ARCUS CAPITAL PARTNERS

Q3 | 2020 MARKET COMMENTARY

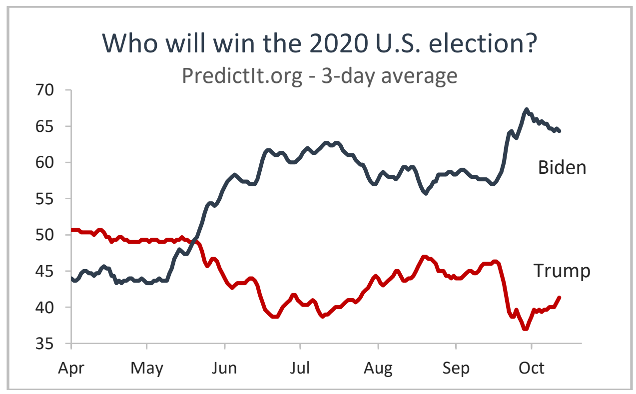
Dear friends of Arcus Capital Partners,

We hope this letter finds you in good health during this extraordinary time. The third quarter ended with an uptick in volatility, but most asset classes managed to finish in the green. The global economy continued to rebound; however, many data points remain below their pre-COVID levels. On a positive note, global stocks pushed higher during the quarter, and several domestic indexes made new all-time highs. Interest rates stayed anchored near historically low levels due to large-scale monetary stimulus measures and demand from yield-seeking investors. Lastly, commodities rallied but came under pressure during September. Overall, the final three months of 2020 will likely keep investors on their toes, but the current set up appears favorable for stocks and other risk assets.

I. Market & Economic Overview

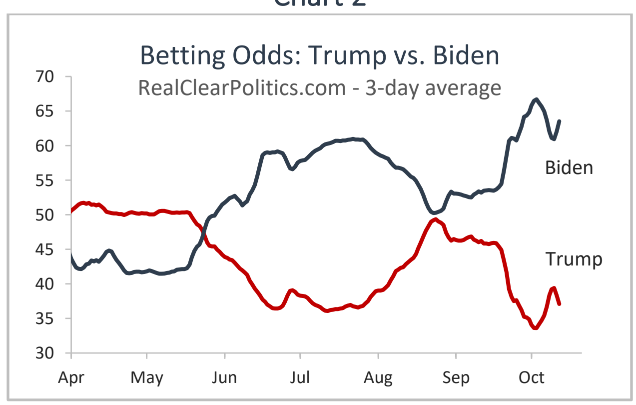
With summer officially over and hopes of a COVID-19 vaccine increasing, the market has shifted its focus to the upcoming elections. According to many polls and the current betting odds, Joe Biden is leading President Trump by a wide margin (Charts 1 & 2). Interestingly, research from J.P. Morgan shows that the predictive power of polling is not very accurate until the final 30 days leading up to the election.[1] Recall in 2016, most polls projected Hillary Clinton as the most likely winner until election night. Either way, this election could become controversial for another reason. Specifically, the coronavirus has created mobility issues for many people, which will likely lead to increased use of mail-in ballots and could delay the final results. Several states plan to allow mail-in ballots postmarked by November 3rd to be counted in the days/weeks after the official election concludes.[2] Under a worst-case scenario, if the Electoral College does not determine a winner by mid-December, the results are nullified. Under this unlikely scenario, Congress will hold a contingent election to choose the president and vice president (click here for more details). Regardless of the outcome, investors should expect bouts of instability in the coming months. However, any weakness could prove to be a buying opportunity as equities have historically rallied during the first year of the presidential cycle.[3]

