

Dear friends of Arcus Capital Partners,

We are excited to announce the launch of our new quarterly commentary. This piece will cover a range of topics, including but not limited to: the global financial markets, the macro economy, and other one-off topics we think you will find interesting. Please let us know what you think as feedback is always appreciated.

With the first half of 2018 complete, this year is shaping up to be very different than 2017. So far, global equity markets have struggled with only US stocks managing to generate a positive return. Bonds have not been immune and finished the first half in the red as interest rates continued to grind higher. Lastly, commodities have been somewhat of a bright spot due to rising energy prices.

### I. US Equities

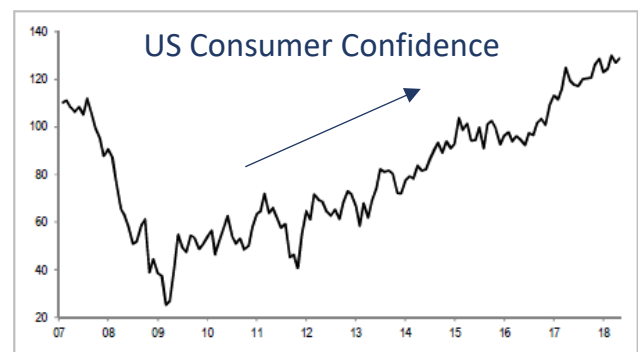
Similar to the first quarter, the last three months were volatile for investors. The global economy has become increasingly bifurcated as the US has seen its growth outlook upgraded, and the rest of the world has lost its positive momentum from 2017. This has been the most obvious in the FX (currency) markets where the US dollar (USD) continued to appreciate against most foreign currencies.<sup>1</sup> Global equity markets also started diverging after running in-synch for most of 2017. US stocks have been the clear leader so far this year with small caps and cyclical sectors like technology and consumer discretionary leading the way. Nevertheless, the synchronized growth story witnessed during 2017 is likely to regroup during the back half of 2018 and should support global equity markets.

Outside of the market volatility, the Federal Reserve (Fed) raised rates for the seventh time during the current hiking cycle. They also maintained their positive growth outlook and

conveyed plans to hike two more times this year.<sup>2</sup> In addition, the Fed is set to accelerate their balance sheet reduction program over the coming quarters. At this point in the tightening cycle, Federal Reserve policy is not yet restrictive; however, this is something we are watching closely as the Fed has inadvertently ended previous bull markets via *policy mistakes*. **Assuming the domestic data remain intact, we anticipate another two rate hikes during 2018 and 3-4 in 2019.**

Domestic equities rallied during Q2 with the S&P 500 Index finishing up **3.46%** for the quarter.<sup>3</sup> Volatility remained elevated, but after retesting the February lows, US stocks were able to find their footing. Interestingly, during all of 2017, the S&P 500 only had 8 days where it closed up or down by more than 1%. So far this year, the S&P 500 has already experienced over 30 such days.<sup>4</sup> This increased level of volatility is an apt example of the mean-reverting nature of stocks. Last year's linear market has been transformed into one full of surprises. Even so, the fundamental backdrop remains sturdy and should support US stocks over the next 6-12 months.

Chart 1



Source: J.P. Morgan

US firms continue to experience strong topline sales growth as consumer confidence (Chart 1) and



small business optimism remain near all-time highs.<sup>5</sup> Much of this is being driven by the recently enacted tax cuts which are now taking effect. These cuts may continue stimulating domestic spending as consumers and businesses deploy their newfound savings. The tax reform is also helping corporate earnings; the effective tax rate for S&P 500 companies fell from ~26-27% to 21-22% in Q1 2018.<sup>6</sup> Outside of the tax cuts, another tailwind for equities is share buybacks. J.P. Morgan estimates that US firms will use newly repatriated earnings to repurchase \$800B of their own stock.<sup>7</sup>

*“Rising wages and increasing commodity prices are two cost inputs worth watching closely.”*

