

Dear friends of Arcus Capital Partners,

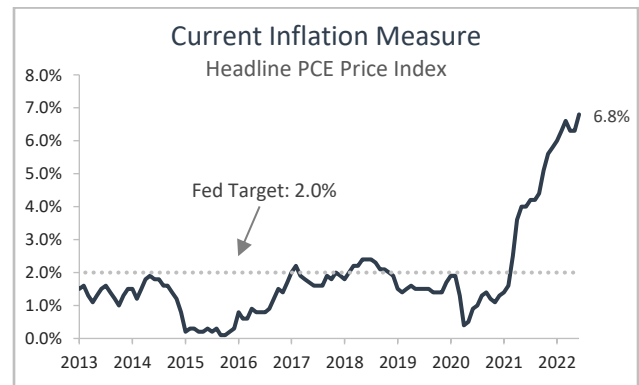
We hope this letter finds you well and that you are having a great summer. During the second quarter, the Federal Reserve (Fed) roiled markets as they aggressively raised interest rates to tame a decades-high inflation rate. In turn, tighter financial conditions led to deteriorating economic data and applied additional pressure to asset prices. Global equities were down double-digits as investor sentiment turned bearish on the back of increased recessionary fears. Interest rates rose during the quarter but finished below their recent highs. Finally, commodities were mixed but ended in the red at the index level due to US dollar strength and investors discounting a slower growth outlook. We maintain a positive view of equities over the next twelve months; however, we recognize that near-term headwinds could lead to 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

For the first time in over two years, the main topic of discussion amongst investors was not the coronavirus. Instead, market participants focused on inflation data and how it would shape the Federal Reserve's monetary policy. Roughly a year ago, many experts (including the Fed) believed that the uptick in inflation would be transitory and begin to subside later in the year. Unfortunately, supply-chain bottlenecks, labor shortages, rising commodity prices, and several other factors led to a continued price increase for most goods and services (Chart 1). This outcome forced the Fed to move into restrictive territory much faster than most pundits expected. At the start of the year, analysts anticipated no more than three rate hikes in 2022 (e.g. 25 basis points (bp) = 0.25%). As of late July, the Fed has hiked nine times and will likely raise rates four more times by year-end.<sup>1</sup> It is

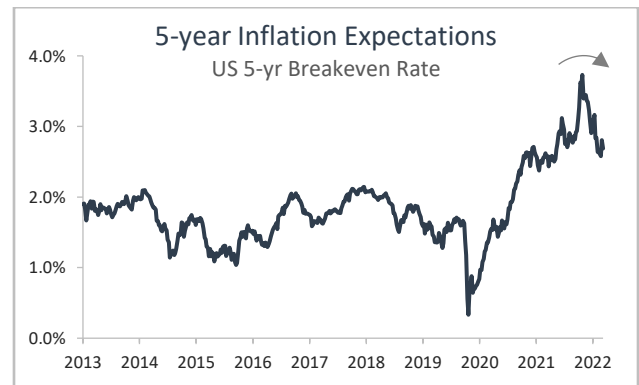
also worth noting that the Fed raised rates in June and July by 75 basis points for the first time since 1994.<sup>2</sup> Policy shifts of this magnitude have historically had severe repercussions for the markets and the economy, and this cycle is no different. Equities, credit, and high-quality fixed income declined in unison during the first half of 2022. Additionally, domestic growth began to decelerate due to slowing demand and higher costs. Nonetheless, we may have seen peak inflation data for this cycle. Several metrics have started rolling over and should allow the Fed to slow the pace of its future rate hikes (Charts 2-3). This result would bode well for most asset classes.

