ARCUS CAPITAL PARTNERS

Q3 | 2024 Market Commentary

Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great year. During the quarter, the Federal Reserve (Fed) embarked on the start of its first interest rate-cutting cycle since the depths of the pandemic. Additionally, resilient economic growth, strong corporate earnings, and bullish investor sentiment sent equities to new all-time highs. Interest rates finally took note of the improving inflationary data and declined across the yield curve. Lastly, commodities returns varied within the index as gold prices soared and crude oil prices fell. We maintain a positive view of equities but expect higher volatility as we enter the heart of the election season. Within fixed income, we still prefer private credit to public markets and expect interest rates to drift higher over the near term. Finally, we suggest investors keep a long-term perspective and focus on adding to positions on material weakness.

I. Market & Economic Overview

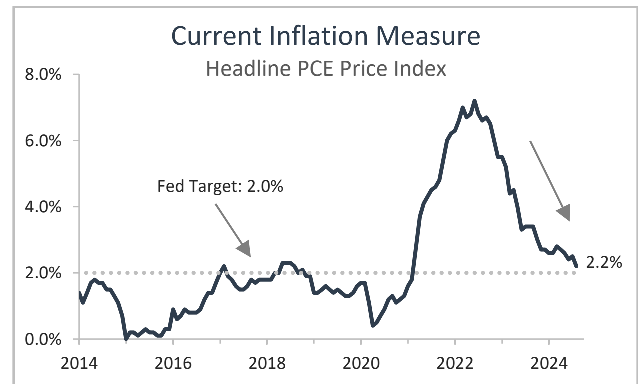
The third quarter underwent a flurry of market-moving headlines ranging from Vice President Harris replacing President Biden on the 2024 Democratic ticket to the Federal Reserve cutting interest rates for the first time since 2020 (Chart 1). Equity markets ignored the noise and continued marching higher, with several indexes registering new all-time highs. The primary catalyst was the prospect of imminent Federal Reserve interest rate cuts, which eventually came at the September meeting with a 50 basis point (100 basis points = 1.0 %) reduction. The decision to cut rested on the Fed's view that inflation was no longer a threat and the labor market had cooled. Specifically, the Fed's preferred inflation measure is back near its 2% target and should continue declining (Chart 2). Also, the labor market has normalized to pre-covid levels as labor supply has gradually increased and job openings have decreased (Charts 3).

Chart 1

Fed Goes Big to Protect the Labor Market
Bloomberg L.P. |
The Federal Reserve lowered its benchmark interest rate by a half percentage point on Wednesday, an aggressive start to a policy shift aimed at bolstering the US labor market. Projections released following their two-day meeting showed a narrow majority,

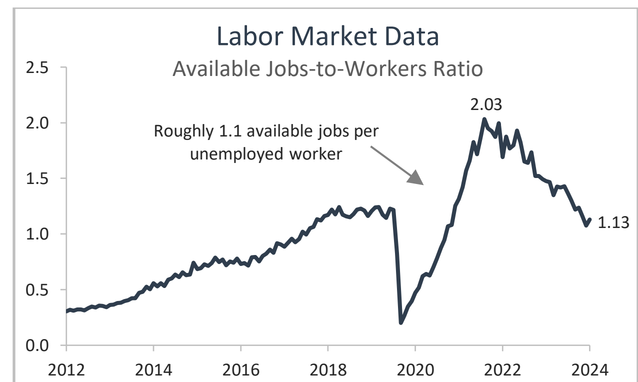
Source: Bloomberg

Chart 2



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

Chart 3

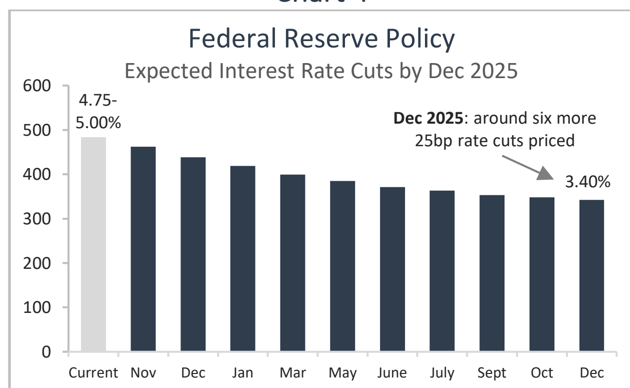


Source: Bloomberg; Arcus Capital Partners; data shown is the ratio of US JOLTs Job Openings and total unemployed workers.

