ARCUS CAPITAL PARTNERS

Q1 | 2023 Market Commentary

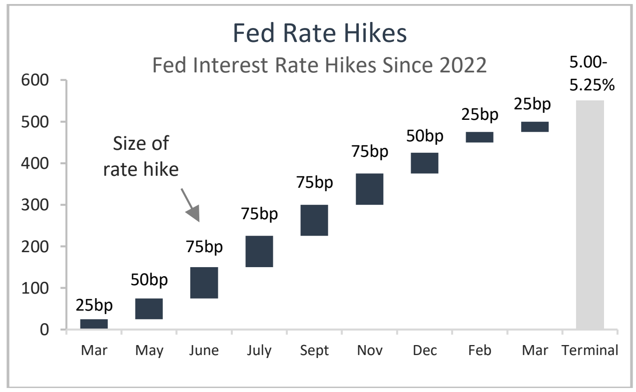
Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great start to the year. The first quarter of 2023 provided investors some reprieve after a difficult prior twelve months. During the quarter, stocks and bonds finished in the green but continued to experience high levels of volatility. The Federal Reserve (Fed) maintained its restrictive policy and raised short-term rates two more times. That said, global equities managed to rally and finish up nicely. Interest rates ended lower but oscillated violently during the quarter. Finally, commodities were weaker, except for gold. We maintain a positive view of equities and credit over the next twelve months; however, near-term headwinds could create periods of higher volatility and lower prices in the interim. We believe investors should maintain a long-term view and continue adding to positions on material weakness.

I. Market & Economic Overview

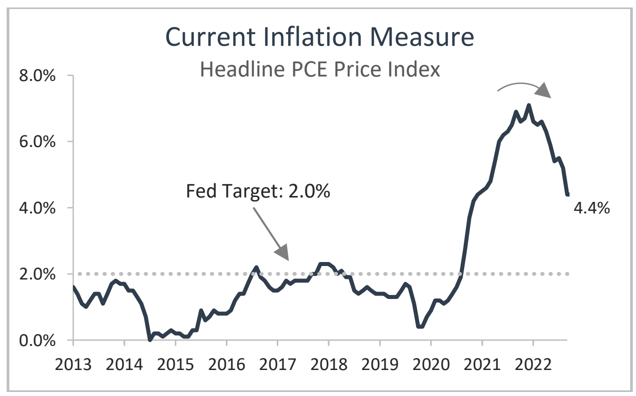
Inflation and central bank tightening remained top of mind during the quarter, but investors shifted their focus to the timing of potential rate cuts. In fact, the Fed was forced to inject liquidity into the financial system in March when several regional banks (e.g. Silicon Valley Bank) came under pressure due to concerns over unrealized losses on their balance sheets. Fortunately, the central bank intervention helped the banking system to continue working properly, and the contagion did not spread to other parts of the market. It also allowed the Federal Reserve to keep short-term interest rates at their current level instead of cutting them as they have previously done during similar episodes (Chart 1). Lastly, inflation pressures continued to subside, which should ease the need for additional rate hikes this year (Charts 2-3).

Chart 1



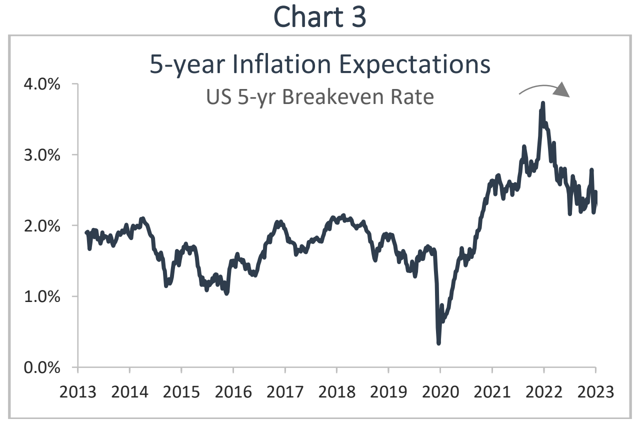
Source: Bloomberg; Arcus Capital Partners; bp = basis point; 100bp = 1.0%

