

Dear friends of Arcus Capital Partners,

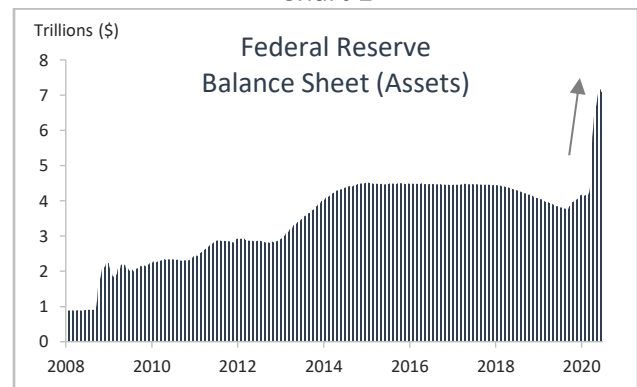
We hope this letter finds you in good health during this extraordinary time. The past three months provided much needed relief to many global markets after a tumultuous first quarter. However, investors remain focused on the fallout from the coronavirus (COVID-19) as a large portion of the world population is still under some form of lockdown measure, and new cases continue to climb, albeit at a slower pace. Sadly, the global pandemic has not only taken many lives, but it has also wreaked havoc on the global economy and financial markets. Fortunately, during the second quarter, equities rallied sharply after briefly falling into bear market territory, interest rates maintained their historically low levels, and commodities generally rallied.

### I. Market & Economic Overview

As the first quarter came to a close, the global economy was under immense pressure due to COVID-19. Fears of a looming depression were rampant as companies continued to lay off workers, the financial markets remained volatile, and new infections and deaths climbed. Nonetheless, green shoots were slowly emerging. China came back online after being the first country to shut down, US and European new case statistics started improving, and global governments and central banks delivered significant stimulus packages. For example, the Federal Reserve expanded its balance sheet by ~\$3T (Chart 1), cut short-term rates to near zero, and set up corporate lending facilities. In addition, Congress passed a massive fiscal plan that provided small business loans, increased unemployment benefits, and gave middle to low-income Americans direct assistance through cash payments. These encouraging developments led many experts to forecast the possibility of a V-shaped recovery and, in turn, provided a bullish

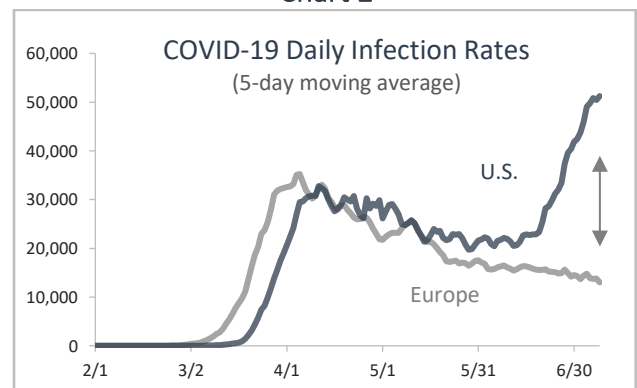
signal to the depressed capital markets. Stocks quickly rallied off their lows, and sentiment gauges such as the VIX Volatility Index started receding – suggesting that fear was leaving the market. Over the remainder of the quarter, this trend continued across many asset classes, especially areas that experienced the largest drawdowns in March.

Chart 1



Source: Bloomberg; Arcus Capital Partners

Chart 2



Source: ECDC; Arcus Capital Partners; data as of 7/8/20.