Chart 1



Source: RealClearPolitics; Bloomberg; Arcus Capital Partners

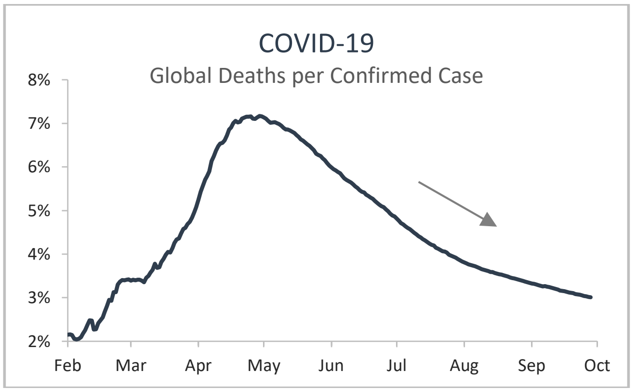
Chart 2



Source: PredictIt; Bloomberg; Arcus Capital Partners

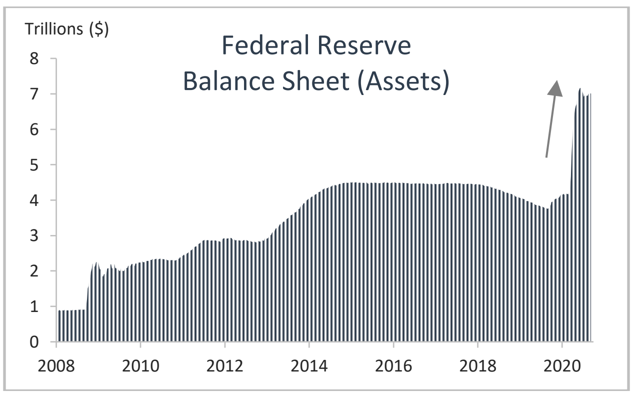
Away from the election, the COVID-19 pandemic remains top of mind. The number of globally confirmed cases continues to climb as available testing improves, but the number of deaths as a percentage of infections has steadily declined (Chart 3). Additionally, many pundits are optimistic that a vaccine could get approved by the end of the year or early-2021. This outcome would go a long way to restoring the economic damage caused by the quarantine measures.

Chart 3



Source: Bloomberg; Arcus Capital Partners

Chart 4



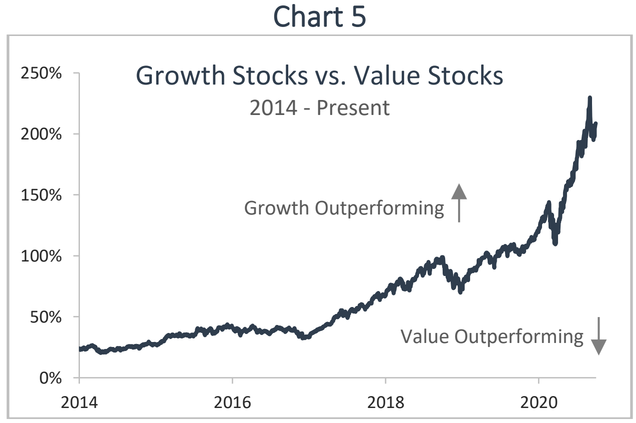
Source: Bloomberg; Arcus Capital Partners

From here, the macro outlook remains dependent on two key variables. The first is the length of time needed to get a vaccine approved. As noted, this could occur in the next 3-6 months and would be a positive catalyst for the global economy. The second factor is the willingness of central banks and governments to provide additional monetary and fiscal aid. Within the US, the Federal Reserve has implemented massive programs and has markedly expanded its balance sheet (Chart 4). On the fiscal side, the US government has provided significant assistance and is currently working on another package. Collectively, this support and aid from other central banks and governments should allow the global economy to escape recession during 2020. The equity markets have already priced-in a V-shaped recovery, but divergences have formed under the surface. In particular, the spread between COVID winners (e.g. tech) and losers (e.g. airlines) has become very wide and could remain that way until a vaccine is approved. **We anticipate the remainder of the year will be volatile but think patient investors will continue to be rewarded.**

II. US Equities

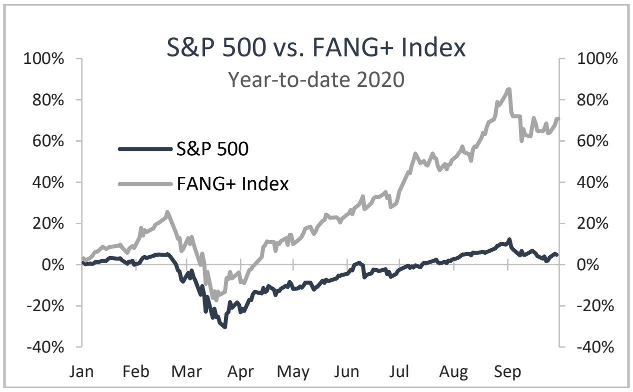
Domestic stocks continued to climb during the third quarter on the back of improving earnings, firming growth, and large-scale stimulus. The S&P 500 index finished up **8.93%**, and the smaller capitalization Russell 2000 index was up **4.93%**.[4] The ongoing trend of growth stocks (e.g. Apple) outperforming value stocks (e.g. Exxon Mobil) continued as well (Chart 5). In fact, the growth index has outperformed value by over 30% year-to-date – the widest spread since the late-1990s.[5] The large gap between the indexes is best explained by their underlying holdings. The growth index is dominated by the FANG stocks (e.g. Facebook, Apple, Amazon, Netflix, and Google), which have benefited from the stay-at-home orders; and the value index consists of companies hurt by the pandemic (e.g. banks). A deeper dive also shows that the FANG+ Index has significantly outperformed the S&P 500 index in 2020 and now make-up roughly 20% of its total market cap (Chart 6).[6] This outperformance and high concentration is not a reason to turn bearish but something we are watching. For now, a COVID vaccine is the most apparent catalyst required to spark a reversal of this enduring phenomenon.

