ARCUS CAPITAL PARTNERS

Q1 | 2024 Market Commentary

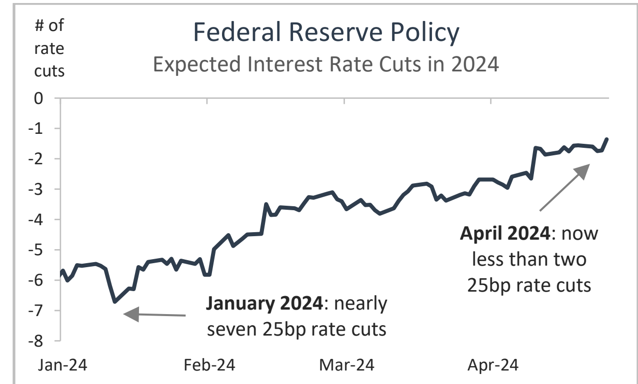
Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great start to the year. The momentum from last year carried through into the first quarter as strong global growth and the hope of Federal Reserve (Fed) rate cuts propelled equity markets higher. Investors shrugged off sticky inflation data and rising interest rates and pushed stocks to new all-time highs. Interest rates retraced much of their end-of-year decline and pressured parts of the bond market. Lastly, commodities rallied on the back of geopolitical risk and increasing global demand. We maintain a positive view of equities but expect higher volatility and more modest returns over the balance of the year. Within fixed income, we still prefer private credit to public markets but think interest rates are once again nearing attractive levels. Finally, we suggest investors keep a long-term perspective and focus on adding to positions on material weakness.

I. Market & Economic Overview

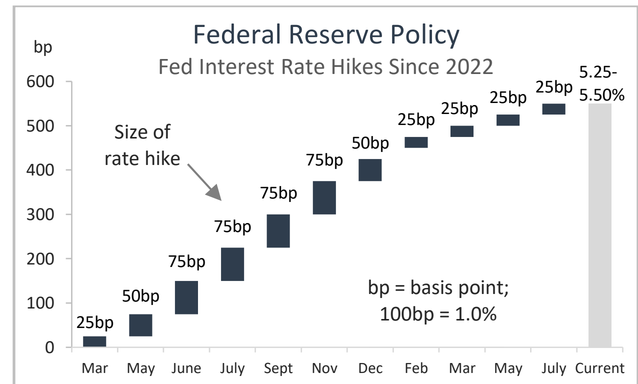
US stocks pressed to new highs in Q1 as investors maintained their bullish outlook from late 2023. The main catalysts were solid domestic growth (helped by fiscal spending) and expectations for imminent Federal Reserve interest rate cuts due to falling inflation and a normalizing labor market. In early January, the futures market priced nearly seven cuts in 2024 (Chart 1). This dovish outlook was welcomed by investors who believed that the Fed's restrictive policy dating back to early 2022 was no longer warranted (Chart 2). Moreover, the Fed's quantitative tightening (QT) program was still on autopilot and was expected to continue over the coming quarters (Chart 3). All of this suggested that the market was comfortable with the notion that the Federal Reserve would start cutting interest rates in the face of a firming domestic economy, a healthy labor market, and stocks trading near all-time highs.

Chart 1



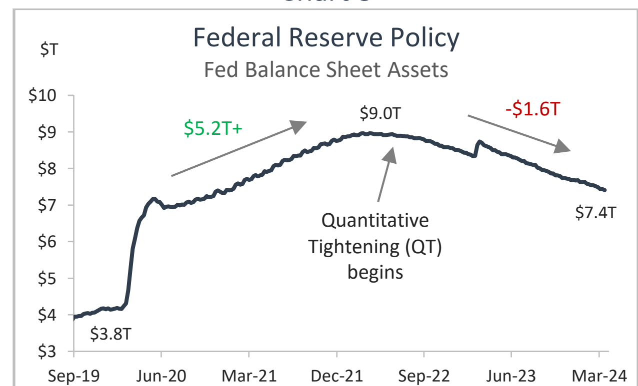
Source: Bloomberg; Arcus Capital Partners

Chart 2



Source: Bloomberg; Arcus Capital Partners

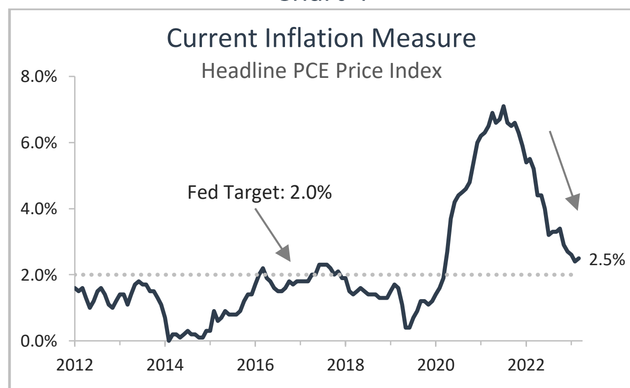
Chart 3



Source: Bloomberg; Arcus Capital Partners; $T = trillions.