Chart 1



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

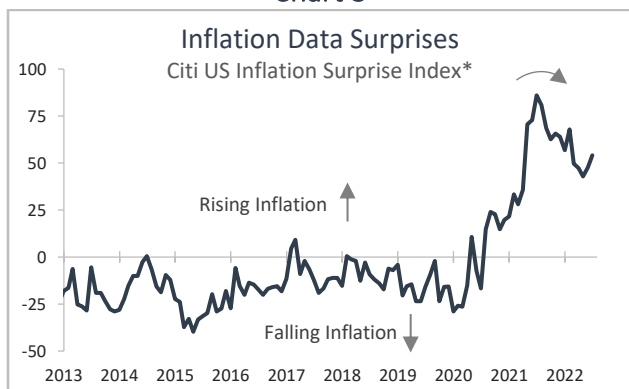
Chart 2



Source: Bloomberg; Arcus Capital Partners



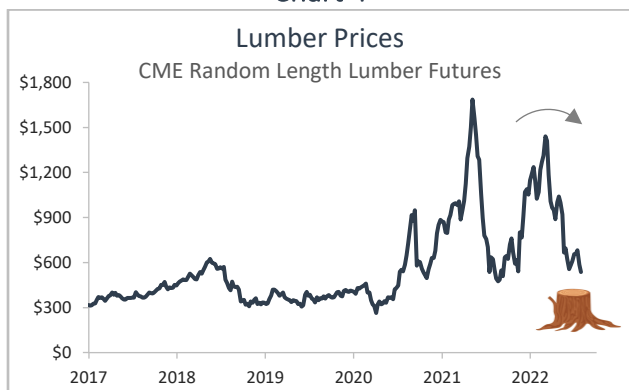
Chart 3



Source: Bloomberg; Arcus Capital Partners; \*Citi US Inflation Surprise Index definition available at the end of the commentary.

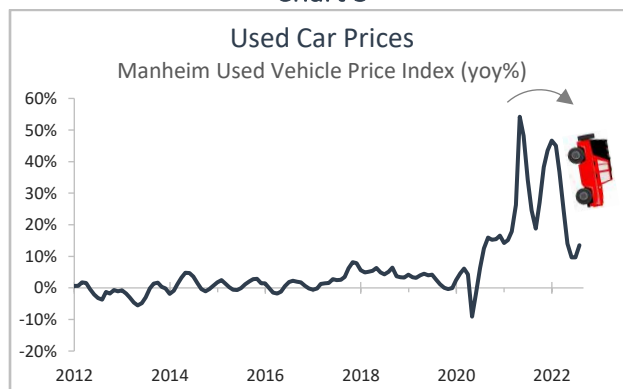
The Federal Reserve’s preferred measure of inflation, the Core Personal Consumption Expenditure (PCE) Price Index, is still well above its target rate of 2.0% but recently started moderating. The Fed will likely continue tightening its monetary policy until it sees substantial progress on the inflation front. Nevertheless, prices in some areas have declined over the last few months. For instance, lumber prices have fallen as rising rates and record-level prices have dampened the red-hot housing market (Chart 4). Likewise, freight rates are down from recent highs, used vehicle prices have been falling, and a rise in retail inventories suggests price discounts are forthcoming (Chart 5). It is worth noting that monetary policy changes tend to have a lagged effect on economic activity and prices, so the trend of softening data and lower prices should continue during the back half of the year. On the other hand, the financial markets tend to recognize turning points much quicker and may be signaling a change has already occurred.

