

Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you had a great summer. The third quarter was packed full of market-moving headlines and saw volatility increase across all asset classes. Global equities were mixed with US large cap stocks moving higher but many other markets declining. Interest rates continued to fall due to the same catalysts as last quarter: slowing economic growth, additional easing from central banks, and anxieties related to the US-China trade war. Commodities declined but saw notable rallies within the precious metals group. Overall, investors seemed nervous as they attempted to make sense of the current backdrop. Nevertheless, the near-term outlook is improving as global data attempt to stabilize, central banks continue to provide monetary stimulus, and the lingering trade wars slowly de-escalate – all of which could create a promising fourth quarter.

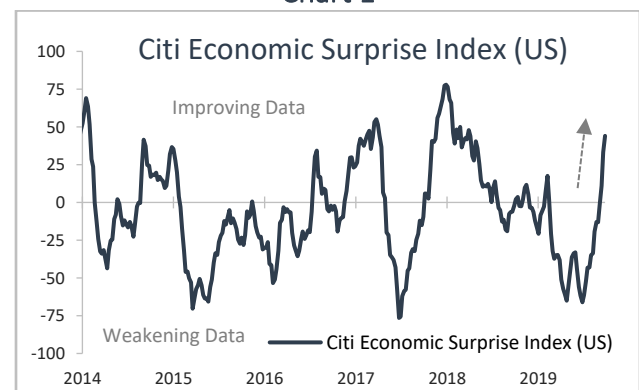
I. Market & Economic Overview

Throughout the third quarter, global markets continued to exhibit above average volatility as investors were forced to endure a constant flow of macro events, geopolitical headlines, and presidential tweets. Specific examples included the Federal Reserve (Fed) cutting short-term rates for the first time in 10 years; President Trump introducing additional tariffs on Chinese imports; terrorist attacks on Saudi Arabian energy infrastructure; and the launch of formal impeachment proceedings against the President. So far, the latter two appear to have been more noise than news but it is too early to draw any formal conclusions. However, the Fed rate cuts, and additional tariffs were much more noteworthy and could have longer-lasting implications on the markets and global economy.

At the end of July, the Federal Reserve reduced short-term interest rates for the first time since late

2008. This was a complete reversal by Fed policymakers who just raised rates at their December meeting and had anticipated two additional hikes this year.¹ The rationale behind the July cut (and an additional one in September) was based on growing uncertainty surrounding the US-China trade war, slowing global growth, and lack of inflationary data. Their forward guidance suggested that additional cuts may be warranted but will continue to be data dependent. Based on recent comments from Chairman Powell, it is clear that the Federal Reserve is attempting to extend the current business cycle by easing financial conditions, but there is growing concern that they will lack the adequate monetary tools needed to pull the economy out of the next recession. Although it does not appear as if they are considering negative interest rates, the Fed may be forced to revisit the idea if and when the next recession occurs. For now, domestic activity data have been surprising to the upside (Chart 1) and trade talks appear to be progressing; nonetheless, we anticipate one more rate cut in 2019.

Chart 1



Source: FactSet; Arcus Capital Partners

As has been the case for well over a year, the US-China trade war continues to garner the most attention. The day after the Fed cut interest rates in July, President Trump imposed additional tariffs



on Chinese goods. This sparked a month-long period of increased stock market volatility and sent rates to multi-year lows. In fact, at one point in August, J.P. Morgan estimated the total value of negatively yielding debt to be around **\$17T**, or **~30%** of the Bloomberg Global Aggregate Bond index.² Unfortunately, the trade war has also continued to weigh on CEO confidence which has in turn reduced corporate spending and could start hurting the labor market. Even so, many data points have recently started firming, and global equities and rates quickly retraced a large portion of the August decline. **Looking forward, headline risks will likely remain high, but we believe President Trump will get some sort of trade deal done in order to avoid a US recession or bear market before the election.**

II. US Equities

Domestic stocks ended the quarter mixed as investor sentiment turned cautious. The S&P 500 large cap index finished up **1.70%**, while the smaller capitalization Russell 2000 Index, ended down **-2.40%**.³ Interestingly, the S&P 500 index has only increased by **~10%** since the beginning of 2018 when the trade war began (Chart 2), and most non-US indexes are actually trading well below their early-2018 levels. It is clear that tariffs and trade tensions have been the biggest detractors to global growth and investor confidence over the last year and a half.