Chart 2



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

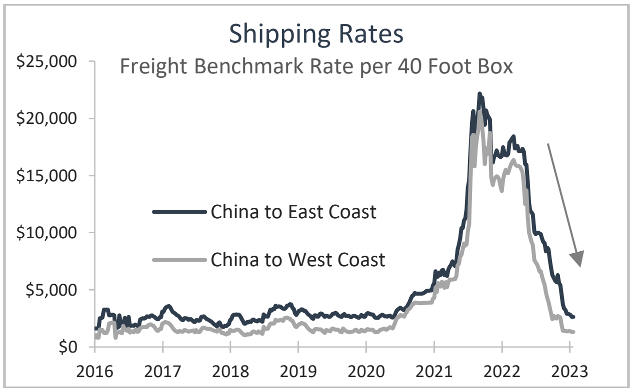
Chart 3



Source: Bloomberg; Arcus Capital Partners

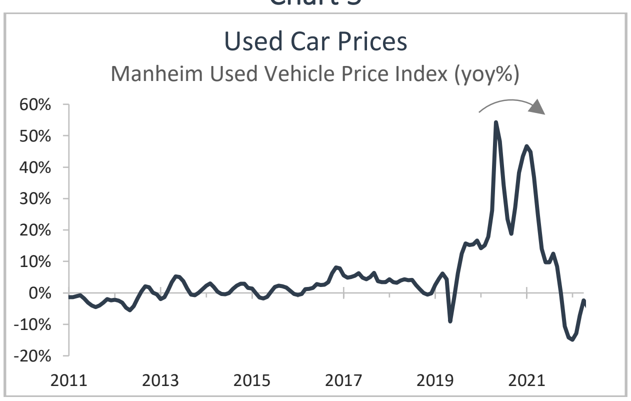
Several inputs have provided relief to pricing pressures, including the gradual healing of global supply chains and additional apartment units coming online. This positive development is best conveyed by declining shipping rates, moderating used car prices, and falling rents (Charts 4-6).

Chart 4



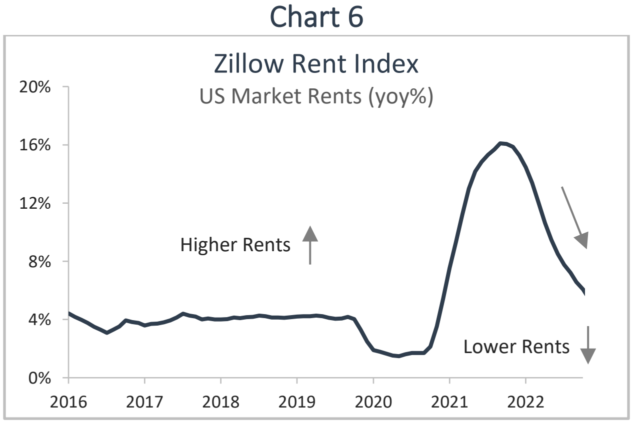
Source: Goldman Sachs; Arcus Capital Partners

Chart 5



Source: Bloomberg; Arcus Capital Partners

Chart 6



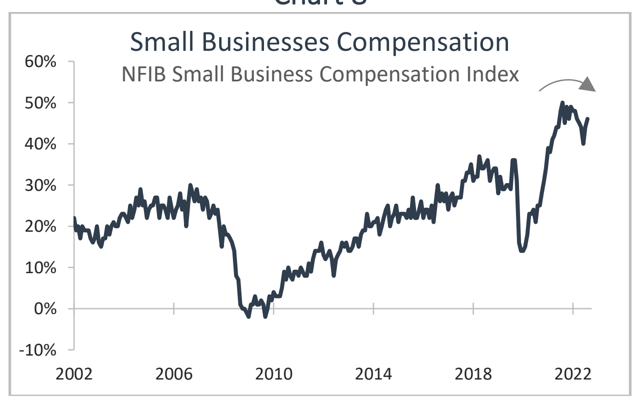
Source: Bloomberg; Arcus Capital Partners; data shown is the year-over-year change in used vehicle prices.

Labor shortages and higher wages have been noteworthy catalysts behind the uptick in inflation, but they are also improving. Today, there are roughly 1.7 open jobs per unemployed worker, but that number should continue declining over the coming quarters, leading to lower employee compensation (Charts 7-8).