Chart 5



Source: Bloomberg; Arcus Capital Partners; Growth represented by the Russell 1000 Growth ETF (IWF); Value represented by the Russel 1000 Value Index (IWD).

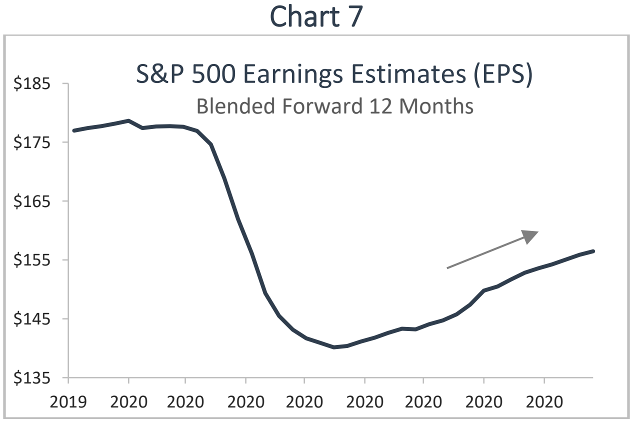
Chart 6



Source: Bloomberg; Arcus Capital Partners; see appendix for FANG+ Index constituents.

Fundamentals improved during the quarter as domestic firms reported above-average profits and forward estimates were revised higher (Chart 7). That said, price-to-earnings (P/E) multiples and other valuation metrics continue to inflate and remain elevated relative to history. Even so, the current low rate environment has made equities more attractive than fixed income and could support higher multiples. Lastly, domestic economic data points have been improving since bottoming in the second quarter, and the worst may be behind us. Housing data have been very resilient, and the labor market has slowly recovered. Consumer confidence and spending struggle to regain pre-COVID levels but have rebounded off the lows. From here, additional fiscal stimulus will remain a vital part of supporting the recovery effort.

Chart 7



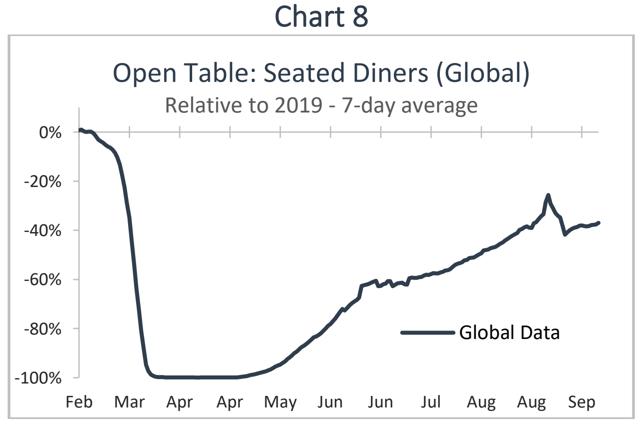
Source: Bloomberg; Arcus Capital Partners

The November elections are one of the last potential headwinds for equities in 2020. Right now, the market is pricing in an uptick in volatility around the election and the month afterward. The most significant risk appears to be a contested result or an extended delay in the official outcome, not the candidate who gets elected. Finally, it is worth repeating a statistic we discussed last quarter. According to Strategas Research, if the market is higher during the 3-months before the election (starting August 3rd), 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.[7] **Regardless of the election outcome, we remain optimistic that the economy will continue recovering over the next year and have a favorable long-term US equity outlook.**