Chart 4



Source: Goldman Sachs; Arcus Capital Partners

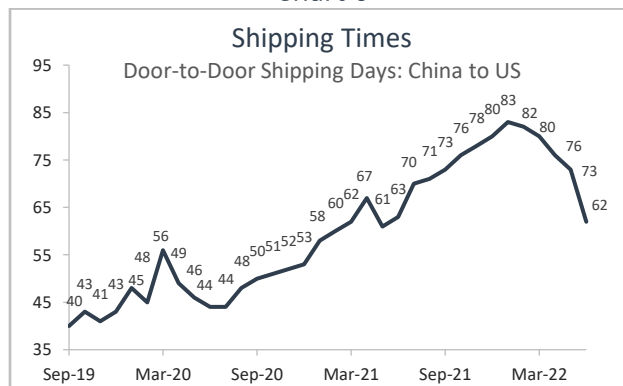
Chart 5



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

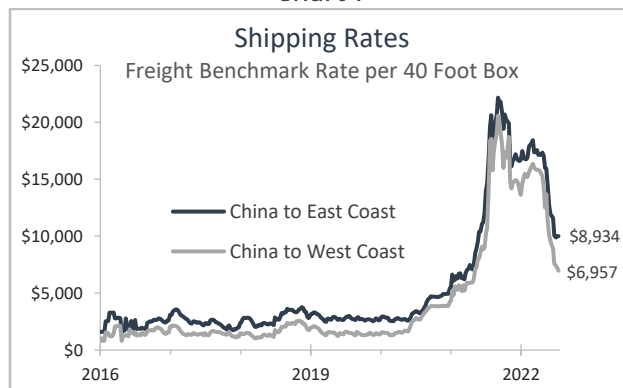
Supply-chain bottlenecks are also starting to heal, helping to reduce shipping times and costs (Charts 6 & 7). Fortunately, falling Covid-19 cases in China have allowed their government to ease pandemic-related lockdown measures. This positive development should help alleviate prices as the supply of Asian goods (e.g. semiconductors) increases and input costs continue to decline.

Chart 6



Source: Goldman Sachs; Arcus Capital Partners

Chart 7

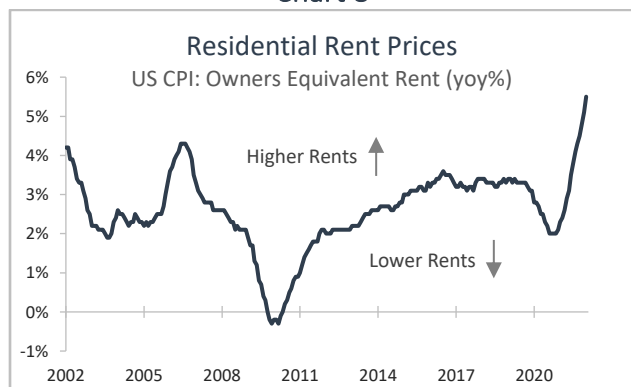


Source: Bloomberg; Arcus Capital Partners



We expect inflation to gradually fall over the balance of the year but remain above pre-pandemic levels. That said, there are a few areas where prices remain elevated. For instance, residential rents remain at all-time highs as many potential home buyers have decided to rent (Chart 8). Contributing factors include a nationwide housing shortage, record-level asking prices, and increased mortgage rates. Nevertheless, an increase in the supply of multi-family units (e.g. apartments) and reduced selling prices for single-family homes should eventually lead to lower rents.

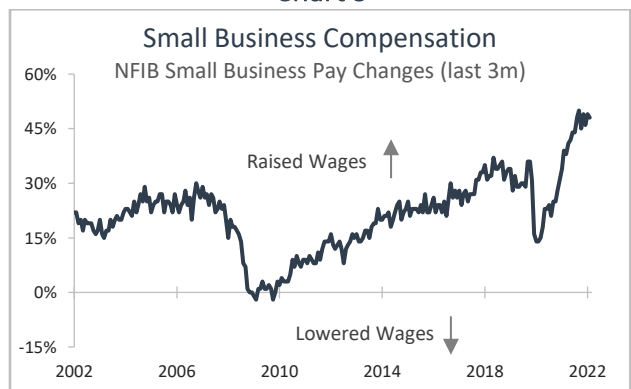
Chart 8



Source: Bloomberg; Arcus Capital Partners

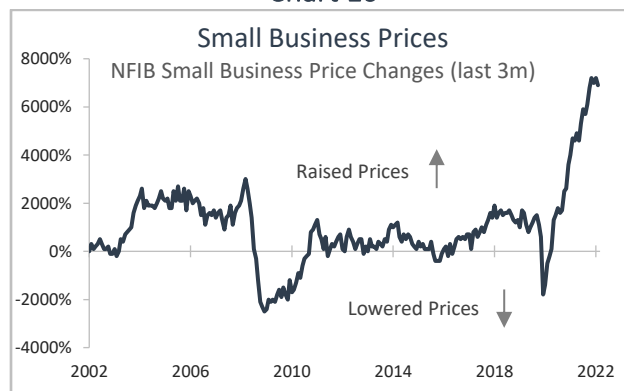
Another area of concern is the tight labor market. A lack of quality labor has forced employers to raise wages to entice workers, and, in turn, they have raised prices to offset this and other increased costs (Charts 9-10). The Federal Reserve is keenly aware and hopes to decrease the number of open jobs by slowing the economy. This process is slow, but jobless claims have started ticking up, and the number of available jobs has recently declined.<sup>3</sup>