Chart 7

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

Chart 8



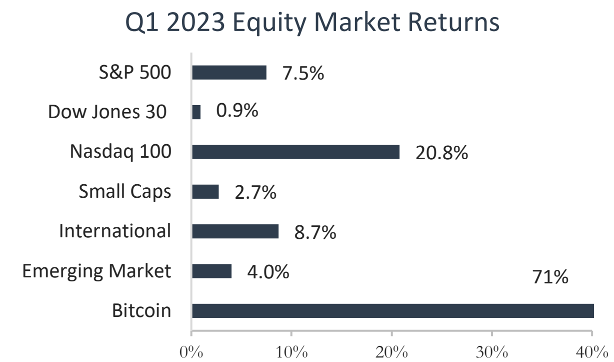
Source: Bloomberg; Arcus Capital Partners; data shown is the percentage of small businesses raising employee compensation.

The macro backdrop remains mixed, but the domestic economy has been resilient and could be turning a corner. The Federal Reserve is committed to breaking inflation but has likely entered the final innings of its current hiking cycle. Finally, the capital markets appear optimistic and are currently pricing in a soft landing (i.e. mild recession); however, stretched valuation, declining earnings, and eventual margin contraction could create headwinds for stocks during the rest of the year.

II. Global Equities

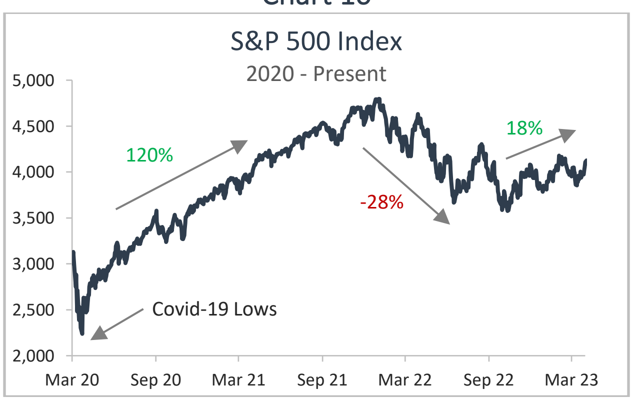
Global equities rallied during the quarter and were led higher by US large cap growth stocks (Charts 9-10). However, the regional banks (e.g. Silicon Valley Bank) suffered significant losses during the quarter due to stresses caused by the Federal Reserve's aggressive interest rate hikes (Chart 11).

Chart 9



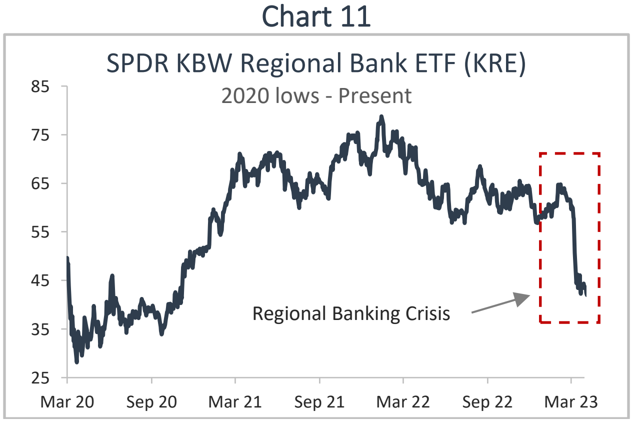
Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends.

