

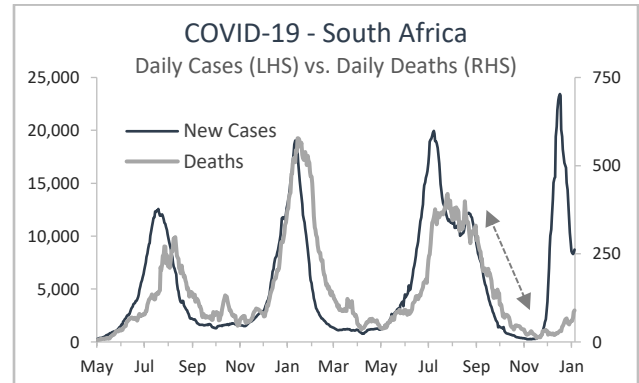
Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you had a wonderful holiday season. The final quarter of 2021 followed the recent trend of market-moving headlines focused on COVID-19 – this time, it was the Omicron variant. Even so, investors looked through the noise once the medical data showed that Omicron is less severe than Delta, especially for vaccinated individuals. Global equities finished the quarter with mixed results but were generally positive across the broad indexes. Short-term interest rates moved higher in anticipation of 2022 rate hikes by the Federal Reserve, while longer-term rates remained anchored. Lastly, commodities finally paused on the back of US dollar strength and negative growth revisions due to Omicron. Our 2022 outlook is positive for equities and commodities but negative for rate-sensitive fixed income. We anticipate much higher levels of equity market volatility compared to the last two years but believe that investors should add on weakness.

### I. Market & Economic Overview

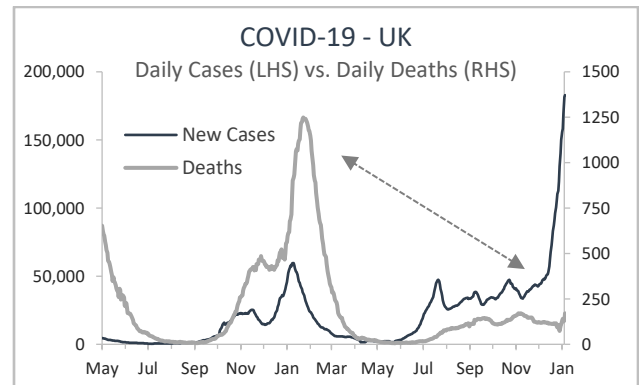
The final quarter of 2021 capped off the second calendar year since the pandemic began. The good news is that past pandemics (e.g. Spanish Flu) tended to last less than 24 months and experienced 4-5 waves before evolving into an endemic.<sup>1</sup> Although Omicron is more transmissible, studies have shown that it is less deadly and has milder symptoms than past variants. Additionally, improving vaccination rates and immunity levels are helping keep deaths well below previous levels (Charts 1-3).<sup>2</sup> Current data from South Africa indicates that new cases peak much faster than earlier waves, suggesting that many regions should be approaching peak case levels. Finally, Omicron's high transmissibility could start to crowd out the more deadly Delta variant. This result would help end the pandemic quicker and allow countries to ease lockdown measures (Chart 4).

Chart 1



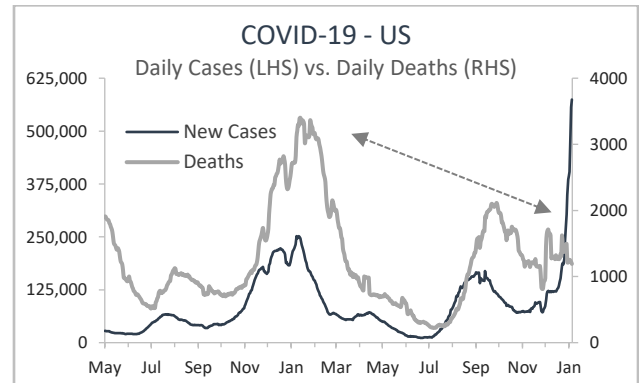
Source: Our World in Data; Arcus Capital Partners; 7-day avg.