From here, the macro outlook is dependent on two key variables. The first is the length of time needed to find a vaccine or see a meaningful deceleration in infection rates. As of now, the curve is flattening, but “hot spots” have started appearing in the US (Chart 2). A second wave would be detrimental to the potential for a V-shaped recovery, but the

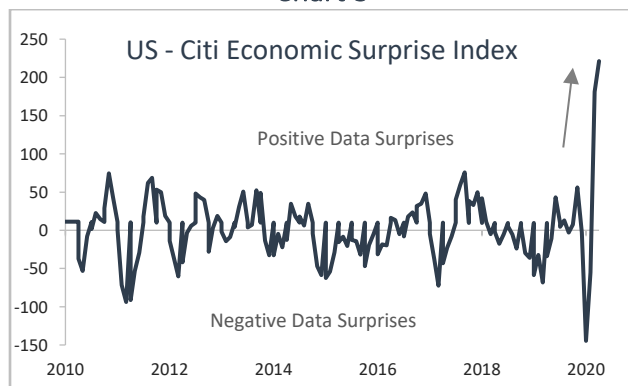


recent spike in new cases could partially be the result of increased testing. The second factor is the size and scope of additional policy responses by governments and central banks. So far, the existing measures have been a success – partially due to being more extensive and targeted than programs used during the Global Financial Crisis (GFC). They were also implemented quicker than during the GFC, which has likely limited the extent of the damage. The global economy is currently in the middle of a deep recession; however, it may end up being one of the shortest on record. **We anticipate the next few quarters will remain volatile but believe patient investors will be rewarded.**

## II. US Equities

Domestic stocks rallied to finish strongly after declining into bear market territory during Q1. For the second quarter, the S&P 500 index finished up **20.5%**, while smaller capitalization stocks, as represented by the Russell 2000 index, ended up **25.4%**.<sup>1</sup> Although these two indexes remain negative on the year, the tech-heavy NASDAQ Composite index was able to make new all-time highs during the quarter.<sup>2</sup> Improving economic conditions (Chart 3) and massive fiscal and monetary stimulus responses were some of the reasons noted for the robust performance.

Chart 3



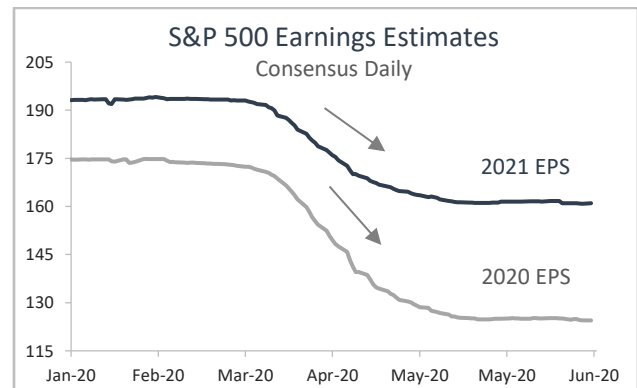
Source: Bloomberg; Arcus Capital Partners; more info on the index available at the end of this note.

The fundamental backdrop for US equities remains a potential headwind as rising prices and a reduced earnings outlook has led to inflated price-to-earnings (P/E) multiples. In fact, consensus earnings estimates (EPS) have seen negative

revisions since March due to the impact of COVID-19 (Chart 4). The good news is that they appear to be stabilizing and could be revised higher if activity data continue to improve. Additionally, low interest rates could support higher P/E multiples due to lower borrowing costs.

The 2020 elections remain one of the most significant near-term unknowns for the market. The most bearish outcome for the markets is likely a Democratic sweep. This result would likely lead to higher corporate tax rates, increased regulation, and other legislative actions that could hurt earnings. At the same time, a win for Trump, who is seen as being market-friendly, could result in additional trade tensions (e.g. US-China trade war), which may harm the already fragile economy. It is too soon to know how the election will unfold, but the S&P 500 has historically been an excellent leading indicator. According to Strategas Research, if the market is higher during the 3-months before the election (starting August 3<sup>rd</sup>), the incumbent party has won. On the flip side, if the market is lower during the same 3-month period, the opposing party has won. This statistic has been accurate in every presidential election since 1984, and 87% of the time since 1928.<sup>3</sup>

Chart 4



Source: Bloomberg; Arcus Capital Partners

Looking at the economy, the US is in the middle of a deep but potentially short-lived recession. Unlike the contraction that followed the financial crisis, the current slowdown is event-driven (e.g. natural disaster) and not related to an asset or credit bubble. Despite this difference, the COVID-19 recession has already inflicted significant damage.