From here, the total number of future 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). The market is currently pricing around six more 25 basis point cuts over the next year or so (Chart 4). This path may be too aggressive if domestic economic data remains resilient over the coming quarters, but regardless, more interest rate cuts are coming.

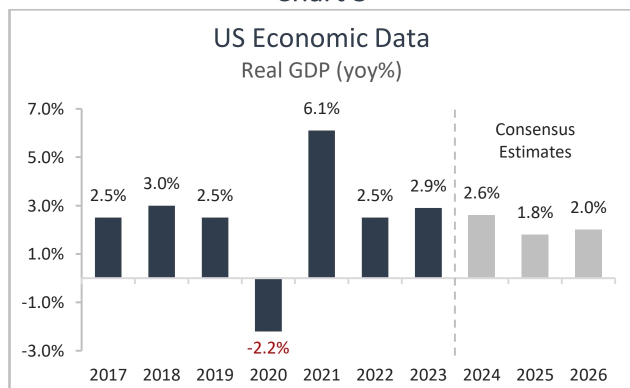
Chart 4



Source: Bloomberg; Arcus Capital Partners

The US economy continues to hum along at a steady pace, and experts forecast this trend will continue over the foreseeable future (Chart 5). The tailwind of rate cuts, continued fiscal spending, and falling inflation should support an already firming economic backdrop. That said, several parts of the economy show signs of fatigue and require close monitoring.

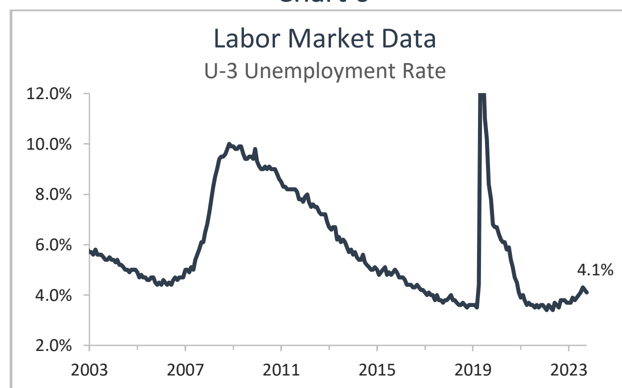
Chart 5



Source: Bloomberg; Arcus Capital Partners

Recent reports have shown signs of weakness in the labor market, with the unemployment rate sitting at **4.1%**, near the highest level in several years (Chart 6). However, the spike in illegal immigrants over the past 24 months has flooded the labor pool and may be skewing the data. It is still too soon to make any conclusions, but it is clear the labor market has cooled, and the current situation requires closer scrutiny over the coming months. For now, companies have slowed their hiring but are not yet firing employees, which is a positive sign for the economy.

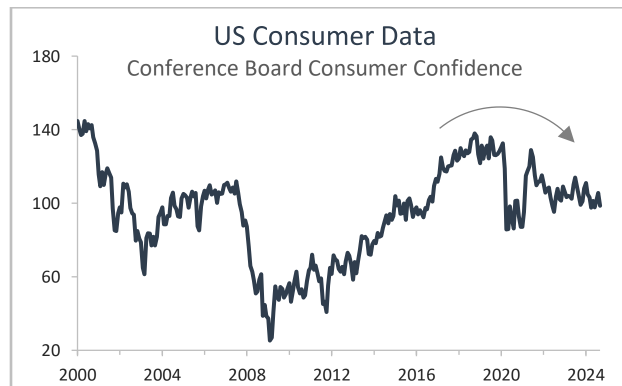
Chart 6



Source: Bloomberg; Arcus Capital Partners

The US consumer is another cohort showing signs of stress, and many consumer-based metrics are beginning to deteriorate (Chart 7). As mentioned last quarter, CEOs across many industries have noted a slowdown in spending, delayed purchases, and a preference for lower-cost items. Also, credit card and auto loan delinquencies continue to rise and leak into traditionally more seasoned borrowers.[1] Depleted savings, record borrowing costs, and persistently higher prices have likely all played a part in the waning confidence and increase in past-due bills. With consumption making up nearly two-thirds of domestic GDP, this is another area we are watching closely.