Chart 2



Source: FactSet; Arcus Capital Partners

The domestic economy grew over the last quarter but started showing some signs of weakness. The US consumer continues to be the workhorse

driving economic growth, but certain consumer confidence measures suggest that this trend might be turning. The labor market remains healthy but has started cooling in certain sectors – this could be playing a part in the softer consumer data. Finally, the manufacturing sector has continued to weaken and now sits in contractionary territory for the first time since 2016. On the bright side, the housing market has improved with help from lower interest rates, and many domestic data points have recently started beating expectations. In aggregate, the US economy is showing normal late-cycle stresses, but many pundits are hopeful that the soft data is transitory and will reaccelerate over the next few quarters – we agree. **Overall, the odds of a recession occurring in the next 12 months has risen but remains below 50%.**

Fundamental valuations have not changed much since last quarter with the forward 12-month price-to-earnings ratio (P/E) for the S&P 500 still sitting around **17x**.⁴ As noted last quarter, this level is not overly expensive but does not allow much room for error. With that being said, any improvements in US data would likely provide a nice tailwind. More importantly, any sort of trade deal with China could boost CEO confidence, release pent-up corporate demand, and lead to increased capital expenditure spending. Also, any reduction in tariffs would likely go straight to the bottom line of the firms that have been directly impacted. Outside of fundamentals, investor sentiment remains negative and could be one of the best contrarian arguments in favor of stocks. Investors are rightfully nervous and have reduced their equity allocations accordingly; however, any positive developments could lead investors back to the stock market and push prices higher. Overall, the outlook for US equities is bullish but less so than earlier this year. **We remain optimistic but stand ready to reduce exposure as needed.**

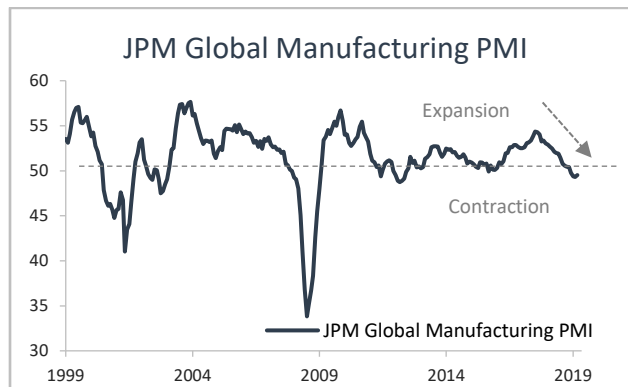
III. International Equities

Looking abroad, non-US equity performance was mixed as the global growth picture remained weak. Developed International (MSCI EAFE) and Emerging Market (MSCI EM) equities ended the quarter down **-1.0%** and down **-4.25%**, respectively.⁵ Drivers contributing to their



underperformance included tepid growth in Europe and Asia, a defiantly strong US dollar, and fallout related to the US-China trade war. Similar to the US, global manufacturing has been slowing and also sits in contractionary territory (Chart 3). Somewhat unsurprising is the fact that this data point peaked in early-2018, the same time non-US equities made their last highs and when the US-China trade war commenced. Assuming trade tensions ease, non-US markets will likely be one of the largest benefactors. In the meantime, the European Central Bank (ECB), Bank of Japan (BOJ), and People's Bank of China (PBOC) have all implemented new stimulus measures in hopes of providing a backstop.

Chart 3



Source: J.P. Morgan; Arcus Capital Partners

Lastly, valuations for international developed and emerging market indexes are attractive but not overly cheap. Slowing growth has hurt earnings which continue to be revised lower. Even so, these areas are under owned by investors and could experience a period of outperformance if there is a trade resolution or improvement in global data.

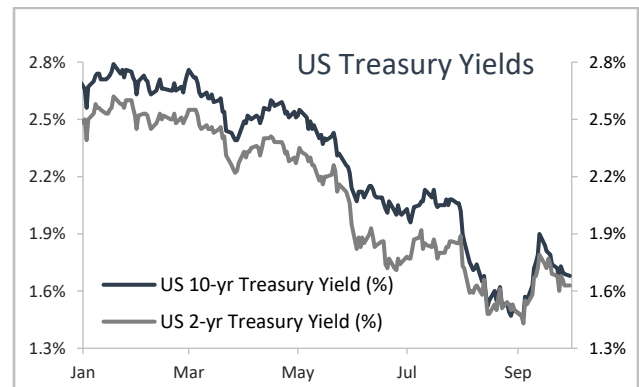
For these reasons we maintain a bullish view.

IV. Fixed Income

Interest rates continued on their downward path throughout the summer and made fresh multi-year lows. Slowing global growth, investor de-risking, and easing by central banks all played a part. The 2-yr and 10-yr US Treasury yields ended at **1.63%** and **1.68%**, respectively (Chart 4).⁶ Additionally, in August, the 2-yr/10-yr yield curve inverted for the first time since the financial crisis (Chart 5). This is important because an inverted or negative yield