Even as stocks move higher, it is important to remember that the current market cycle (think S&P 500) and business cycle (think GDP) are at mature stages relative to history.<sup>8</sup> This does not suggest a bear market (defined as a price drop of 20% or more) or recession is looming, but many late-cycle headwinds are appearing. For instance, rising wages and increasing commodity prices are two cost inputs worth watching closely. These have the potential to squeeze margins and reduce earnings – which can eventually lead to lower equity prices. With valuations currently near the upper-end of their historical range, future equity returns will likely be more modest compared to the last few years. Even so, the odds of a recession remain modest: currently at ~20% over the next 12-months and just over 50% over the next 24-months.<sup>9</sup> Considering the current positive setting, **we remain bullish on US stocks over the next 6-12 months.**<sup>10</sup>

## II. International Equities

Moving overseas, the International Developed (MSCI EAFE) and Emerging Market (MSCI EM) indexes ended Q2 lower by **-1.24%** and **-7.96%**, respectively.<sup>11</sup> Tariffs threatened and enacted by the Trump administration remained in the spotlight during the quarter after talks with China and other US trading partners failed to yield any positive results. Initially, the international markets

appeared unfazed by the trade rhetoric; however, it caught up with them during Q2 as investors trimmed their exposure and rotated into US stocks. With that being said, the bar for positive upside surprises is now very low, especially in Europe where economic data has been disappointing over the past few quarters (Chart 2).

Chart 2



Source: J.P. Morgan; see appendix for additional details on the Citi Economic Surprise Index.

In addition to fallout from a possible “trade war”, the recent US dollar (USD) strength also hindered international equity returns. First, the stronger dollar was a headwind because of the negative translation effect. This is due to overseas investments being worth less when they are converted back to US dollars from a weaker currency (a falling USD has the opposite effect and artificially increases international investment returns). Second, the stronger dollar has made US denominated debt more expensive for foreign countries (they must pay back their debt with a currency that is worth less). This is a bigger problem for EM countries and has been evident in the poor performance of their markets. Nevertheless, these issues could be transitory if the USD stabilizes or weakens in the coming quarters.

On the positive side of the ledger, developed market (DM) earnings are being upgraded, valuations are reasonable in DM and EM, central bank policy remains accommodative, and sentiment towards these markets is already depressed. Collectively, these factors could provide the recipe needed for positive performance through the second half of the year. In the near term, the direction of the US dollar will likely continue to dictate performance. Likewise, global



trade negotiations will remain top of mind for investors and continue to drive sentiment. Even so, **we are currently bullish on international developed stocks and are neutral on emerging market equities.**

### III. Fixed Income

Interest rates rallied to multi-year highs during the quarter with the U.S. 10-yr yield reaching **3.11%** before settling at **2.85%** (Chart 3).<sup>12</sup> The Barclays Aggregate Bond Index ended down **-0.16%**, and the tax-free Barclays Municipal Bond Index finished up **0.87%** for the quarter.<sup>13</sup> Credit related markets fared well and the Bank of America High Yield Index finished up **1.0%**.<sup>14</sup> So far in 2018, global fixed income markets have struggled as rates have risen and investors have lost their appetite for fixed income investments.

Chart 3



Source: J.P. Morgan

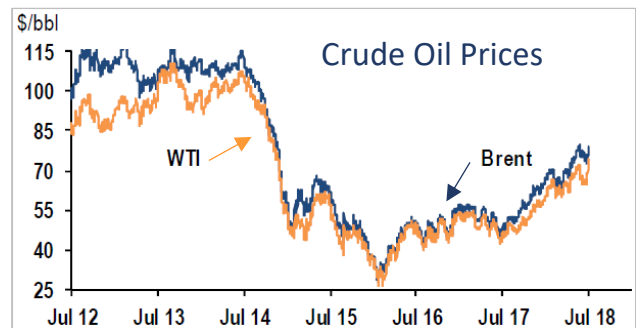
As previously noted, the Federal Reserve has raised rates twice in 2018. If the domestic economic landscape remains firm, the Fed is likely to hike two more times this year. This backdrop has sent shorter-term interest rates higher including the US 2-year yield which ended Q2 trading around **2.53%** - levels not seen in over a decade.<sup>15</sup> We believe this trend will continue as the Fed keeps raising rates over the coming quarters. Eventually, this is likely to cause the yield curve to invert (short-term rates move higher than long-term rates) and is something we are watching. Historically, an inverted yield curve has provided a good recessionary warning; statistically, the risk of a recession following an inverted yield curve is around 70%.<sup>16</sup> For now, we do not see the yield curve inverting for another 6-12 months.

