

Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great start to the year. The beginning of 2019 turned out to be starkly different from the end of 2018. After dropping into bear market territory in late-2018, global equities rebounded sharply on the back of improved sentiment. Interest rates stayed near their recent lows as global growth remained sluggish and many central banks reversed prior plans for tighter monetary policy. Lastly, commodities rallied on the belief that a US-China trade deal would materialize and lead to firmer economic conditions in 2019. Overall, the first quarter did not disappoint and helped mend much of the damage inflicted last year.

### I. Market & Economic Overview

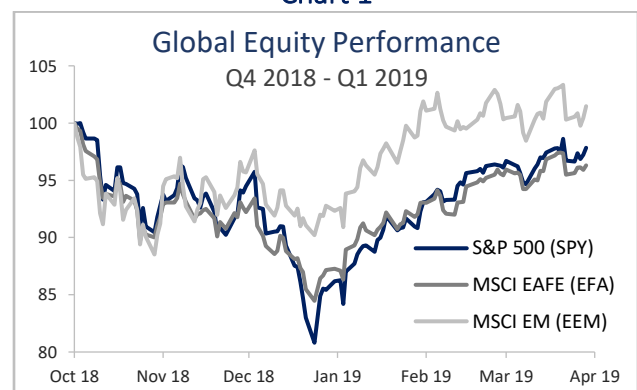
At the end of 2018, investors were extremely worried due to a growing list of issues plaguing the markets. Federal Reserve policy was determined to be too restrictive; the US-China trade negotiations seemed hopelessly deadlocked; global economic data was weakening; and corporate earnings growth was slowing. However, just as it appeared that the end was near, buyers stepped-in and global equities rallied in a V-shaped fashion (Chart 1).

What led to the reversal in sentiment? In our opinion, it was a combination of two major catalysts: a dovish (i.e. less restrictive policy) pivot by the Federal Reserve (Fed) and progress on the US-China trade front. The policy shift by the Fed was a complete reversal from their prior stance which was reaffirmed as recently as December. At that point, they were projecting two interest rate hikes in 2019 and one more the following year – as of now, they don’t anticipate hiking again until the end of 2020.<sup>1</sup> They also updated their plans for the pace of the balance sheet reduction (i.e. assets accumulated through the quantitative easing programs). In December, Fed Chairman Jerome

Powell dismissed the idea that the Fed would slow the pace of the balance sheet runoff to offset weaker data. In fact, he was quoted as saying the program was on “autopilot” – as of the March meeting, it was decided that the balance sheet reduction would end later this year.<sup>2</sup> On balance, the Fed appears to have succumbed to the market weakness and slowing data. Based on the updated Federal Reserve forecasts, we anticipate no rate hikes in 2019.

In addition to the Fed policy reversal, trade talks between the US and China showed material progress during the quarter. President Trump’s newfound desire for resolution was likely influenced by the damage the trade war was having on stocks and the economy. Nevertheless, additional strength from these areas could actually derail the process. It is worth remembering that the President’s negotiating strategy tends to become less amicable when the data/markets are turning in his favor. As of now, expectations are for a formal agreement to be in place sometime during the second quarter – we think this is a realistic outlook.

Chart 1



Source: FactSet; Arcus Capital Partners; returns indexed to 100 at start date and include the reinvestment of dividends; ETF equivalents used for indexes.

As stocks rebounded in early-2019, investors quickly realized that the Q4 decline was sentiment

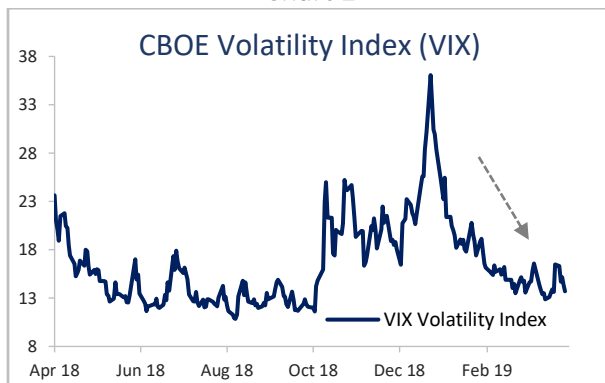


driven and not the beginning of an economic slowdown or earnings recession. With that being said, it is worth noting that economic data remains anemic and needs to improve for the rally to continue. For now, green shoots are starting to appear and could be signaling that the worst is behind us. Last quarter we noted that the global economy and financial markets were facing a crossroads: either climb the wall of worry or prepare for a recessionary period. **We continue to believe the former is more likely to occur and do not see a recession on the horizon.**

## II. US Equities

During the quarter, the current bull market achieved its 10<sup>th</sup> anniversary and is now the longest on record dating back to 1877.<sup>3</sup> What is more impressive is that during this cycle, the S&P 500 never officially closed below the -20% level associated with bear markets; this includes the declines experienced during 2011, 2016, and 2018. Furthermore, US equities handily outperformed their international counterparts. If history is a guide to the future, the next 10 years could prove to be favorable for non-US stocks.