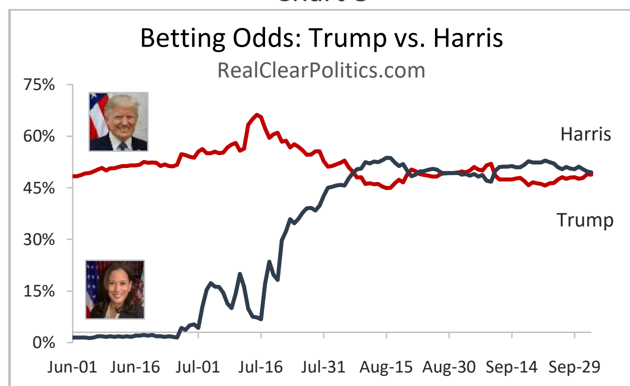
Chart 7



Source: Bloomberg; Arcus Capital Partners

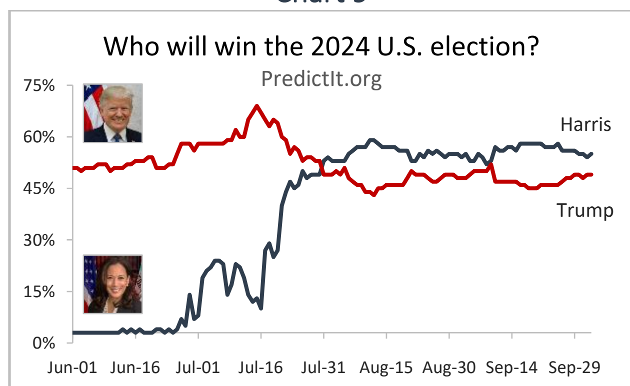
Moving to the 2024 election, we are now in the heart of the cycle, and pundits are expecting a very close race. As of early October, the betting odds and polls show that VP Harris is leading former president Trump by a slight margin (Charts 8-9). However, these measures are notoriously volatile and have a wide margin of error.

Chart 8



Source: RealClearPolitics; Bloomberg; Arcus Capital Partners

Chart 9



Source: PredictIt; Bloomberg; Arcus Capital Partners

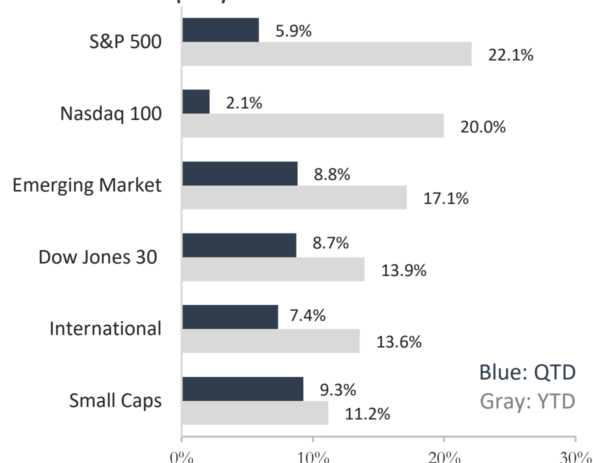
As far as the market is concerned, there tends to be an uptick in volatility in the month leading up to the election, followed by a relief rally. Interestingly, the S&P 500 has correctly predicted 20 of the last 24 election results – if the market is higher in the three months leading up to the election, the incumbent has won.[2] Although it is difficult to summarize the market impact of either candidate's proposed policy, it appears that continued fiscal spending from both candidates should support economic growth and the stock market. Unfortunately, neither candidate has provided a definitive outline of their agenda, but Trump is seen by most as the more market-friendly choice.

The third quarter gave investors a full dose of geopolitical events and headlines, and small cracks continued forming in the macro backdrop. Nevertheless, the markets shrugged it off, and the Federal Reserve responded quickly and cut short-term interest rates to avoid getting behind the curve. We anticipate the Fed will cut by at least 25 basis points over their next two meetings and continue doing so throughout 2025. The election will likely cause an uptick in near-term volatility, but neither candidate's policies pose an immediate threat to the market. The next three months will require investors to be attentive and patient but should lead to higher prices into next year.