III. International Equities

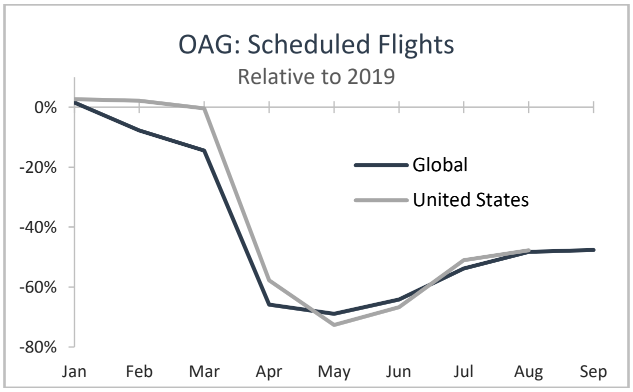
During the quarter, foreign equities once again rallied alongside the US markets. International developed (MSCI EAFE) stocks finished the quarter up **4.87%** while the emerging markets (MSCI EM) moved higher by **9.65%**.[8] Improving economic data, global stimulus programs, and US dollar (USD) weakness contributed to the Q3 performance. Right now, many hard data points (e.g. manufacturing) are back to pre-COVID levels, but other high-frequency activity measures (Charts 8 & 9) are still down year-over-year. Avoiding a second outbreak and new lockdown measures or getting a vaccine approved are critical to help get the global economy back to 2019-levels.

Chart 8



Source: OpenTable.com; Arcus Capital Partners; data includes seated diners from online, phone, and walk-in reservations.

Chart 9



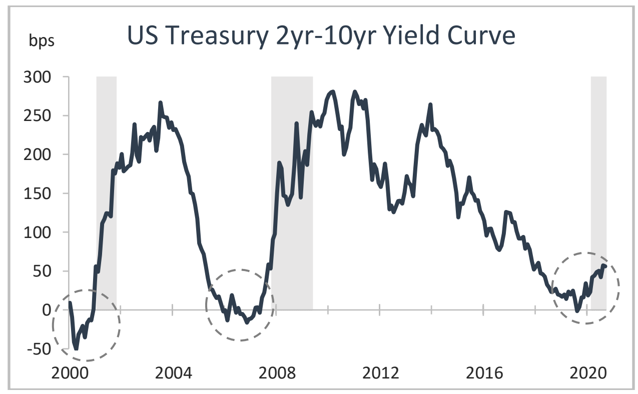
Source: Official Aviation Guide; OAG.com; Arcus Capital Partners

Chart 10

Source: Bloomberg; Arcus Capital Partners

As the global recovery unfolds, non-US equities could perform well on an absolute and relative basis. These markets have lagged their US counterparts over the last decade but are trading at cheaper relative valuations. Additionally, further US dollar weakness could provide a much-needed tailwind. Finally, central banks such as the European Central Bank (ECB) and Bank of Japan (BOJ) have pledged to continue providing monetary support for the foreseeable future. **For these reasons, we maintain a longer-term bullish view on both markets but expect an uptick in volatility in the coming months.**

Chart 11



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

IV. Fixed Income

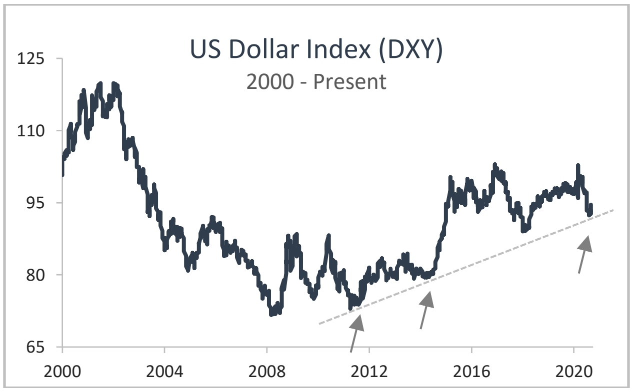
Interest rates traded within a tight range during the quarter and remained near their recent lows (Chart 10). The 2-year and 10-year US Treasury yields ended the quarter at **0.13%** and **0.68%**, respectively.[9] The persistently low volatility seen in the rates market is a consequence of the Federal Reserve's steadfast desire to keep monetary policy as supportive as possible. To do so, they have lowered short-term rates to near zero and are actively buying bonds in the open market. The yield curve (2-yr minus 10-yr yield) continued to steepen similar to past recessionary episodes; however, the steeping pace has been slower this cycle (Chart 11). This is most likely the effect of the Fed's intervention into the fixed income markets and the heightened level of economic and political uncertainty. Lastly, fears of inflation remain low, which could be playing a part in keeping longer-term rates suppressed.