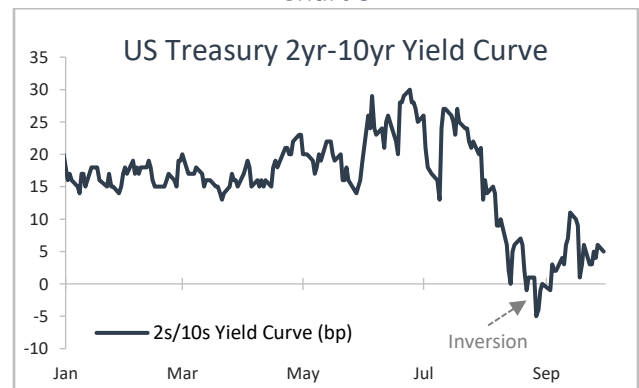
curve has typically preceded most recessions by an average of 18 months.⁷ To be clear, we do not foresee a recession occurring in the near term, and the curve has since steepened out of inversion. Nevertheless, this is something to keep in mind as the current economic cycle matures into one of the longest on record – now over 10 years old.⁸

Chart 4



Source: FactSet; Arcus Capital Partners

Chart 5



Source: FactSet; Arcus Capital Partners

Although interest rates have declined substantially over the last year, part of the move can be justified by the current environment. Some of the contributing factors include waning global growth, dovish central bank policy (i.e. rate cuts), benign inflation, and a strong investor appetite for income producing investments. Even so, the recent decline in rates appears overextended and a retracement higher seems probable. For instance, we do not anticipate a recession occurring in the next year, we are optimistic that global growth is troughing, and think trade tensions will ease – all of which suggest rates could move higher.

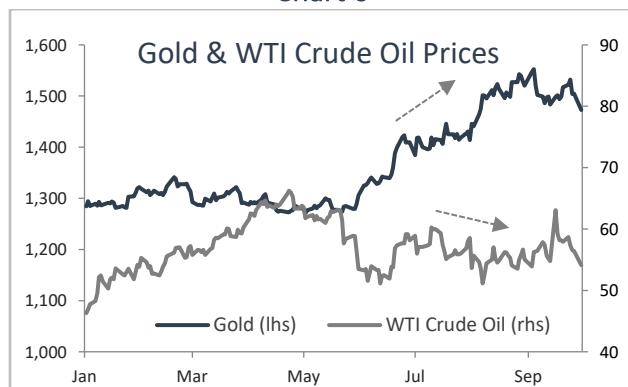


Moving to fixed income indexes, falling rates once again helped boost bond prices and sent the Barclays Aggregate Bond Index and the tax-free Barclays Municipal Bond Index higher by **2.27%** and **1.58%**, respectively.⁹ Nonetheless, interest rates are sitting near their lowest levels of the current market cycle and appear biased to the upside. This in turn makes the core bond space (interest rates sensitive bonds) less attractive as an investment or hedge against equity risk. On the credit side, high yield bonds and leveraged loans performed well during the quarter as yield starved investors had to stretch for income. The Bank of America High Yield Index finished up **1.26%**, and the S&P/LSTA Leverage Loan Index ended up **1.36%**.¹⁰ **Going forward, we expect interest rates to rise but stay in a new lower range. We see the yield curve steepening from current levels and anticipate credit will perform well during the remainder of the year.**

V. Commodities

Commodities finished the quarter down as fears over slowing end user demand weighed on cyclical groups such as industrial metals (e.g. copper) and energy (e.g. crude oil). Not even Chinese stimulus measures or the attack on Saudi energy infrastructure could help prop up these groups. At the index level, the Bloomberg Commodity Index finished down **-1.84%**.¹¹ Below trend global growth and a stronger US dollar were the two biggest headwinds for the space. **With that being said, this trend could reverse if activity data improve or the US dollar moves lower.**

Chart 6



Source: FactSet; Arcus Capital Partners

Even with the index finishing down, there were some positive sub-groups worth mentioning. Gold and silver had standout quarters as the precious metals directly benefited from the heightened level of macro uncertainty, falling rates, and equity volatility (Chart 6). **We think gold and silver can continue to outperform over the coming year.**

VI. Looking Ahead

With the final months of the year upon us, we believe the same global macro drivers will continue to dictate the market's trajectory into year-end. Investors will be closely watching the progress of the US-China trade war; the path of the global economy; and central banks' ability to stimulate growth via looser monetary policy. For now, it appears that President Trump holds all the cards; he alone has the potential to extend the business cycle with a trade deal or risks a recession or bear market during an election year. As we move closer to 2020, we think he will choose a détente with China, but the window for getting a deal done is closing.

For the fourth quarter, we maintain a positive view on global equities and do not expect a replay of last December. Assuming global growth starts firming or trade tensions ease, equities and interest rates will likely move higher. The final months of the year have historically been favorable for stocks which would dovetail nicely with our outlook. However, investors must remain nimble and recognize that the cycle is very mature – potential asset price appreciation may be limited. Looking ahead, we will continue monitoring indicators that have historically provided hints of an impending bear market – some of which have already started flashing early warning signs. For that reason, we hold a cautious but optimistic view of the markets and global economy for the rest of 2019.

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. Federal Reserve
2. J.P. Morgan
3. FactSet
4. FactSet
5. FactSet
6. FactSet
7. J.P. Morgan
8. J.P. Morgan
9. FactSet
10. FactSet
11. FactSet

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