Chart 10



Source: Bloomberg; Arcus Capital Partners

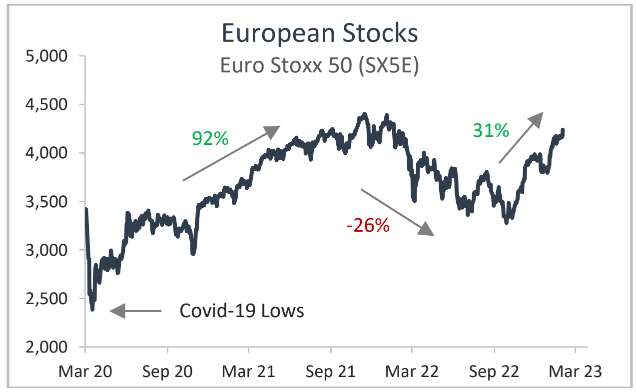
Chart 11



Source: Bloomberg; Arcus Capital Partners

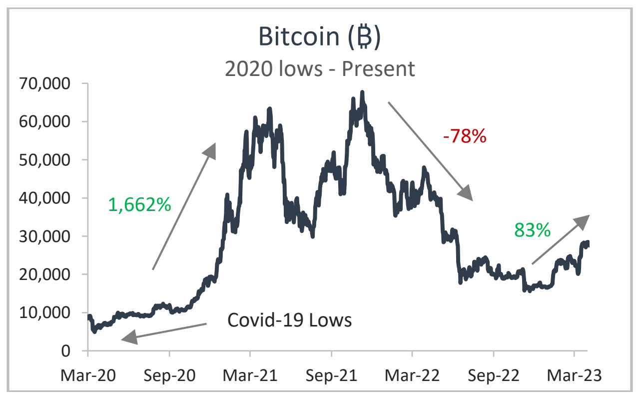
Non-US equities and cryptocurrencies performed well due to the slightly weaker US dollar and improving investor sentiment, which acted as a tailwind (Charts 12-13).

Chart 12



Source: Bloomberg; Arcus Capital Partners

Chart 13



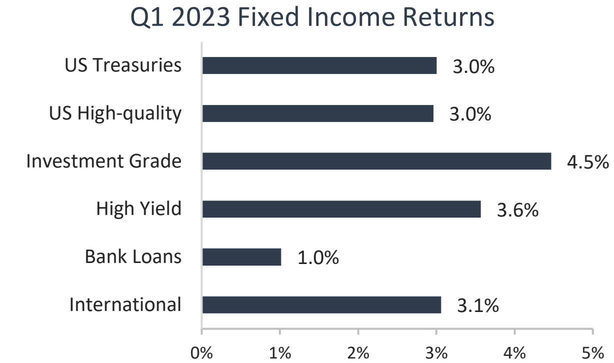
Source: Bloomberg; Arcus Capital Partners

In our view, investors must remain patient and be willing to buy stocks when they feel the most out of favor. We maintain a positive long-term outlook for US equities and prefer higher-quality companies that pay dividends. We remain optimistic about developed and emerging market stocks outside the US but would like to see more improvements before becoming bullish.

IV. Fixed Income

After pushing higher throughout 2023, interest rates finally declined in Q1. This helped most sectors within the bond market end the quarter with a gain (Chart 14). That said, interest rates remain biased higher for the next few quarters.

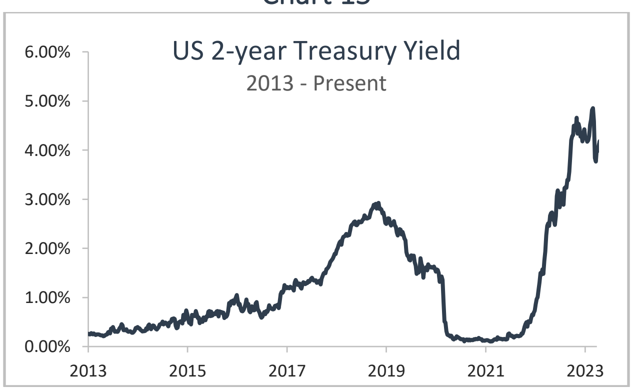
Chart 14



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends.

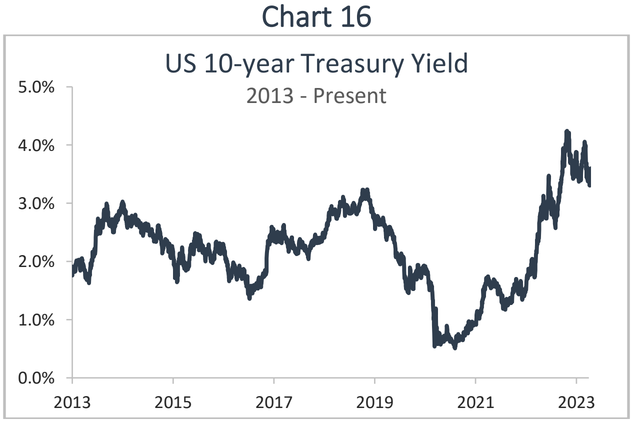
The US 2-year treasury yield got as high as **5.08%**, and the 10-year yield peaked at **4.09%** before declining (Charts 15-16).[1] For the remainder of the year, yields have the potential to move higher, but we may have seen the cycle highs on the longer parts of the yield curve (e.g. 30-year).