Chart 2



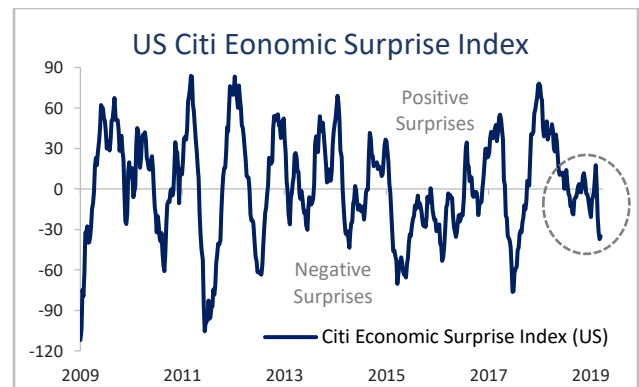
Source: FactSet; Arcus Capital Partners

More recently, US stocks pushed higher during the quarter and were able to recoup majority of the losses incurred in 2018. The bellwether S&P 500 Index finished up **13.65%**, and smaller capitalization stocks, as represented by the Russell 2000 Index, ended up **14.58%**.<sup>4</sup> Volatility declined as equities rallied, and the VIX Volatility Index (fear index) dropped towards 12-month lows after peaking in December (Chart 2).<sup>5</sup> Lastly, the

cyclically-oriented PHLX Semiconductor Index (SOX) led the markets higher and ended up **22.79%**.<sup>6</sup> According to J.P. Morgan, the semiconductor index is a reliable forward-looking indicator for global manufacturing data. Based on this relationship and the recent positive performance from semiconductor stocks, global manufacturing data could begin improving in Q2.

Outside of the stock markets, domestic economic data has continued to disappoint expectations. The Citi Economic Surprise Index for the US resides in negative territory but could be close to turning higher (Chart 3). On a positive note, labor markets remain healthy and the unemployment rate is currently at 3.8%.<sup>7</sup> Overall, the economic picture is fairly balanced: consumer confidence is near cycle highs, small business optimism has moderated but remains elevated, the manufacturing and non-manufacturing indexes are in expansion mode, and the recent weakness in the housing market could be temporary.<sup>8</sup> Lastly, inflation appears contained and might soften in the coming quarters as it has after previous equity market drawdowns of ~20%.<sup>9</sup> **Based on this data, the odds of a recession occurring in the next 12 months remain low.**

Chart 3



Source: FactSet; Arcus Capital Partners

Compelling valuations were a big tailwind in Q1 as the forward price-to-earnings ratio (P/E) for the S&P 500 reached ~14x in December. Since then, earnings estimates have been revised lower as share prices have risen. This has caused the 12-month forward P/E for the S&P 500 to expand to around 16.5x which is in line with historical averages.<sup>10</sup> Assuming a US-China trade deal is reached, or

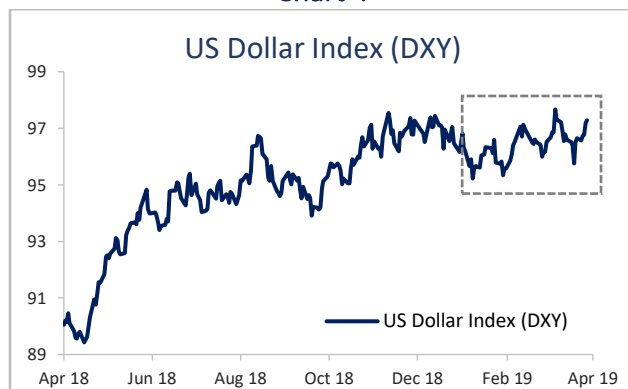


economic data improves, earnings results could surprise to the upside and support higher prices. Outside of earnings, other positive catalysts for equities include share buybacks, dividend increases, and institutional investors reentering stocks. Looking ahead, the outlook for the US is positive, albeit less so than it was in late-December. **Nevertheless, we remain bullish but will likely reduce exposure in the coming quarters.**

### III. International Equities

International equities rebounded alongside US shares as fears over a global recession gradually subsided. Developed International (MSCI EAFE) and Emerging Market (MSCI EM) equities ended Q1 higher by **10.34%** and **9.91%**, respectively.<sup>11</sup> The indexes performed well even as the US dollar index strengthened (Chart 4). As noted in past letters, international equities tend to outperform when the US dollar is falling (or weakening) due to the positive impact of currency translation.