II. Global Equities

Global equities continued rallying during the quarter, and several indexes made fresh all-time highs. The S&P 500 finished up **5.89%** – here are some interesting performance stats[3,4]:

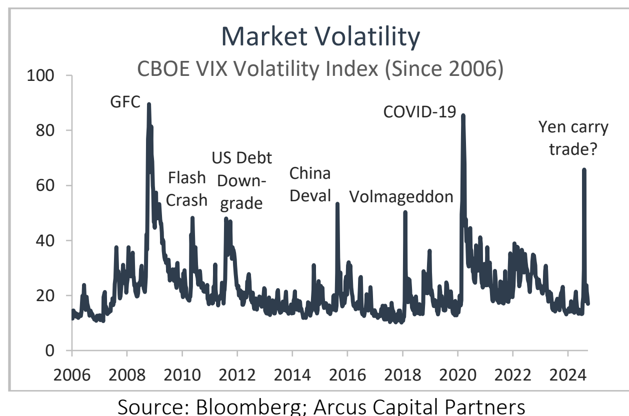
- Best Sector: Consumer Discretionary **+7.02%**
- Worst Sector: Energy **-2.79%**
- Best stock: GE Vernova (GEV) **+49%**
- Worst stock: Super Micro Computer (SMCI) **-49%**
- New all-time highs made this year: **43**
- Positive months this year: **8 out of 9**
- YTD return through September: **9th best since 1928**



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

Global equities pressed higher during the third quarter but forced investors to endure a pickup in volatility. In early August, the VIX Volatility Index made its largest intraday move on record and spiked to levels not seen since the pandemic or Great Financial Crisis (Chart 10).[5] It is unclear what the catalyst was for the spike, but it appears a weaker US unemployment number sparked a massive rotation out of US stocks by Japanese investors and created a vicious feedback loop.

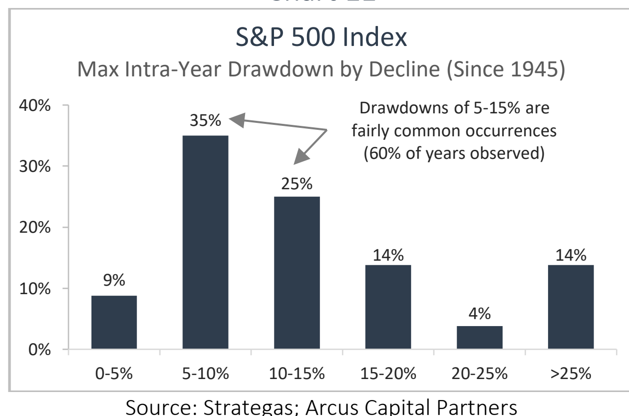
Chart 10



Source: Bloomberg; Arcus Capital Partners

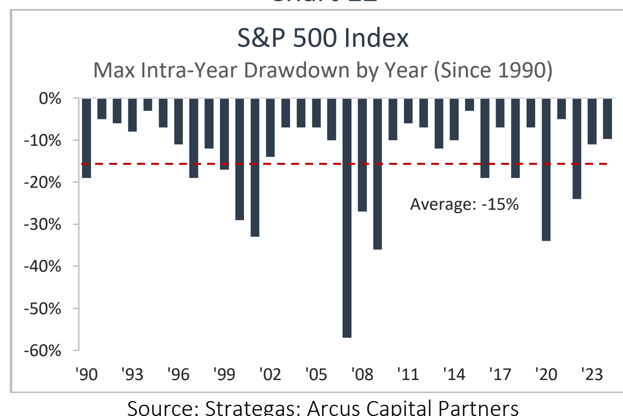
Until the early-August decline, the S&P 500 had not closed down by more than 2%+ since early 2023.[6] However, even though volatility spiked to extreme levels, the market only declined by around 10%, which has historically been commonplace (Chart 11). In fact, the market typically declines each year by an average of 15% – drawdowns are even smaller declines during non-recessionary periods (Chart 12). This year has been no different as the market quickly recovered from its decline and went on to make fresh all-time highs.