Chart 9



Source: Bloomberg; Arcus Capital Partners

Chart 10



Source: Bloomberg; Arcus Capital Partners

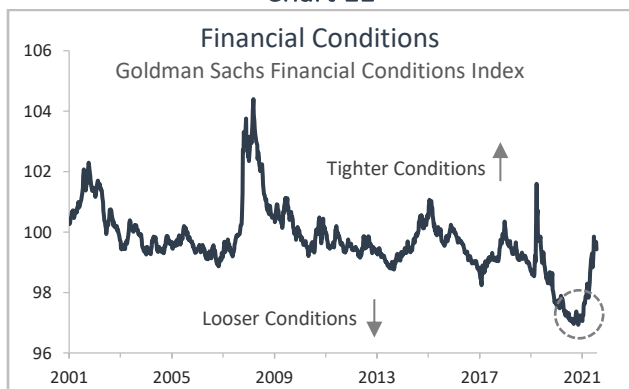
The odds of a recession remain elevated, and according to the latest GDP print, we may already be in one.<sup>4</sup> The technical definition is two quarters of negative GDP growth; however, other data points remain firm and suggest this would be an extremely mild recession. Over the coming quarters, the market has several hurdles to navigate, including: additional Fed tightening; slowing global growth; and depressed consumer and CEO confidence. Additionally, the mid-term elections are fast approaching and have historically coincided with increased market turbulence. **Overall, the macro backdrop remains mixed, but some indicators suggest that asset prices may have put in their lows for this bear market cycle. We believe volatility will remain elevated over the coming months but see weakness as a long-term buying opportunity.**

## II. US Equities

After a weak start to the year, domestic equities ended the second quarter deep in the red. The S&P 500 index finished well off its intra-quarter lows and ended down by **-16.11%**, while the small cap Russell 2000 index declined by **-17.21%**.<sup>5</sup> Financial conditions continued to tighten as the Federal Reserve remained committed to raising rates to fight inflation (Chart 11). This put downward pressure on the broad equity markets and adversely impacted companies and sectors with a growth bias, such as technology (Charts 12-13). These areas performed very well over the last few years when financial conditions were loose but have since given back much of their gains.



Chart 11



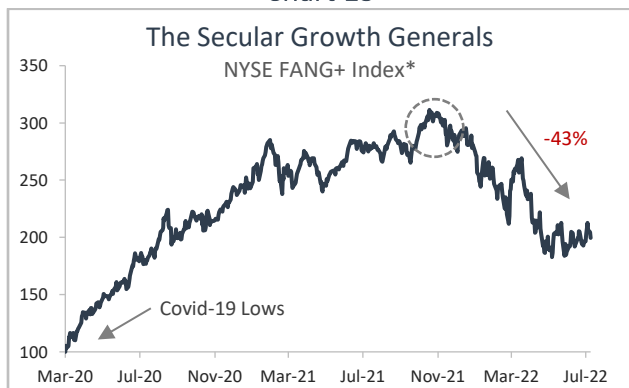
Source: Bloomberg; Arcus Capital Partners; the GS FCI Index is the weighted average of riskless interest rates (49.5%), exchange rates (6%), equity valuations (4.9%), and credit spreads (39.6%), with weights that correspond to the direct impact of each variable on GDP.

Chart 12



Source: Bloomberg; Arcus Capital Partners

Chart 13



Source: Bloomberg; Arcus Capital Partners; performance indexed to 100 on March 18, 2020; \*NYSE FANG+ Index definition available at the end of the commentary.