Chart 15



Source: Bloomberg; Arcus Capital Partners

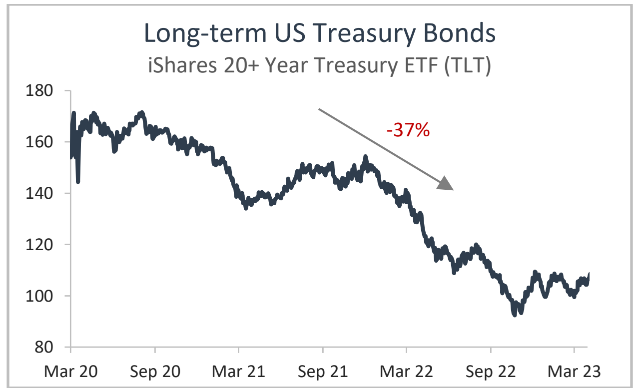
Chart 16



Source: Bloomberg; Arcus Capital Partners

The impact of higher interest rates was felt across the bond market and led to severe drawdowns in longer-duration sectors (Chart 17).

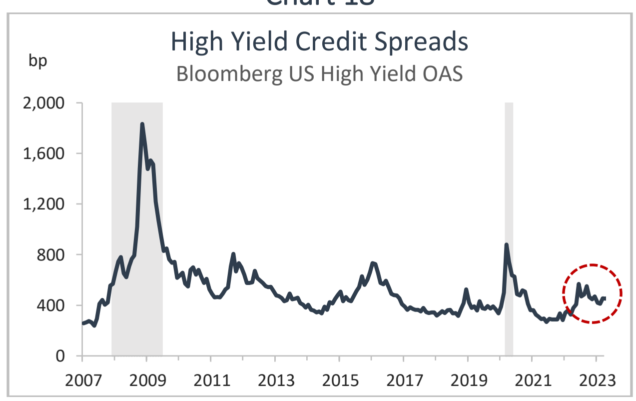
Chart 17



Source: Bloomberg; Arcus Capital Partners

Finally, credit spreads, a way to measure the health of the corporate bond market, remain below recessionary levels (Chart 18). This is a positive sign and suggests that the market feels secure about the ability of US corporations to repay their debts.

Chart 18



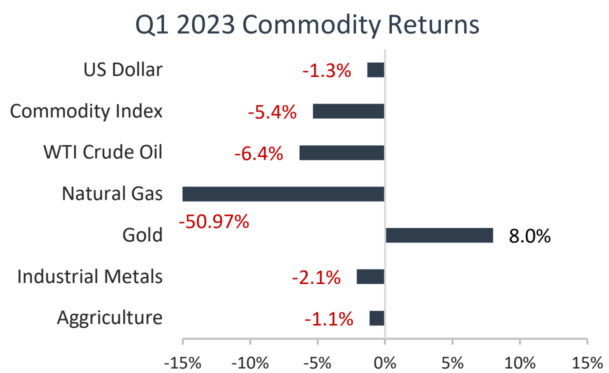
Source: Bloomberg; Arcus Capital Partners; grey shaded areas are NBER recessionary periods.

We expect 1-2 more rate hikes in 2023 before the Fed ends its tightening cycle. In turn, we now see value in high-quality bonds (e.g. Treasuries). Within public credit (e.g., high yield), yields are attractive, but the market may need to further discount the prospect of a recession. Finally, we maintain a favorable view of the private credit market (e.g. middle market lending).

V. Commodities

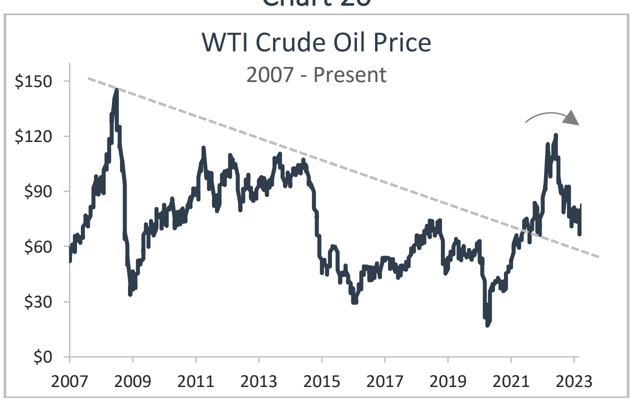
Almost the entire commodity complex finished lower during Q1, with the exception of gold (Chart 19). The energy sector was hit especially hard even as the US dollar posted a slight loss (Charts 20-21). Much of the weakness was linked to investors pricing in slower growth over the coming quarters.