Chart 2



Source: Our World in Data; Arcus Capital Partners; 7-day avg.

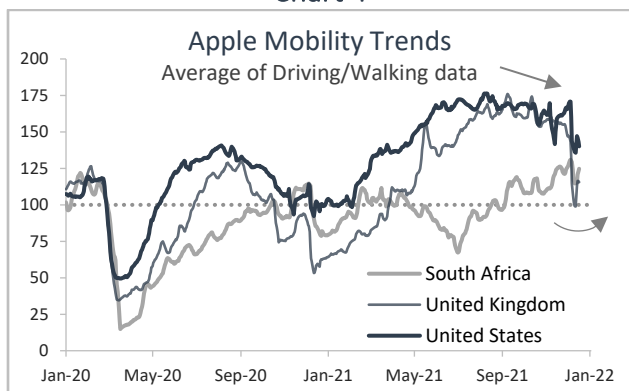
Chart 3



Source: Our World in Data; Arcus Capital Partners; 7-day avg.



Chart 4



Source: Apple; Arcus Capital Partners; volume of requests for directions for driving and walking activity as compared to baseline of 1/13/2020

Inflation also continued to garner attention from investors and the Federal Reserve. The expectation for "transitory" data quickly changed to "sticky" as supply chain disruptions, labor shortages, and strong demand kept prices elevated (Charts 5-6). Some of the most significant gains within the inflation index have come from car prices (new and used), housing, and commodity inputs. As shipping bottlenecks eventually find relief and the global economy reopens, prices should stabilize. However, the Federal Reserve is not waiting and has expedited its plan to taper bond purchases and raise short-term interest rates. We expect the first rate hike to come as early as their March meeting and see several more increases occurring over the coming year. For now, it is unclear whether tighter monetary policy will help ease supply/demand-related inflation pressures; that said, it certainly poses a risk for financial markets that have been reliant on low interest rates over the past decade.

Chart 5



Source: Bloomberg; Arcus Capital Partners

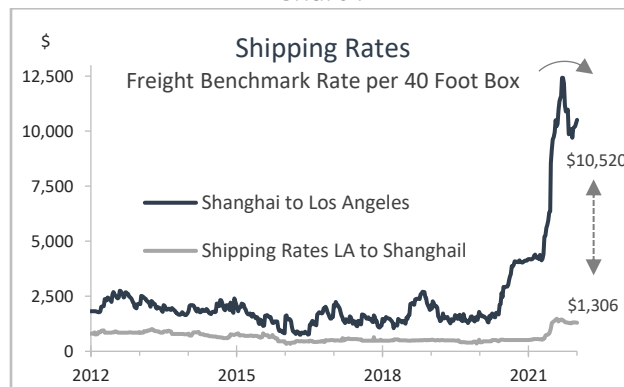
Chart 6



Source: Bloomberg; Arcus Capital Partners

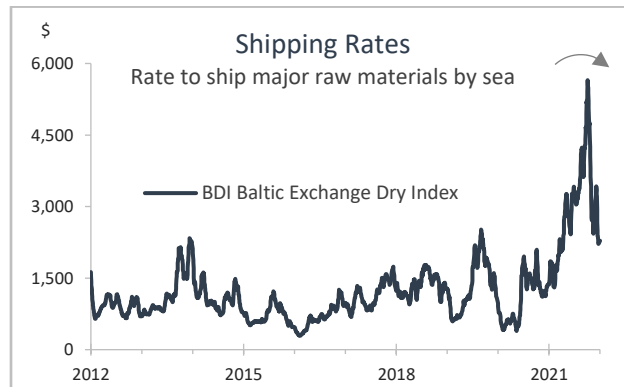
As previously noted, the coronavirus created disruptions across the global supply chain, which has led to goods shortages and increased shipping costs (Charts 7-8). For instance, over 95 container ships were waiting to dock at the Los Angeles and Long Beach ports at the end of December.<sup>3</sup> On the cost side, shipping rates have slowly declined but remain above pre-pandemic levels.