Equities will likely remain volatile and rangebound over the next few quarters as the Fed raises short-term rates and the mid-term elections loom. Mid-term election years have experienced an average

drawdown of ~19% that bottoms just ahead of the election.<sup>6</sup> However, these occurrences have provided attractive buying opportunities – the S&P 500 has rallied by ~32% over the next twelve months.<sup>7</sup> For now, the market appears to be trading in a sideways consolidation as investors wait for more clarity. Oversold areas within the growth-oriented sectors, such as technology, may rally from current levels but are unlikely to reemerge as market leaders. **In our view, investors must remain patient and selective when buying stocks. We maintain a favorable outlook for US equities and prefer higher-quality companies that pay dividends.**

### III. International Equities

Foreign stock performance was negative for the quarter as international developed equities (MSCI EAFE) declined by **-14.32%**, and emerging markets (MSCI EM) fell by **-11.37%**.<sup>8</sup> High inflation and tightening global central bank policy led many analysts to downgrade their view of non-US stocks. That said, the worst may have passed for EM stocks, specifically Chinese equities. China recently started easing its lending standards to spur economic growth (Chart 14). Unlike the rest of the world, China is attempting to loosen financial conditions. It is also worth noting that Chinese markets have declined by ~50%, and their valuations are attractive relative to their long-term averages.<sup>9</sup> Risks remain intact and include the prospect of a global recession and rising covid cases in Asia. **We maintain our positive view of EM equities but have downgraded our outlook for non-US developed markets to neutral.**

Chart 14



Source: Bloomberg; Arcus Capital Partners



## IV. Fixed Income

Interest rates marched higher during the quarter as persistently high inflation and hawkish rhetoric from the Federal Reserve caused investors to shun bonds. At the start of the year, analysts anticipated the Fed would raise short-term rates no more than three times in 2022 to around 0.75%. Today, that number sits closer to ~3.50%, with the expectation of several additional 50bp increases.<sup>9</sup> The US 2-year yield ended the quarter at **2.95%**, while the 10-year yields finished at **3.01%** (Chart 15).<sup>10</sup>

Chart 15



Source: Bloomberg; Arcus Capital Partners

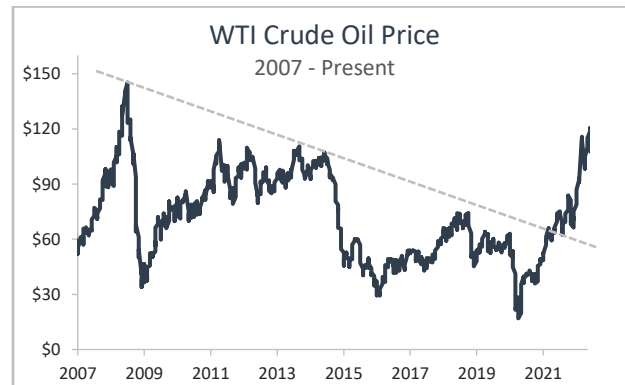
Rising yields weighed on rate-sensitive bonds and pushed them further into the red. The Barclays Aggregate Bond Index finished down by **-4.69%**, while the tax-free Barclays Municipal Bond Index dropped **-2.94%**.<sup>11</sup> Credit markets were not immune, as the Bloomberg High Yield Index finished the quarter down by **-9.83%**, and the S&P/LSTA Leveraged Loan Index only declined by **-4.45%**.<sup>12</sup> Overall, credit markets are not showing any major cracks, but this is an area we are watching closely for signs of stress.

**We expect the Fed to raise short-term interest rates to 3.0-3.50% in 2022 and continue hiking in early 2023 towards a terminal rate of 4.0%. This is likely to push interest rates higher across the yield curve. Higher-quality bonds remain unattractive due to their inverse relationship with rates, which are likely to keep rising this year. Within credit, we prefer floating rate sectors and private credits with a lower correlation to the public market and interest rates.**