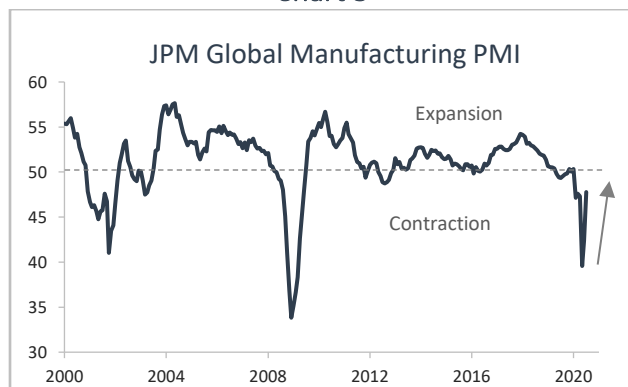


The widespread containment measures have had a profound negative effect on business activity. The exact shape of the recovery will not be known for many quarters; however, the worst data might be behind us. Additionally, current and future fiscal and monetary stimulus programs should help soften the blow. **We maintain a cautiously optimistic view that the economy will recover over the coming year but recognize that the situation remains fluid. Our view on US equities is neutral over the near term due to looming risks such as the election.**

### III. International Equities

During the quarter, non-US stocks recovered alongside their domestic counterparts. International developed (MSCI EAFE) equities finished the quarter up **15.1%** while emerging market (MSCI EM) stocks ended higher by **18.1%**.<sup>4</sup> Much of the strength was tied to the enormous global stimulus measures, firming economic data (Chart 5), and improving coronavirus infection rates. It is worth noting that many foreign countries quickly implemented stringent lockdown measures and were slower to reopen their economies. These factors may have helped contain the virus better than within the US; however, it is still unclear if the recent uptick in new cases within US cases is a result of increased testing. One final catalyst that boosted non-US equities was the US dollar (USD), which weakened during the quarter.

Chart 5



Source: J.P. Morgan; Arcus Capital Partners

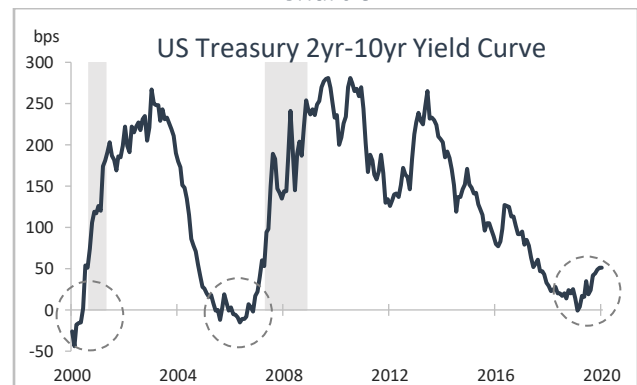
As the global recovery continues to unfold, international developed and emerging market stocks could perform well on an absolute and

relative basis, especially if the USD declines further. As of now, these markets are trading at cheaper valuations relative to the US and could see renewed investor interest going forward. **For these reasons, we maintain a longer-term bullish view on both markets but expect an uptick in volatility in the coming months.**

### IV. Fixed Income

Interest rates remained near historically low levels during the quarter after the Federal Reserve cut short-term rates to the zero-bound in Q1. The 2-year and 10-year US Treasury yields ended the quarter at **0.15%** and **0.66%**, respectively.<sup>5</sup> Interestingly, the yield curve (2-yr minus 10-yr yield) steepened, similar to prior recessionary periods (Chart 6). This reaction suggests the market is expecting the Fed to remain on hold (i.e. no rate hikes) for the foreseeable future but sees less downside potential for longer-term rates.