Chart 7



Source: Bloomberg; Arcus Capital Partners

Chart 8



Source: Bloomberg; Arcus Capital Partners



Over the coming quarters, we expect prices to moderate as the pandemic moves to the endemic stage and the global economy reopens. This outcome should have a short-term deflationary effect on goods prices, but they will likely remain above pre-pandemic levels for the foreseeable future. **For now, the macro setup for 2022 is positive, but the wave of stimulus provided by governments and central banks over the last few years is quickly receding. This reduction is likely to increase volatility for risk asset but should create investible opportunities.**

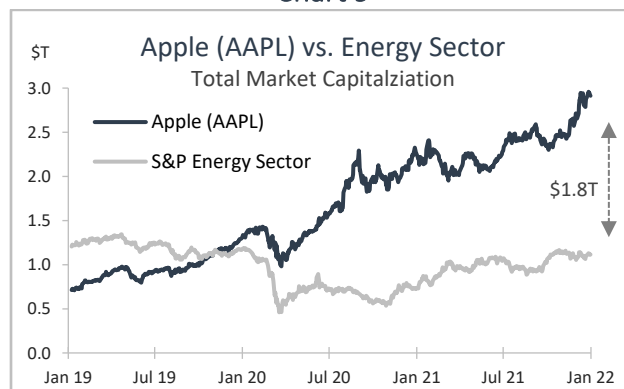
## II. US Equities

Last year turned out to be a tale of two markets. On the surface, the broad indexes finished with stellar performance; however, under the hood, many parts of the market finished down or well below their intra-year highs. The S&P 500 index ended the quarter up **9.75%**, while the smaller capitalization Russell 2000 index ended up **0.42%**.<sup>4</sup> For the year, the S&P 500 climbed **28.68%** and posted a few remarkable stats:<sup>5</sup>

- Percentage of days the market traded higher: **57%**
- Number of new closing all-time-highs: **70**
- Percentage of stocks with positive returns: **88%**
- Number of stocks up 50% or more: **101**
- Largest peak-to-trough drawdown: **5%**

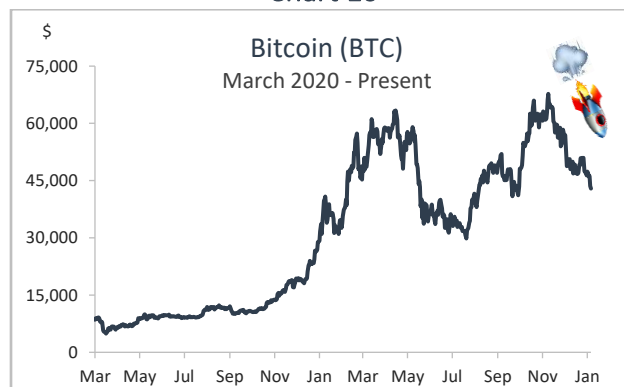
Within the S&P 500, the top-5 stocks drove 32.6% of the total return, while the top-25 made up 55.1%.<sup>6</sup> Within the Nasdaq 100, Microsoft (MSFT), Apple (AAPL), Google (GOOG), Nvidia (NVDA), and Tesla (TSLA) accounted for 70% of the indexes return even though they are only ~37% of the weight of the index.<sup>7</sup> Individual companies such as Apple (AAPL), which makes up 6.8% of the S&P 500 and drove 8.1% of its 2021 return, have become massive and are now dwarfing whole sectors (Chart 9).<sup>8</sup> As investors continue to flock to index funds, there is a risk that the largest names eventually underperform and drag the entire market down – this is not a reason to sell but something to watch. Crypto-currencies are another area worth monitoring – cryptos such as Bitcoin are a good indicator of investor sentiment and represent the current speculative fervor (Chart 10).

Chart 9



Source: Bloomberg; Arcus Capital Partners

Chart 10



Source: Bloomberg; Arcus Capital Partners

Several sectors underperformed the broad market during 2021 (Chart 11). Areas such as biotech saw aggressive selling in the first quarter that lasted into early 2022. It is unclear what sparked the de-risking within the "bubble stocks," but the prospect of reduced liquidity, higher interest rates, and extreme valuations likely played a part.