Chart 11



Source: Strategas; Arcus Capital Partners

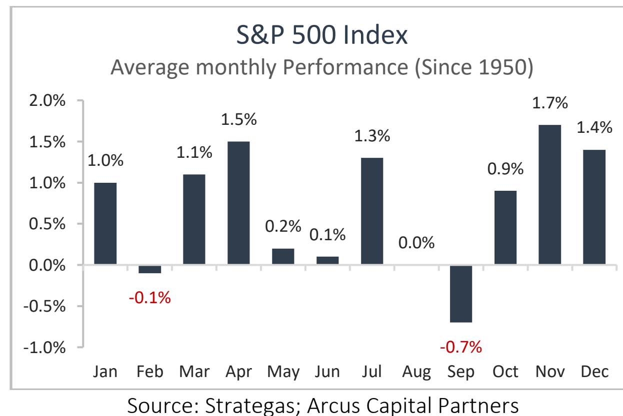
Chart 12



Source: Strategas; Arcus Capital Partners

Although equities saw an uptick in volatility during August, the market bucked the historical trend of weakness in September, when it finished up for its fifth month in a row. This degree of positive price momentum has historically led to higher prices over the next six and twelve months.[7] It also comes at the start of the fourth quarter, which tends to be a favorable period for stocks (Chart 13). Lastly, as previously noted, the equity market tends to decline in the month leading up to the election and then rally once the uncertainty has passed.

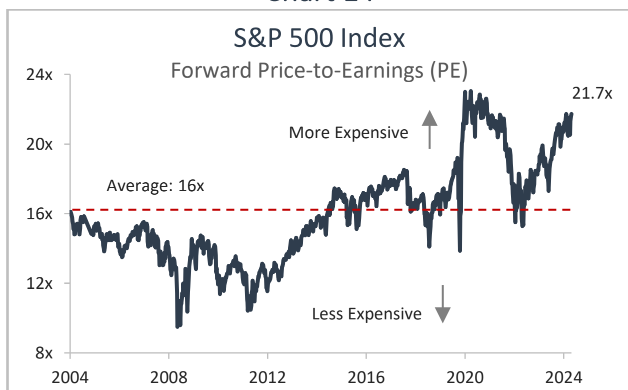
Chart 13



Source: Strategas; Arcus Capital Partners

One headwind many market participants point to is the elevated level of valuations. Currently, the market trades at a price-to-earnings ratio (PE) of 22x compared to the 20-year average of 16x (Chart 14). It is worth noting that the average stock within the index trades at a relatively lower valuation – the S&P 500 has a high concentration of growth stocks (e.g. NVIDIA) with higher multiples due to their positive growth prospects.

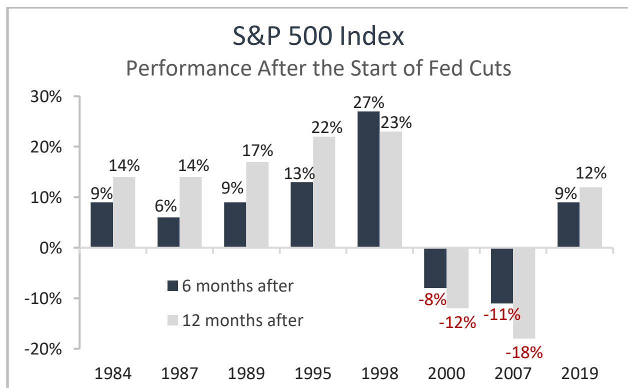
Chart 14



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

Shifting back to the Federal Reserve's decision to cut interest rates and its impact on the market, equities have typically rallied after the start of a cutting cycle as long as the economy did not go into recession (Chart 15). The domestic economic backdrop remains intact, so the Fed's recent monetary policy decision should be considered normalization (i.e. non-recessionary) rather than emergency relief (i.e. recessionary). The prospect of lower borrowing costs and falling inflation should continue to support earnings growth.

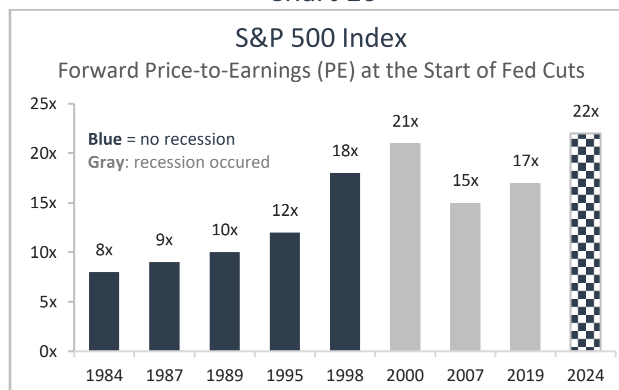
Chart 15



Source: J.P. Morgan; Arcus Capital Partners

One potential roadblock to this outlook is, once again, the rich valuation level at which the market is trading right now. Going back to 1984, the S&P 500's current PE ratio is the highest it has been at the start of any cutting cycle (Chart 16). This data point is not necessarily bearish, but it warrants some caution and may limit the market's upside potential relative to past cycles.

