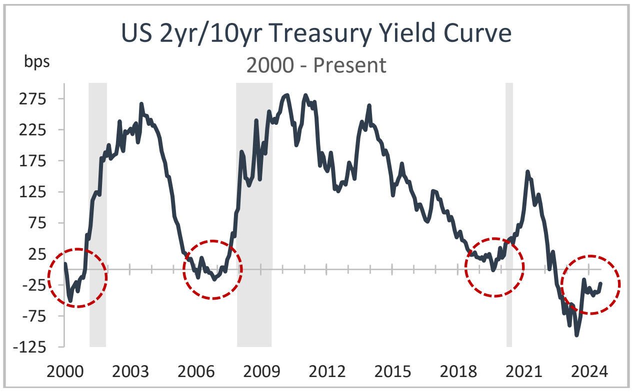


Source: Bloomberg; Arcus Capital Partners

Another warning sign has come from the steepening of the yield curve (US 2-year minus 10-

year yield). The curve has been negative (i.e. shorter-term rates higher than long-term rates) since mid-2022 and has predicted several past recessions (Chart 17). We are closely watching to see if and when the curve turns positive, as recessions have typically followed.

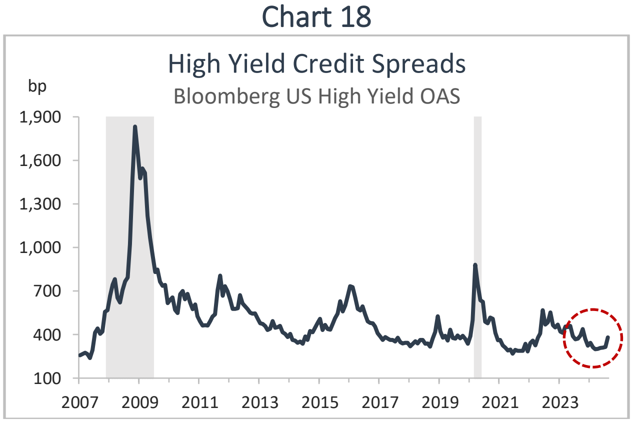
Chart 17



Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

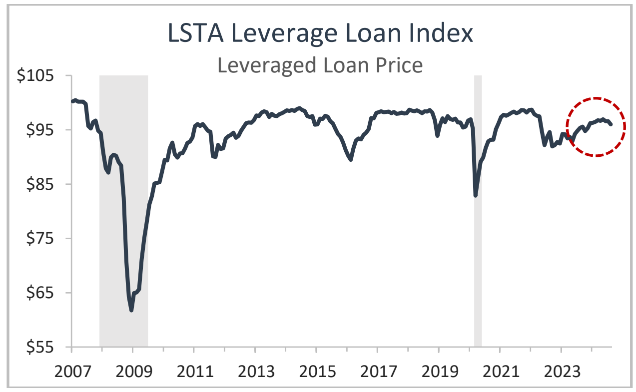
Credit spreads, a way to measure the health of the fixed-rate corporate bond market, remain well below recessionary levels – indicating limited stress for borrowers (Chart 18). Leveraged loan prices, representing floating-rate borrowers, also reside above levels that have historically hinted at borrower stress (Chart 19). The private credit markets are also in good shape and offer attractive yields versus the public market. Potential headwinds include a sharp increase in rates above the recent highs, a softening economic backdrop, or a further uptick in default rates.

Chart 18



Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

Chart 19

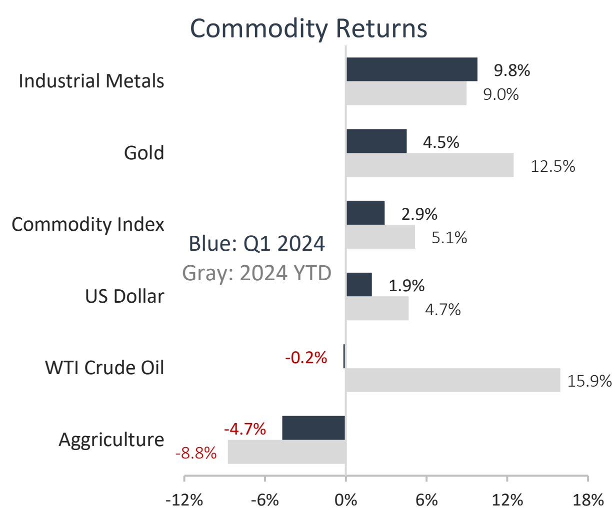


Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

We believe the Fed has concluded its tightening cycle and will likely begin cutting short-term interest rates in September. We see value in high-quality bonds (e.g. Treasuries) but would wait until longer-term interest rates (e.g. 10-year) stabilize at higher levels before buying. We are neutral on publicly traded credit (e.g. high yield), as current yields and spreads leave little room for error. Finally, we maintain a favorable view of the private credit market (e.g. middle market lending) due to its higher yields and less volatile return profile.