Chart 19



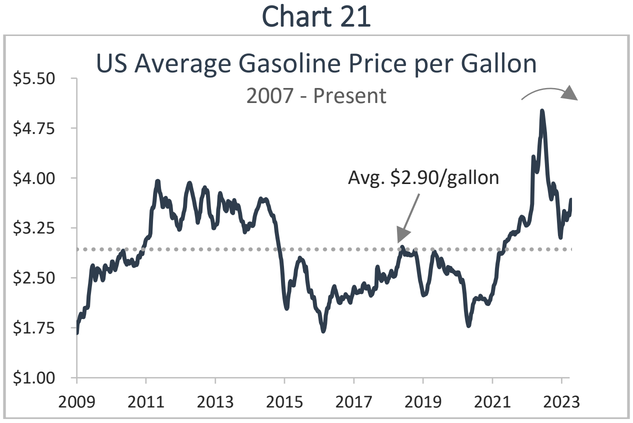
Source: Bloomberg; Arcus Capital Partners

Chart 20



Source: Bloomberg; Arcus Capital Partners

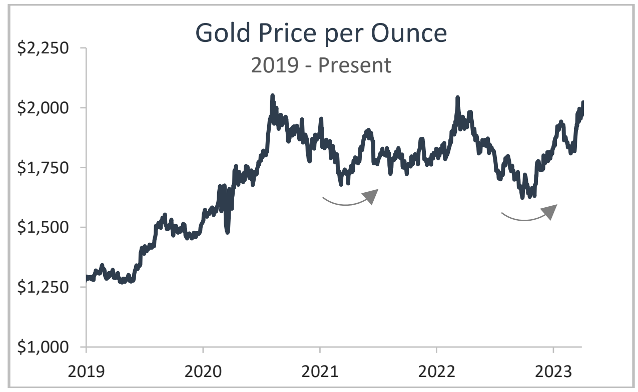
Chart 21



Source: Bloomberg; Arcus Capital Partners

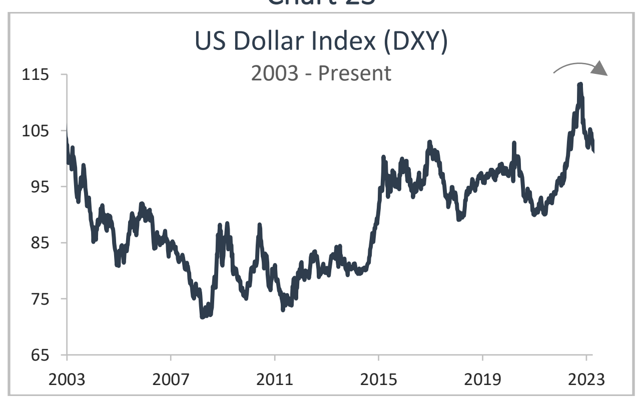
Gold ended the quarter higher after an especially difficult 2022 (Chart 22). Falling interest rates and a weakening US dollar helped the yellow metal (Chart 23).

Chart 22



Source: Bloomberg; Arcus Capital Partners

Chart 23



Source: Bloomberg; Arcus Capital Partners

We remain bullish on economically sensitive commodities (e.g. energy) but recognize that a recession would force us to reassess this view. Gold should continue acting as a good hedge but may provide a better entry point later in the year. Lastly, the US dollar appears ready to move higher in the near term before weakening over the balance of the year.

VI. Looking Ahead

The setup for equities has recently improved, but we expect volatility to stay elevated until the Federal Reserve concludes its tightening policy. Investors should focus on higher-quality companies that can withstand rising costs and return capital to shareholders through dividends.

After rising for over a year, we believe interest rates may have peaked for the cycle. Inflation is moderating, and the Federal Reserve should end its tightening campaign during the first or second quarter. This should reduce interest rate volatility and support rate-sensitive bonds such as Treasuries and high-quality corporates, which now offer attractive yields. High-yield credit spreads have widened but need more time to discount the possibility of a hard landing in 2023. 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 remain structurally bullish and act as a natural inflation hedge but could face near-term headwinds if there is a recession. Additionally, gold has the potential to provide ballast during volatile periods but should provide a better entry-point later in the year.

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:
1. Bloomberg

Important Risk and Disclosure Information

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