Chart 16



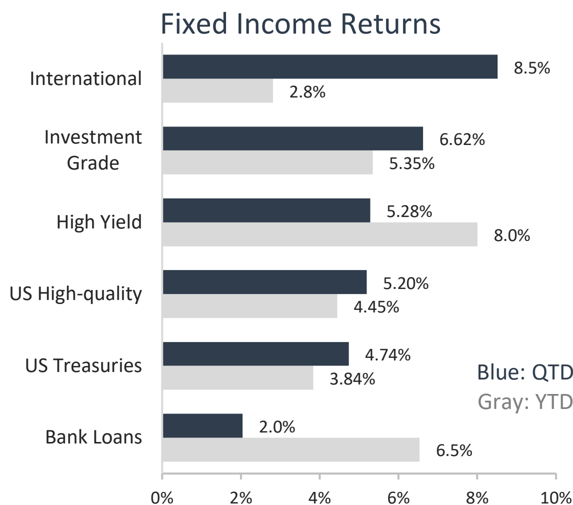
Source: Goldman Sachs; Arcus Capital Partners

We believe the setup for equities is attractive, but we firmly expect continued volatility until the election passes. Lower interest rates, falling inflation, and continued economic growth should support corporate earnings growth. We continue to favor domestic shares due to their higher-quality characteristics and growth potential. Specifically, we like large-cap companies that can buy back shares or return cash to shareholders in the form of dividends. Furthermore, small and mid-cap companies have tended to benefit from rate cuts. Non-US developed and emerging market stocks continue to lag behind their US counterparts, but recent stimulus measures from China and potentially troughing Euro-area growth could help them close the gap.

III. Fixed Income

During the quarter, several benign inflation prints, a cooling labor market, and dovish Fed policy sent interest rates lower and boosted bond prices. The US 2-year treasury yield finished nearly a percent lower and closed at **3.64%**, while the 10-year yield dropped to **3.75%** – here are some interesting comparative stats from the quarter[8]:

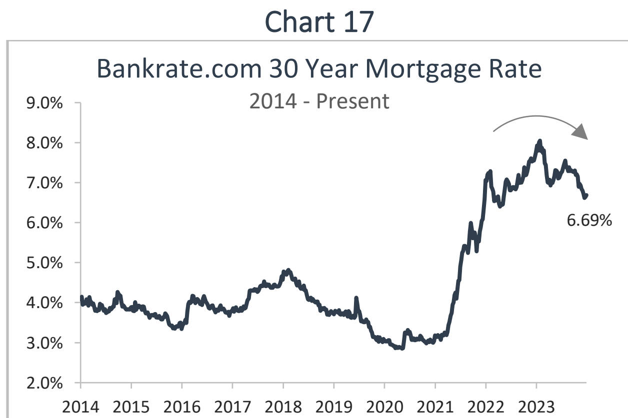
- Fed Balance Sheet Assets (today): **$7.08T**
- Fed Balance Sheet Assets (2022 peak): **$8.97T**
- High Yield Money Market Rate (today): **4.80%**
- High Yield Money Market Rate (2020): **0.01%**
- 30-year Mortgage Rate (today): **6.69%**
- 30-year Mortgage Rate (2020): **3.08%**



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

Over the last year, softer inflation readings, weaker employment numbers, and the prospect of the looming Fed cutting cycle helped drive yields lower from multi-decade highs around 5.0%. During that period, reference rates such as the 30-year fixed rate mortgage dropped markedly (Chart 17).