V. Commodities

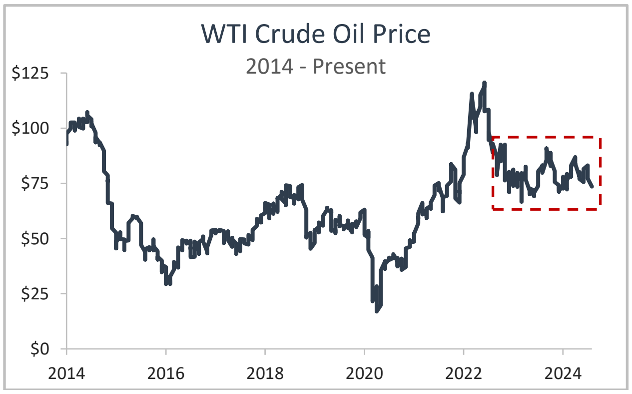
The commodity complex ended the quarter higher and was led by industrial metals and gold, even as the US dollar strengthened.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q2 24; gray = 2024 YTD.

Crude oil stayed in a tight range during Q2 and ended flat (Chart 20). The outlook remains mixed due to various factors. Geopolitical turmoil should support crude; however, the prospect of slowing global growth may weigh on prices. These crosscurrents suggest oil should continue trading in a range over the coming months.

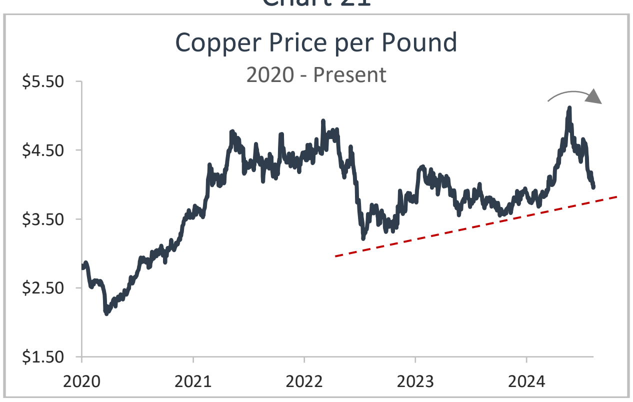
Chart 20



Source: Bloomberg; Arcus Capital Partners

Copper prices declined during the quarter and now reside at a critical crossroads (Chart 21). This industrial metal (i.e. Dr. Copper) is considered a gauge for global growth and appears to hint at a slowdown. A break of its multi-year uptrend line would damage the firming global growth narrative.

Chart 21



Source: Bloomberg; Arcus Capital Partners

Gold performed well during the quarter, making new all-time highs. Once again, the combination of central bank demand, unstable geopolitics, and the prospects of lower interest rates helped the yellow metal post a positive return. The current setup remains attractive, but a near-term consolidation might be necessary before the next rally can begin.

Due to the mixed economic outlook, we remain neutral on economically sensitive commodities (e.g. energy/industrial metals). The setup for gold is bullish but could provide investors with a better entry at a later date. Lastly, the US dollar is likely to weaken over the balance of the year.

IV. Looking Ahead

Our second-half outlook for equities is cautiously optimistic. Equities tend to perform well during re-election years, especially after posting solid first-half returns, as they have done this year. Nevertheless, historical data suggests that the current period of low volatility is long in the tooth and could end soon. Additionally, lofty valuations and weakening economic data could act as a headwind to higher prices. Investors should focus on quality companies trading at attractive valuations that can return capital to shareholders through dividends and buybacks.

Interest rates climbed back toward the 2023 cycle highs but quickly reversed lower. The Fed will likely start cutting rates at their September meeting, followed by quarter cuts. We like higher-quality bonds (e.g. Treasuries) but would wait for long-term rates to stabilize before buying. Lastly, we prefer the private credit market (e.g. middle-market lending), where yields are higher and less correlated to interest rates and the public markets.

Finally, cyclical commodities point to a potential slowdown, while gold could offer upside potential if interest rates decline or market volatility spikes.

As always, we are available to discuss these items and address any questions. Thank you for the trust you place in our firm.

Sincerely,

Arcus Capital Partners

Sources:
1. Federal Reserve
2. Bloomberg
3. Strategas Research
4. Bloomberg
5. Strategas Research
6. Bloomberg

Important Risk and Disclosure Information

This commentary is furnished for informational purposes only and is not investment advice, a solicitation, an offer to buy or sell, or a recommendation of any security to any person. Managers' opinions, beliefs and/or thoughts are as of the date given and are subject to change without notice. The information presented in this commentary was obtained from sources and data considered to be reliable, but its accuracy and completeness is not guaranteed. It should not be used as a primary basis for making investment decisions. Consider your own financial circumstances and goals carefully before investing. Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward looking statements are not indicators or guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification strategies do not ensure a profit and cannot protect against losses in a declining market. All indices are unmanaged, and investors cannot invest directly into an index. You should not assume that an investment in the securities or investment strategies identified was or will be profitable.