At the index level, rate-sensitive taxable and municipal bonds experienced muted performance. The Barclays Aggregate Bond Index ended the quarter up **0.62%**, and the tax-free Barclays Municipal Bond Index finished the quarter higher by **1.23%**.[10] Within credit, spreads continued to grind tighter while bank loan prices increased. The Bloomberg High Yield Index finished up **4.60%**, and the S&P/LSTA Leveraged Loan Index ended up **4.14%**.[11] **Overall, interest rates appear biased upward but are unlikely to move materially higher in the near term. We think rate-sensitive bonds are unattractive and prefer credit.**

V. Commodities

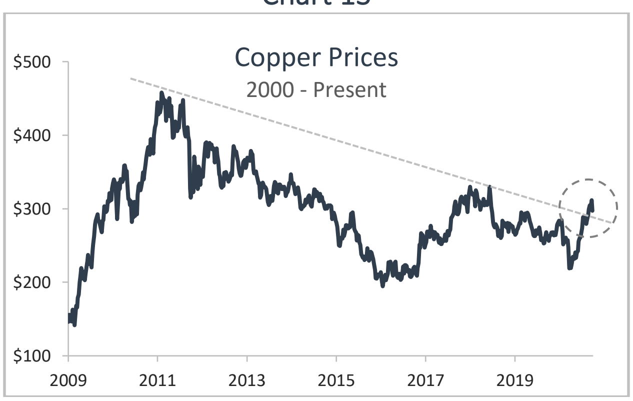
Commodities rallied during the quarter and benefited from the ongoing US dollar weakness (Chart 12) and firming economic conditions. The Bloomberg Commodity Index finished up **9.07%**.[12] Within the index, cyclical subgroups, such as the base metals (e.g. copper), broke out of multiyear downtrends as economic activity gained momentum (Chart 13). Precious metals saw continued investor interest, which sent silver higher and gold to new all-time highs (Chart 14). Finally, energy-related commodities remained in a tug-of-war between oversupplied global markets and large producers attempting to support prices via production cuts (i.e. OPEC).

Chart 12



Source: Bloomberg; Arcus Capital Partners

Chart 13



Source: Bloomberg; Arcus Capital Partners

Chart 14

Source: Bloomberg; Arcus Capital Partners

Overall, cyclical commodities (e.g. copper) are pricing in a global rebound but may need time to consolidate their recent gains. In contrast, precious metals should continue to benefit from a weakening USD, political/economic uncertainty, and increased market volatility.

VI. Looking Ahead

We keep a cautiously optimistic view on global equities for the next three months but expect increased volatility. Even so, the longer-term backdrop for risk assets is bullish and supportive of additional upside. Improving earnings, large-scale monetary and fiscal stimulus programs, and firming economic data should keep the markets elevated. That said, areas such as growth stocks have seen outsized returns relative to past bear market recoveries and may need time to digest their recent gains. Assuming the market becomes more volatile around the election, investors should consider using it as an opportunity to add to stocks.

Within equities, cyclical sectors have historically exhibited the best performance coming out of recessions – this has remained true this cycle.[13] Nevertheless, pockets of value have opened up, and investors may want to add to underperforming sectors that may benefit from a COVID vaccine. Interest rate-sensitive bonds such as Treasuries and US high-grade corporates have performed well but could struggle if rates remain range-bound or move higher. Finally, lower-rated credit such as high yield bonds and bank loans could continue to provide attractive returns as earnings recover, and investors seek out higher-yielding investments. Looking ahead, we plan to remain focused on locating attractive investment opportunities and continue to believe investors must be patient and keep a long-term view.

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. J.P. Morgan
2. NPR.org
3. Strategas Research
4. Bloomberg
5. Bloomberg
6. Bloomberg
7. Strategas Research
8. Bloomberg
9. Bloomberg
10. Bloomberg
11. Bloomberg
12. Bloomberg
13. Goldman Sachs

*FANG+ Index Constituents: Facebook, Apple, Amazon, Netflix, Google, Alibaba, Baidu, NVIDIA, Tesla, and Twitter

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