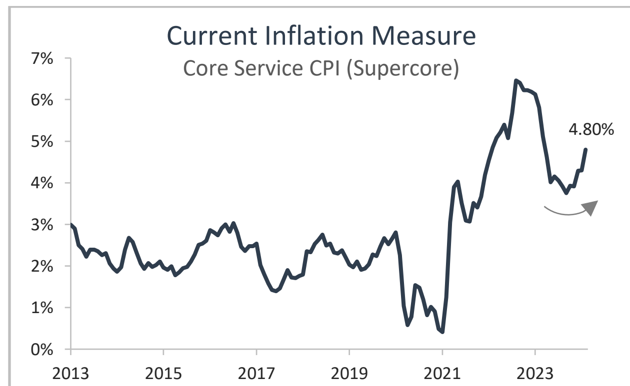
By mid-February, a series of hotter-than-expected inflation prints forced the market to rethink its uber-dovish Fed outlook. Inflation declined at the headline level, but several internal components reversed higher (Chart 4). In fact, the Federal Reserve's preferred "supercore inflation" gauge, which measures a basket of goods and services minus food and energy inflation and housing inflation, began increasing during the quarter (Chart 5). At first, the market perceived the reports to be seasonal anomalies; however, the current trend indicates that inflation may be stickier than expected, and the market has since modified its expectations from nearly seven interest rate cuts in 2024 to less than two. Fed officials have echoed this adjustment and publicly stated they are in no hurry to cut rates if inflation has not returned to their preferred level. We believe the Fed will likely cut rates at some point this year and think the recent uptick in inflation data is related to lagging indicators that should retrace lower over time.

Chart 4



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

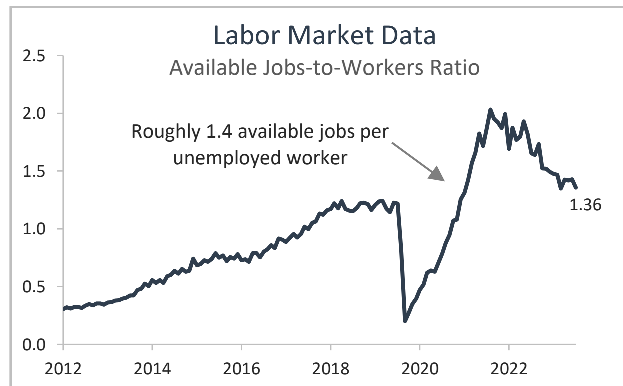
Chart 5



Source: Bloomberg; Arcus Capital Partners

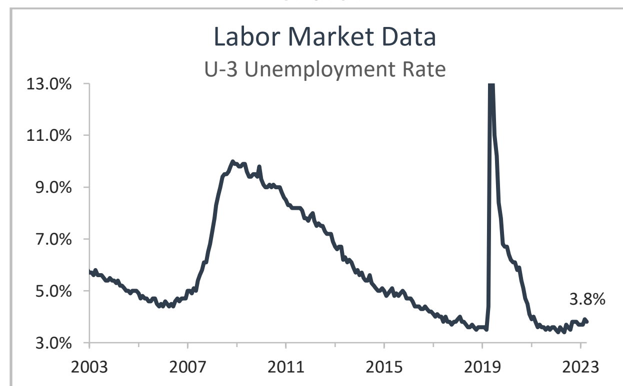
The labor market continues to normalize toward pre-pandemic levels and should gradually reduce wage pressures (i.e. employer-friendly market). As previously noted, the labor supply has increased, and employers have reduced the number of available jobs rather than cutting their headcount (Chart 6). Lastly, the unemployment rate currently sits at **3.8%**, indicating the strength of the economy and jobs market (Chart 7).