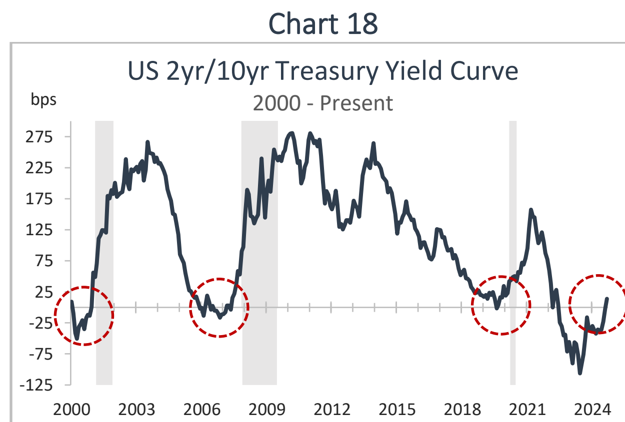
Chart 17



Source: Bloomberg; Arcus Capital Partners

Although interest rates declined across the various points on the yield curve (e.g. 1-month to 30-year), not every tenor has decreased by the same amount. For instance, the 2-year yield has fallen more than the 10-year yield, which has resulted in the yield curve (US 2-year minus 10-year yield) uninverting (Chart 18). The curve has been inverted (i.e. shorter-term rates higher than long-term rates) since mid-2022, and several previous un-inversions have preceded recessions. That said, the current economic backdrop is not recessionary.

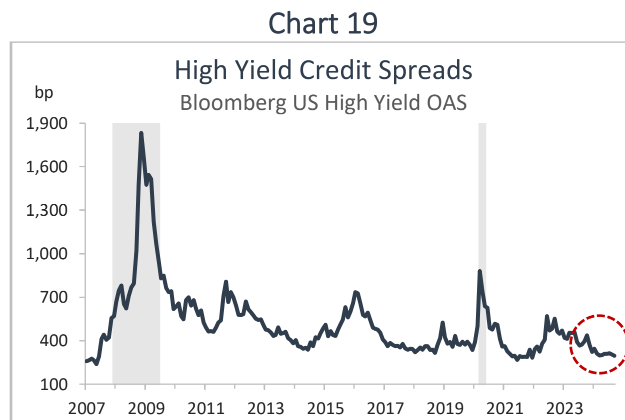
Chart 18



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

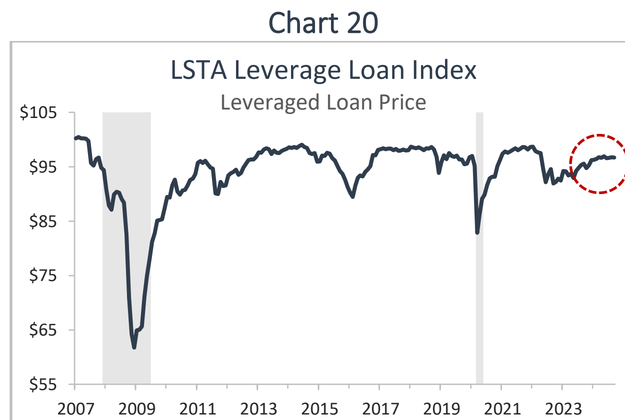
Credit spreads (a barometer for the fixed-rate corporate bond market) remain well below recessionary levels (Chart 19). Leveraged loan prices, representing floating-rate borrowers, are also healthy and trade above levels that have historically hinted at borrower stress (Chart 20).

Chart 19



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

Chart 20



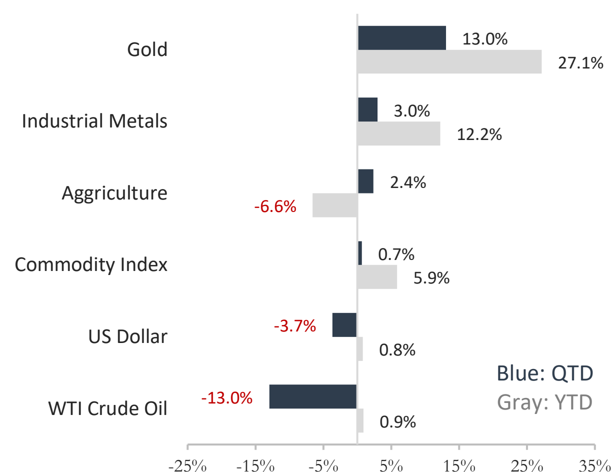
Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

We believe the Fed will cut by at least 25 basis points over their next two meetings and continue doing so throughout 2025. This does not mean that interest rates across the curve will fall in unison, and we expect increased rate volatility over the near term. 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 due to its higher yields and less volatile return profile.