## V. Commodities

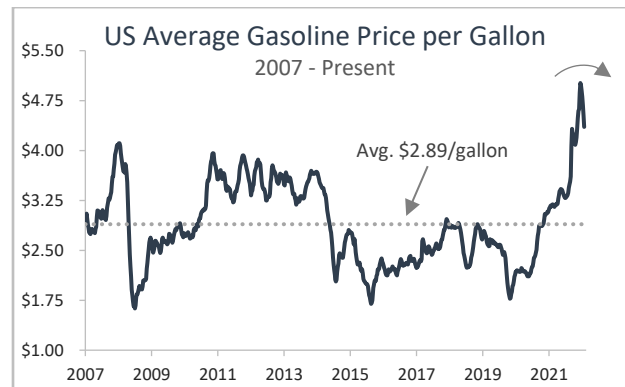
After a solid start to the year, the commodity complex finished down slightly during the last three months. The Bloomberg Commodity TR Index ended the quarter down **1.12%**.<sup>13</sup> That said, crude oil climbed to ten-year highs, sending gasoline prices to nearly \$5/gallon (Charts 16-17). The longer-term outlook for energy remains uncertain as central banks remove accommodative policy to tame inflation, potentially slowing the global economy and hurting oil demand. Another wildcard is the war between Russia and Ukraine – an eventual ceasefire will likely erase the war premium embedded in current prices.

Chart 16



Source: Bloomberg; Arcus Capital Partners

Chart 17



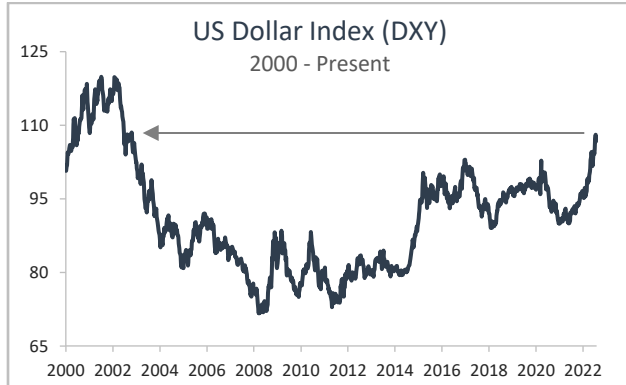
Source: Bloomberg; Arcus Capital Partners

Elevated equity volatility and increased macro uncertainty helped gold prices, even as the US dollar (USD) strengthened and interest rates rose (Chart 18). Over the last decade, investors have consistently hedged equity risk with high-quality bonds (e.g. Treasuries) due to their inverse nature.



However, this relationship broke down in 2022 as stock and bond prices declined simultaneously, forcing investors to seek uncorrelated hedges. Other asset classes, such as cryptocurrencies (e.g. Bitcoin), also failed to offer downside protection during the recent bout of equity weakness. For now, the setup for gold remains positive and should provide an attractive hedge against continued equity volatility and geopolitical risks.

Chart 18



Source: Bloomberg; Arcus Capital Partners

**We remain bullish on economically sensitive commodities but recognize that near-term headwinds are forming. We also think precious metals may provide a good hedge in the current market environment.**

## VI. Looking Ahead

Over the next few quarters, we expect equity volatility to stay elevated and believe the market will remain rangebound. Tighter monetary policy, the looming mid-term elections, and softer

economic data are some of the hurdles the market faces. Nevertheless, any potential weakness could set up a great buying opportunity as equities have historically performed well the year after a mid-term election. For now, investors should focus on higher-quality companies that can withstand rising costs and return capital to shareholders.

Above-average inflation, fading monetary policy support, and reduced investor demand have the potential to push interest rates higher across the yield curve, albeit at a slower pace. In turn, rate-sensitive bonds such as Treasuries and high-quality corporate bonds stand to underperform. The one caveat is short-term rates, which could start looking interesting if the Fed raises rates as expected. Credit spreads remain very tight and do not offer attractive risk-adjusted returns. We prefer floating rate loans and private credit (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. Additionally, gold has the potential to continue hedging against market volatility and macro risks.

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. Federal Reserve
3. Bloomberg
4. Bloomberg
5. Bloomberg
6. Strategas Research
7. Strategas Research
8. Bloomberg
9. Bloomberg
10. Bloomberg
11. Bloomberg
12. Bloomberg
13. Bloomberg

\*The Citi Inflation Surprise Indices measure price surprises relative to market expectations. A positive reading means that inflation has been higher than expected and a negative reading means that inflation has been lower than expected.

\*The NYSE FANG+ Index is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded growth stocks of technology and tech-enabled companies such as Facebook, Apple, Amazon, Netflix, and Alphabet's Google.

**Important Risk and Disclosure Information**

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