Chart 6



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

Chart 7

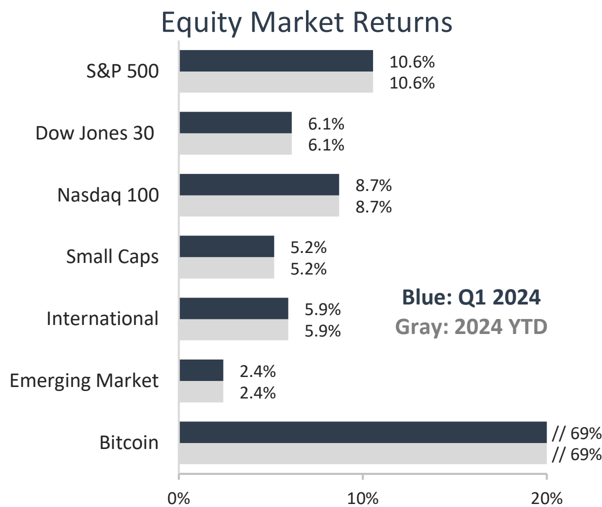


Source: Bloomberg; Arcus Capital Partners

The macro backdrop for the US remains positive and supportive of risk markets. The Fed's rate-policy decisions remain data-dependent with a laser-sharp focus on inflation. Stickier inflation and positive economic growth point to a wait-and-see approach over the coming quarters. That said, several potential speedbumps will be watched closely by investors and the Fed, including: the US elections; continued geopolitical conflicts; and elevated equity valuations.

II. Global Equities

Global equities continued their march higher, and several indexes registered fresh all-time highs (Chart 8). Volatility remained low, and investors experienced minimal movement toward the downside.



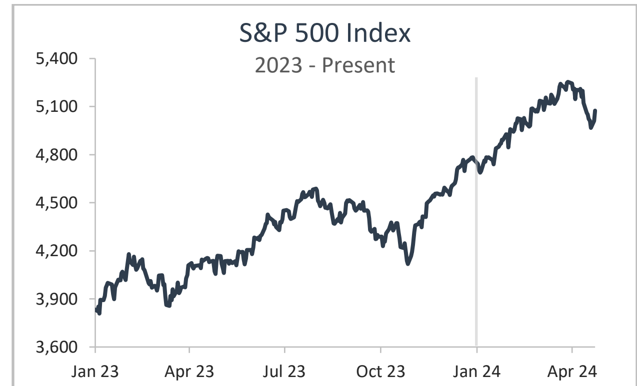
Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q1 24; gray = 2024 YTD.

Unlike 2023, the returns for the first quarter were more diverse and not dominated by the growth sectors (e.g. technology). Other areas, such as energy and financials, were accretive to the S&P 500's total return. However, at the company level, a number of the top-performing names within the S&P 500 were once again semiconductors and drastically outperformed the index (Chart 9). Finally, Bitcoin continued its stellar run and ended the quarter in parabolic fashion (Chart 10).

The S&P 500 finished up **10.6%** for the quarter – here are some interesting performance stats[1,2]:

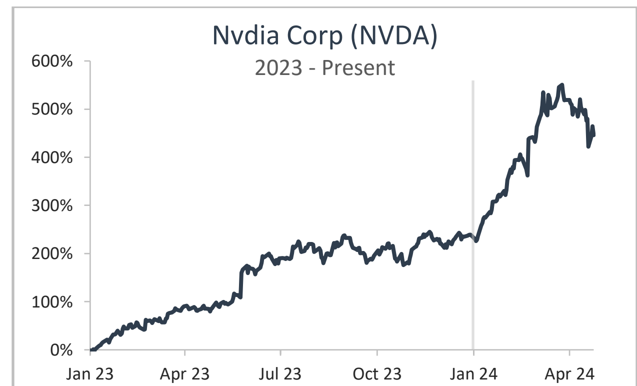
- Top 7 index weightings: **+16.2%**
- Remaining 493 names: **+9.5%**
- Best Sector: Communications **+15.5%**
- Worst Sector: REITs **-1.4%**
- Best stock: Super Micro Computer (SMCI) **+255%**
- Worst stock: SolarEdge Tech (SEDG) **-52%**
- Number of record closes: **22**
- Days the market ended up over 2%: **1 day**
- Days the market ended down over 2%: **0 days**

Chart 8



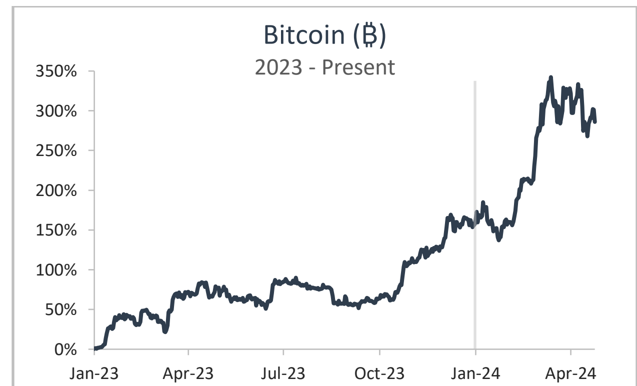
Source: Bloomberg; Arcus Capital Partners