Chart 11



Source: Bloomberg; Arcus Capital Partners; performance normalized to 100 as of 12/31/20; Bubble Basket: SPAK ETF; ARKK ETF; IPO ETF; XBI ETF.

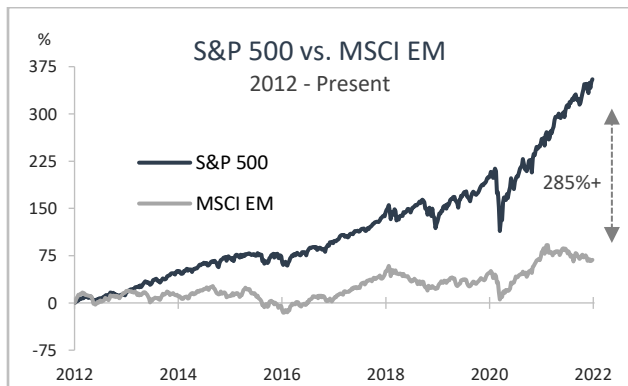


Over the coming quarters, investors may reallocate to the most beaten-down groups looking for a relief rally, but the headwinds mentioned above remain intact and could limit their upside. Alternatively, parts of the market tied to the global reopening and rising interest rates should perform well. These sectors include energy, financials, travel & leisure, and small caps, to name a few. Lastly, certain growth sectors (e.g. unprofitable tech) could struggle as rates rise and liquidity fades. **That said, we maintain a favorable outlook for US equities in 2022 and prefer small caps and value sectors (e.g. energy).**

### III. International Equities

Foreign stock performance was mixed as the developed markets outperformed the emerging markets. International developed (MSCI EAFE) gained 3.52%, and the emerging markets (MSCI EM) declined by -0.85%.<sup>9</sup> The decade-long trend of EM underperformance has been well documented, but 2021 was especially frustrating for investors (Chart 12).

Chart 12



Source: Bloomberg; Arcus Capital Partners; Performance is total return and includes dividends

After a solid showing in 2020, many parts of the EM index continued to rally in early 2021. However, cracks in the façade began to form when China started reducing its post-pandemic support measures. At that point, Chinese stocks quickly started declining, and some areas eventually gave back all their post-COVID gains (Charts 13 - 14). Other countries within the EM index also fared poorly, including Brazil, which has declined nearly 37% after peaking in June (Chart 15).

Chart 13



Source: Bloomberg; Arcus Capital Partners; China: FXI ETF.

Chart 14



Source: Bloomberg; Arcus Capital Partners

Chart 15



Source: Bloomberg; Arcus Capital Partners

In our view, the worst has likely passed for EM stocks, and there could be brighter days ahead. First, China has recently started easing credit standards to spur economic growth (Chart 16). This policy response has typically coincided with positive gains for Chinese equities and EM stocks. It is worth noting that China makes up ~30% of the MSCI EM Index.<sup>10</sup> Second, global growth data



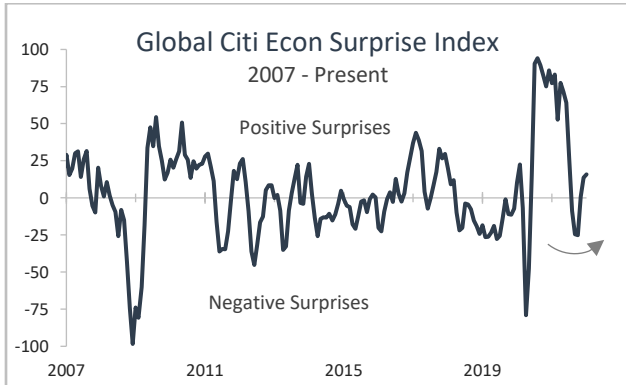
has started surprising to the upside and could continue firming in 2022 as the omicron wave passes (Chart 17). Third, most EM currencies have markedly depreciated against the dollar over the last year due to slowing growth. Assuming this trend reverses, it would provide a tailwind for US investors who invest in dollar terms. Lastly, coronavirus infections should eventually subside and allow for less stringent lockdown measures (i.e. more economic activity).