Chart 6



Source: Bloomberg; Arcus Capital Partners; NBER; grey area denotes a recessionary period.

At the index level, falling interest rates boosted returns for higher-quality taxable bonds and municipal bonds. The Barclays Aggregate Bond Index ended the quarter up **2.90%**, and the tax-free Barclays Municipal Bond Index finished the quarter higher by **2.72%**.<sup>6</sup> Within credit, the Bloomberg High Yield Index finished up **10.18%**, and the S&P/LSTA Leveraged Loan Index ended up **9.70%**.<sup>7</sup> Credit spreads and bank loan prices reversed much of the weakness they experienced during the first quarter as investors sought out higher yields, and the Fed pledged to backstop numerous areas of the bond market. **Looking**



ahead, we anticipate interest rates will stay anchored at the front-end (0-2-yr) but could see the longer-end (10-30-yr) move higher. We think rate-sensitive bonds are unattractive but believe parts of the credit market could provide attractive returns.

## V. Commodities

The commodity complex recovered part of its first-quarter losses as the Bloomberg Commodity Index finished up 5.08%.<sup>8</sup> Within the index, WTI (West Texas Intermediate) crude oil prices rallied after making multi-decade lows and briefly going negative. Two main factors helped push prices higher: 1) the prospect of increased demand as the global economy recovers; 2) continued supply cuts by OPEC (Organization of the Petroleum Exporting Countries) and Russia. Within the precious metals group, gold remained positive for the quarter and upheld its safe-haven status. Silver also saw buying interest after experiencing heavy selling pressure during Q1. Going forward, precious and base metals are likely to remain volatile as investors attempt to understand the incoming data and hedge against equity volatility. **Overall, cyclical commodities (e.g. oil and copper) are pricing in a global rebound but could see renewed downward pressure if economic data points worsen, or there is a second wave of coronavirus cases. Gold and silver could see additional price appreciation on the back of US dollar weakness, political/economic uncertainty, or increased equity volatility.**

## VI. Looking Ahead

Coming into 2020, we held a constructive view on risk assets but stated that investors would need to recalibrate their future return expectations. We noted that most asset classes had recently performed above their long-term averages and were likely to revert to the mean going forward. Although we had no idea about the looming

pandemic, we were growing increasingly concerned about valuations and the longevity of the economic cycle. Roughly three months later, the global economy was in a recession, and most equity markets were in bear market territory and traded at or below their long-term valuations. Since then, global stocks have rebounded sharply and once again appear somewhat expensive relative to history. This is not a reason to sell, but investors must be aware that the risk-reward for equities has moved towards the neutral zone.

For the next twelve months, we keep a cautiously optimistic view on global equities but expect volatility to remain prevalent. Historically, the duration of the peak-to-trough market decline during recessionary bear markets has been 18 months – the 2020 selloff lasted about a month before bottoming.<sup>9</sup> With that in mind, equities may retrace part of the recent rally before resuming their long-term uptrend. If this occurs, it would likely create a great buying opportunity. Within equities, small caps and cyclical sectors (e.g. tech) have typically exhibited the best performance coming out of recessions, and this has remained true during the current episode.<sup>10</sup> High-quality bonds such as US Treasuries have performed well but could lag as interest rates move higher. Finally, credit-oriented fixed income such as high yield bonds could continue to provide attractive returns as earnings bottom and investors seek yield-oriented investments. Looking ahead, we plan to remain nimble and hold an optimistic view that the markets and the global economy will continue to recover over the coming 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
2. Bloomberg
3. Strategas Research
4. Bloomberg
5. Bloomberg
6. Bloomberg
7. Bloomberg
8. Bloomberg
9. J.P. Morgan
10. Goldman Sachs

**Citi Economic Surprise Indices**

\*The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected. For more information please contact your Citi salesperson, visit [www.citivelocity.com](http://www.citivelocity.com).

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