Chart 9



Source: Bloomberg; Arcus Capital Partners

Chart 10

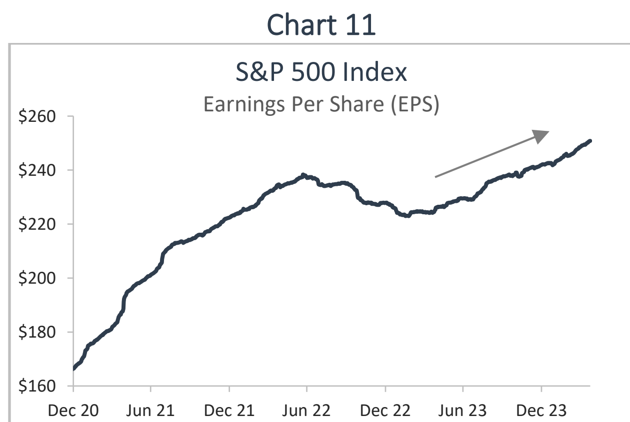


Source: Bloomberg; Arcus Capital Partners

Over the last six months, the impressive rally experienced by US equities has primarily been driven by multiple expansion (i.e. investors willing to pay more for stocks). However, analysts expect earnings to grow over the coming quarters, and so far, most companies have been beating expectations (Chart 11). Valuations are rich, but robust economic growth and falling costs should

provide a tailwind for corporate profits and allow stocks to grow into their elevated multiples. Additionally, it is too early to know the true impact of AI; however, many experts anticipate significant savings for companies due to the need for fewer workers and more efficient processes. Moreover, many pundits expect substantial investment in AI over the coming years, benefiting companies from several industries (e.g. semiconductors).

Chart 11



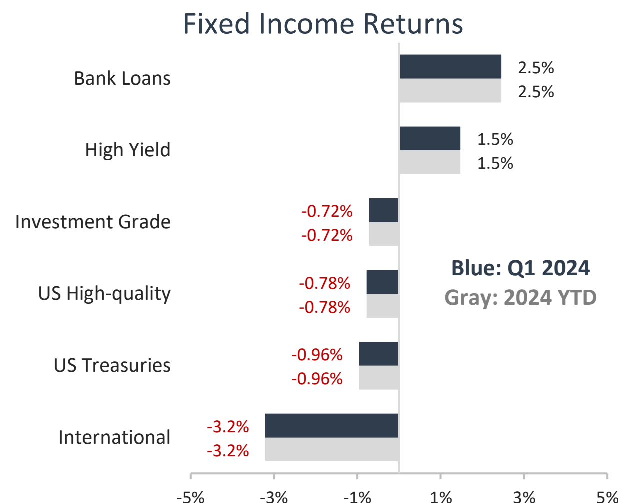
Source: Bloomberg; Arcus Capital Partners. The data shown represents forward EPS estimates over the next twelve months.

The setup for equities remains attractive, but we expect an uptick in volatility as we approach the election. That said, US stocks have historically performed well during re-election years due to the incumbent party's willingness to keep the economy afloat (i.e. fiscal spending) – this is likely to ring true during this election cycle. Furthermore, investor sentiment and positioning have moderated after becoming extreme towards the end of the quarter. Overall, this backdrop should provide equities with the framework needed to move higher over the balance of the year.

We maintain a positive long-term outlook for US equities and would continue to add exposure on meaningful dips. We are becoming more optimistic about non-US developed and emerging market stocks as global growth has firmed and many central banks have started cutting rates. Another favorable catalyst would be a weaker US dollar, which has typically been a significant boon for non-US equities.