Nonetheless, **we do expect rates across the curve to move higher and continue putting pressure on traditional bond investments.** Outside of interest rates, **the credit markets are healthy and remain attractive.** This is due to the low prospects of a recession occurring over the next 12-24 months and their reduced sensitivity to interest rate movements.

### IV. Commodities

Commodities were essentially flat during Q2 as the Bloomberg Commodity Index ended up **0.40%**.<sup>17</sup> Crude oil was a leader within the group and remains one of the best performing assets year-to-date. Production cuts made by the Organization of Petroleum Exporting Countries (OPEC) have helped reduce global oil supply at a time when late-cycle demand remains strong. This rebalancing effort has supported higher oil prices and driven them towards multi-year highs (Chart 4). In addition, headline risks linked to the U.S.-Iran nuclear deal and reduced supply from Venezuela pushed prices higher. In the short term, prices may remain elevated but could recede during the second half of 2018. OPEC has recently discussed increasing production, and US producers have ramped up their drilling efforts as prices have risen. **Taking all of this into account, we see oil prices remaining elevated for the next 6-12 months.**

Chart 4



Source: J.P. Morgan

Outside of energy, precious metals were hit hard with gold down **-5.6%**.<sup>18</sup> Much of the weakness was attributed to the stronger dollar which tends to trade inversely to gold. Longer term, gold has the potential to act as a hedge against risk-off periods but will likely need to see the USD weaken before

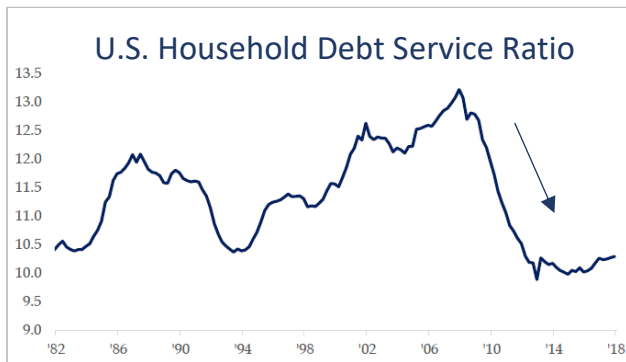


this can occur. In the near term, the commodity complex may continue to struggle if the dollar remains strong; however, longer term, strong global demand linked to synchronized growth could keep prices high.

## V. Looking Ahead

The first half of 2018 turned out to be markedly different than the stable environment experienced in 2017. Volatility returned, the yield curve continued to flatten, and global growth diverged as fears of an ensuing trade war moved closer to becoming a reality. As a result, investors became more concerned with the cycle's old age and started questioning the bull market thesis that previously led the markets higher.

Chart 5



Source: Strategas; total household debt payments to total disposable income.

With that being said, the recent weakness seen in equity prices suggests that the markets may already

be pricing in many potential risks and stocks could rally during the second half of the year. In fact, a number of positive catalysts remain intact, including: the uptrend in global earnings, a better positioned consumer (Chart 5), already negative investor sentiment, and the likelihood of global growth recoupling during the second half of the year. Lastly, although the Fed is tightening, many other central banks remain accommodative via low rates and quantitative easing programs. All of this has the potential to push risk assets higher.

In conclusion, we remain optimistic that the current business and market cycles have room to expand. At the same time, we are on the lookout for evidence that the market's foundation may be faltering. Indicators we are monitoring include: the flattening yield curve, inflationary pressures, signs of credit market stress, and central bank policy mistakes. As of now, in our view, no major warnings signs are flashing which has led us to maintain a constructive view on equities and the global economy.

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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\*Citi Economic Surprise Index: The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that the data releases have been stronger than expected and a negative reading means that the data releases have been worse than expected.

**Important Risk and Disclosure Information**

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