Chart 4



Source: FactSet; Arcus Capital Partners

In addition to waning concern over a global slowdown, a number of the headwinds that drove foreign stocks lower in 2018 have slowly abated. Tensions linked to US trade policy have eased and fears over tighter monetary policy from the European Central Bank (ECB) quickly faded as it reversed course and followed the Federal Reserve's lead. All of these improvements paint a healthier backdrop for non-US markets. As a result, there are numerous reasons to be bullish. First, as discussed in our year-end note, overseas equity markets appeared to have overshot to the downside in Q4 and were pricing in an impending

global recession. At the time, our view was that the fundamental drivers did not support the price decline and that it was sentiment driven – we continue to hold this opinion and think any improvement in global economic data will lead to higher equity prices. Second, valuations continue to look attractive on a relative and absolute basis. The MSCI EM index is trading at a ~12x forward price-to-earnings multiple, and the MSCI EAFE index trading around a ~13.5x forward P/E.<sup>12</sup> Third, any US dollar weakness would be a huge boost to foreign stock prices – the dollar is a bit of a wildcard but looks biased to the downside from current levels. Finally, as previously noted, any formal resolution on the US-China trade front would act as immediate tailwind for global equities. **For these reasons we remain bullish; however, we will likely reduce exposure on any material strength from current levels.**

### IV. Fixed Income

Interest rates continued to receive attention during the quarter even as stocks reversed higher. Once it was known that the Fed was delaying its plan to raise short-term rates, US yields generally declined. The U.S. 2-yr and 10-yr treasury yields fell in Q1 and ended at **2.27%** and **2.42%**, respectively (Chart 5).<sup>13</sup> The Barclays Aggregate Bond Index and the tax-free Barclays Municipal Bond Index finished the quarter up **2.94%** and **2.90%**, respectively.<sup>14</sup>

Chart 5



Source: FactSet; Arcus Capital Partners

Towards the end of the quarter, the US Treasury yield curve (2-yr minus 10-yr yield) garnered interest as fears of an inversion returned (an inversion occurs when short-term rates move



higher than long-term rates). The 2s/10s yield curve continues to trade within a tight range just above the inversion line, and a number of other points on the curve have actually inverted. This is important because an inverted or negative yield curve has typically preceded most recessions. Statistically, the risk of a recession following an inverted yield curve is around 70%.<sup>15</sup> Overall, it appears that interest rates are currently pricing in looser policy from global central banks or weaker economic data in the coming quarters. We think it is the former and anticipate yields will rise alongside firmer data during the rest of 2019.

High yield bonds and leveraged loans were outperformers within the fixed income market during Q1. The Bank of America High Yield Index finished up **7.4%**, and the S&P/LSTA Leverage Loan Index ended up **4.0%**.<sup>16</sup> High yield bonds rallied as investors took advantage of elevated yields. Floating rate loans moved higher but saw continued fund withdrawals as allocators shifted their preference to fixed rate bonds.<sup>17</sup> This was likely predicated on expectations for fewer interest rate hikes in the coming quarters. **Looking ahead, we expect interest rates to stabilize and resume their upward trend, albeit at a slower pace. We think the yield curve (2s/10s) will steepen before inverting in late-2019 or early-2020. Lastly, we see higher yielding areas continuing to perform well over the coming quarters.**

## V. Commodities

Similar to other risk assets, commodities rallied during the quarter. At the group level, the Bloomberg Commodity Index finished up **6.32%**.<sup>18</sup> Crude oil led the way after a difficult 2018 and was the best performing commodity. The Organization of Petroleum Exporting Countries (OPEC) continued to stand by their pledge to limit supply which effectively put a floor under prices. Additionally, reduced fears of a global slowdown provided support. **Due to these positive factors and a potentially weaker US dollar, we believe oil prices can move higher from current levels.**

Precious metals were slightly positive as equity volatility and global macro risks subsided.

However, the dovish pivot by the Federal Reserve could act as an upside catalyst as investors hedge against potential inflationary pressures and a weaker dollar. **Assuming equity volatility increases, or the US dollar weakens, we think precious metals can outperform.**

## VI. Looking Ahead

In our view, the outlook for the remainder of 2019 has drastically improved from just three months ago; however, much of the optimism is likely priced in at current levels as the recovery in global risk assets has been strong. The biggest headwinds coming into the year (US-China trade; Fed policy; and slowing global data) have faded or diminished but could resurface. From here, investors will need to see firmer economic data and a formal resolution between the US and China in order for equities to keep climbing. Additionally, any upside surprises from corporate earnings could help propel stocks higher.

In summary, we remain constructive on global equities but recognize that asset prices have rebounded meaningfully year-to-date. Recent policy shifts by global central banks should help to lengthen the current cycle but will eventually create imbalances within the capital markets. Even so, the investment backdrop still warrants investments in equities and credit which should outperform safe-havens such as government bonds. Looking ahead, we will continue monitoring indicators that have historically provided hints of an impending bear market. These include: the level of the yield curve, credit spreads, and central bank policy decisions. As of now, in our opinion, the warning signs from Q4 have stopped flashing as bright but could return with little notice. For that reason, we maintain a cautiously optimistic view of the markets and global economy for the rest of 2019.

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

Sincerely,

**Arcus Capital Partners**



**Sources:**

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