IV. Fixed Income

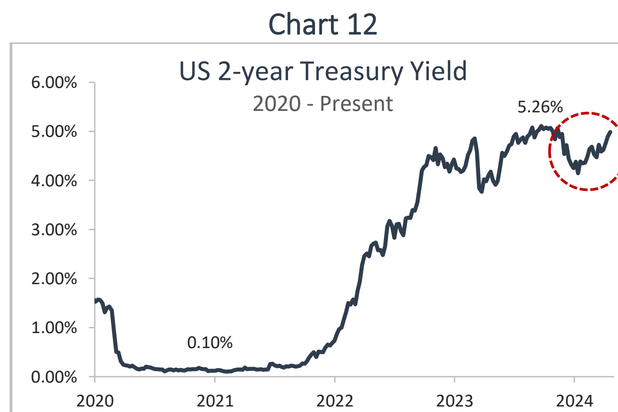
During the quarter, the US 2-year treasury yield retraced much of the end-of-year decline and ended at **4.62%**, while the 10-year yield ended at **4.21%** (Charts 12-13).[3] These moves higher put pressure on interest rate-sensitive parts of the bond market but had little impact on credit.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q1 24; gray = 2024 YTD.

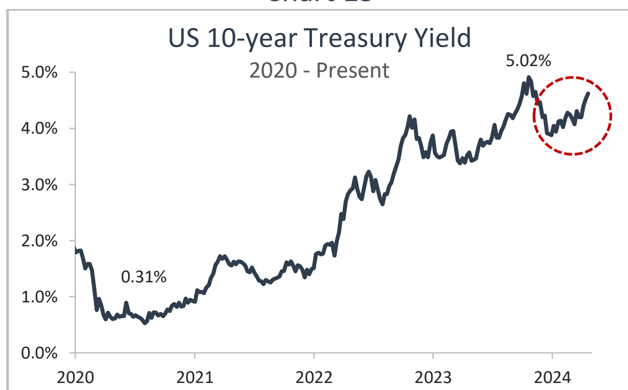
As previously noted, the market was forced to recalibrate its expectations for Fed interest rate cuts in 2024. This shift drove interest rates across the yield curve higher – a theme that has continued after the quarter ended. The economy and markets have been able to withstand interest rates at the current levels, but that could quickly change if the Fed coveys a more hawkish tone at its upcoming meetings or if rates push much higher.

Chart 12



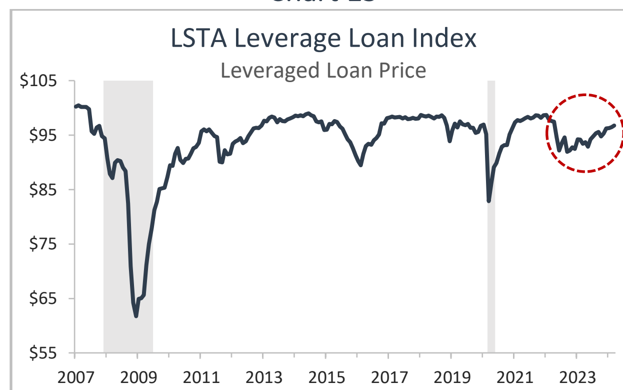
Source: Bloomberg; Arcus Capital Partners

Chart 13



Source: Bloomberg; Arcus Capital Partners

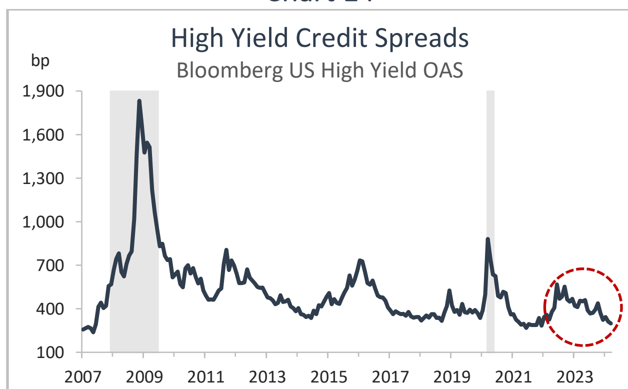
Chart 15



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 and have recently narrowed further – indicating limited stress for borrowers (Chart 14). Leveraged loan prices, representing floating-rate borrowers, also reside above levels that have historically hinted at borrower stress (Chart 15). Although defaults in the high yield and leveraged loan index remain above pre-covid levels, the current issues appear manageable and should subside over the next few quarters. The private credit markets are also in good shape and have reshaped the public markets by redirecting borrowers to private lenders. Potential headwinds include a sharp increase in rates above the recent highs, a softening economic backdrop, or a further uptick in default rates. However, these risks are currently low, and we have seen minimal warning signs suggesting any trouble brewing.