V. Commodities

The commodity complex ended the quarter slightly positive but saw continued strength under the surface within the precious metals – here are some interesting comparative stats from the quarter[9]:

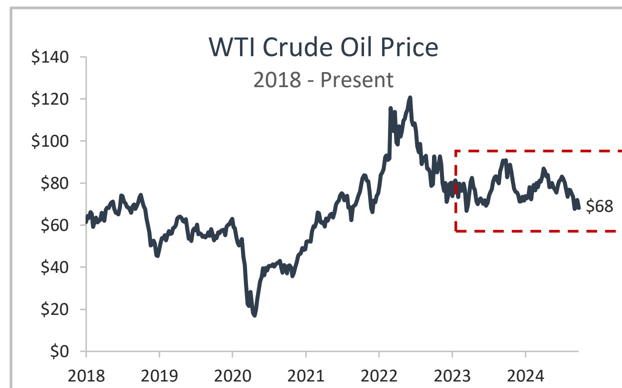
- National Average Gas Price (today): **$3.20/gallon**
- National Average Gas Price (2020): **$2.19/gallon**
- Gold Price (today): **$2,635/ounce**
- Gold Price (2020): **$1,886/ounce**
- Egg Prices (today): **$3.20/dozen**
- Egg Prices (2020): **$1.35/dozen**



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

Crude oil declined during the quarter and remained within the large trading range dating back to late 2022 (Chart 21). The outlook remains uncertain and is being driven by a mix of geopolitical and economic factors. On one hand, geopolitical turmoil should support higher crude prices; however, the prospect of slowing global growth and increased supply from the Middle East could weigh on prices. These crosscurrents suggest crude oil should continue trading in a range over the coming quarters.

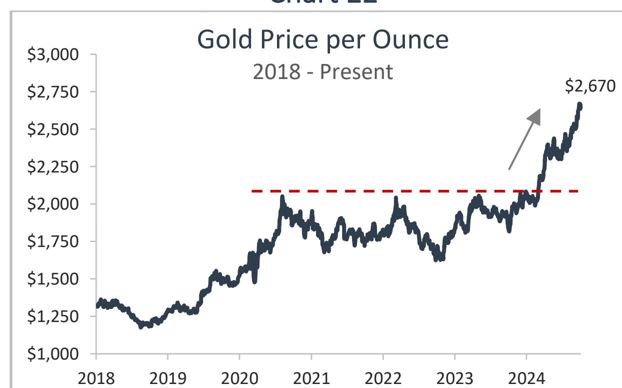
Chart 21



Source: Bloomberg; Arcus Capital Partners

Gold rallied double-digits during the quarter and made fresh all-time highs (Chart 22). Continued central bank demand, unstable geopolitics, and the prospects of lower interest rates helped support the yellow metal. The current setup remains attractive, but a near-term consolidation might be necessary before the next rally can begin.

Chart 22



Source: Bloomberg; Arcus Capital Partners

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 will likely weaken over time as the Federal Reserve cuts interest rates.

IV. Looking Ahead

For the balance of 2024, we remain optimistic and think that equities can continue to perform well. The combination of Fed rate cuts, falling input costs, and positive seasonality should act as tailwinds. Equities tend to perform well during election years, especially after posting solid returns over the first three quarters. That said, October has the potential to test investor resolve as the elections draw closer. Investors should use any potential weakness to add to positions. We favor domestic companies trading at attractive valuations that can return capital to shareholders through dividends and buybacks. We also like small and mid-cap stocks as they tend to benefit from Fed cutting cycles.

Longer-term interest rates have likely troughed for the near term and could move higher over the next few months; however, falling inflation, investor demand, and Fed rate cuts may cause them to make new lows nest year. The Fed should continue cutting short-term rates at their November and December meetings and well into 2025. We like higher-quality bonds (e.g. Treasuries) but would wait for longer-term rates to retrace higher before adding to positions. 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 such as crude oil point to waning global demand, while gold could offer upside potential if interest rates decline further or equity 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. Strategas Research
3. Strategas Research
4. Goldman Sachs
5. Bloomberg
6. Bloomberg
7. Carson Wealth
8. Bloomberg
9. 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.