Chart 14

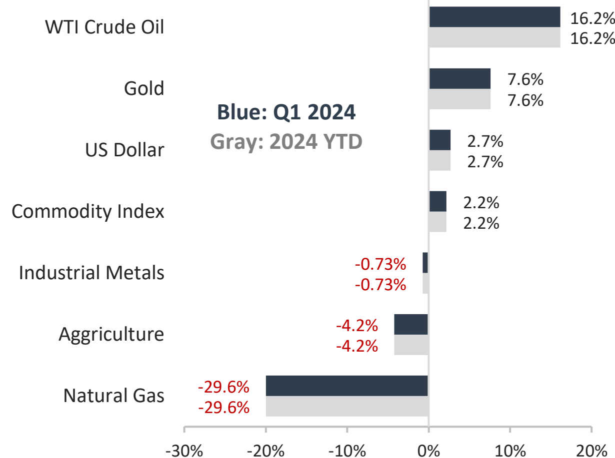


Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

We believe the Fed has concluded its tightening cycle and will likely begin cutting short-term interest rates later this year. We see value in high-quality bonds (e.g. Treasuries) but would wait until longer-term interest rates (e.g. 10-year) stabilize 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

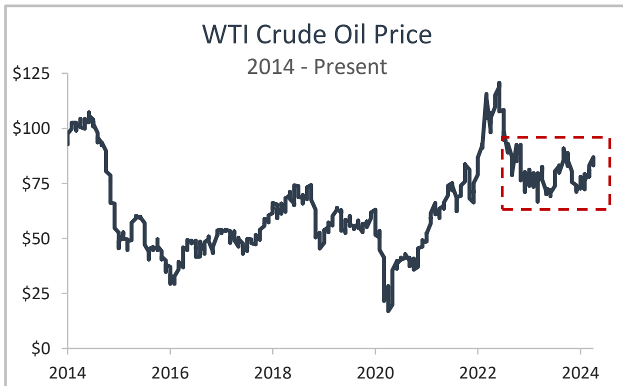
The commodity complex ended the quarter slightly higher and was led by crude oil and gold, even as the US dollar strengthened.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q1 24; gray = 2024 YTD.

Crude oil rallied to start the year and benefitted from tighter supplies and an embedded risk premium linked to the conflict in the Middle East (Chart 16). The outlook for the remainder of the year is mixed due to various factors. For the bulls, improving global growth and OPEC supply constraints should support crude. However, increased output from US shale producers and less risk tied geopolitical tensions in the Middle East may weigh on prices. These crosscurrents suggest oil should trade in a range over the coming months.

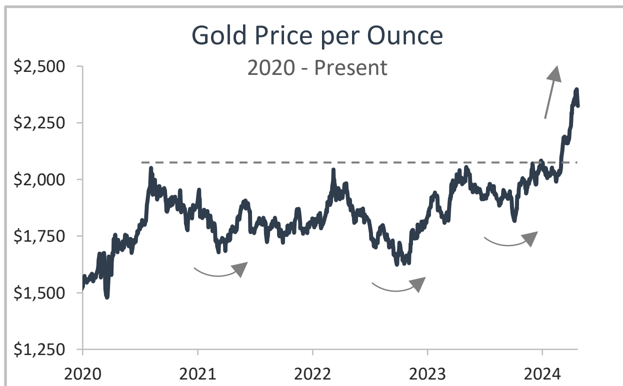
Chart 16



Source: Bloomberg; Arcus Capital Partners

Gold rallied during the quarter and made new all-time highs (Charts 17). 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.

Chart 17



Source: Bloomberg; Arcus Capital Partners

We are neutral on economically sensitive commodities (e.g. energy) but could adjust our outlook in the coming months. The setup for gold is bullish but could provide investors with a better entry point later this quarter. Lastly, the US dollar may rise further before weakening over the balance of the year.

VI. Looking Ahead

The outlook for equities over the rest of the year is balanced but still positive. Historically, equities have performed well during re-election years, but stocks are trading near record highs, and valuations are rich. However, falling inflation should allow the Federal Reserve to start reducing short-term interest rates later this year. Lower costs will also help improve corporate margins, leading to more robust earnings. Investors should focus on quality companies that can return capital to shareholders through dividends and buybacks.

Interest rates have climbed back near the 2023 cycle highs but are unlikely to see much more upside. Longer-term interest rates (e.g. 10-year) could move a little higher over the short term but should eventually settle at lower levels. We like higher-quality bonds (e.g. Treasuries) but would wait for 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, crude oil and gold are structurally bullish but should provide better entry points over the coming quarters.

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. Goldman Sachs
2. Strategas Research
3. Bloomberg

Important Risk and Disclosure Information

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