Chart 16



Source: Bloomberg; Arcus Capital Partners

Chart 17



Source: Bloomberg; Arcus Capital Partners

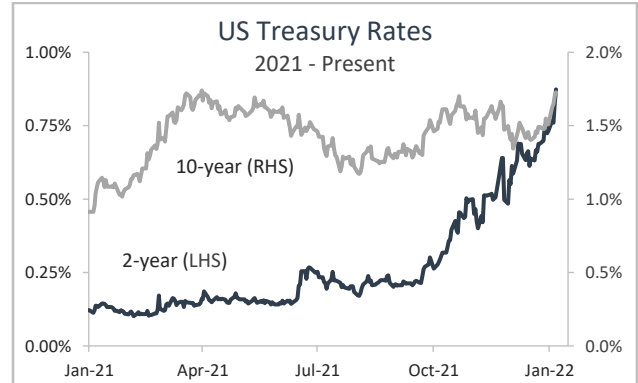
**We maintain our bullish view on non-US equities, developed and emerging. However, we believe the risk-reward is most compelling for EM in 2022.**

#### IV. Fixed Income

Interest rates were volatile throughout the quarter as the Federal Reserve (Fed) confirmed its plan to reduce monetary support. The 2-year yield started at **0.26%** and ended at **0.73%** (Chart 18).<sup>11</sup> This

significant move reaffirmed that investors believed the Fed would begin raising short-term interest rates in early-2022. As of now, the market is anticipating the Federal Reserve will hike at least three times in 2022.<sup>12</sup>

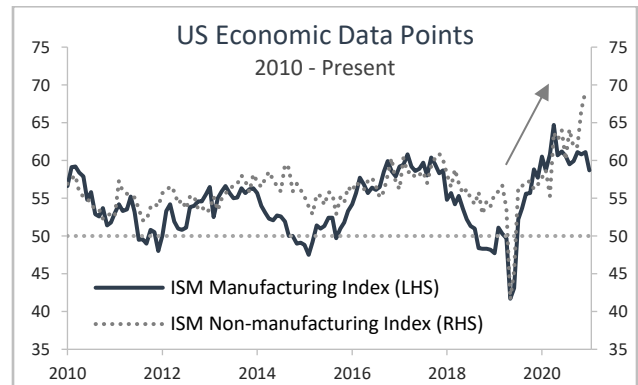
Chart 18



Source: Bloomberg; Arcus Capital Partners

The 10-year US Treasury yield started the quarter at **1.49%** and rose to **1.51%** by quarter-end.<sup>13</sup> Since then, it has climbed further and should continue to do so in 2022. Tighter monetary policy, firming domestic data, and above-average inflation should keep rates moving higher (Chart 19).

Chart 19



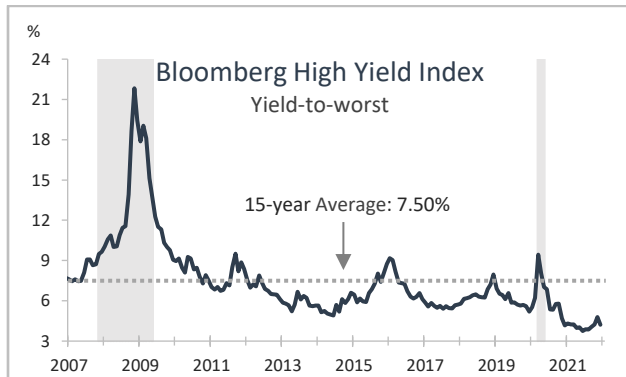
Source: Bloomberg; Arcus Capital Partners

Rate-sensitive bonds mimicked longer-term interest rates and ended the year with unimpressive returns. The Barclays Aggregate Bond Index ended down by **-0.42%**, while the tax-free Barclays Municipal Bond Index rose **0.68%**.<sup>14</sup> Credit markets remained calm, and the Bloomberg High Yield Index finished the quarter up **0.49%**.<sup>15</sup> Bank loan prices increased, and the S&P/LSTA Leveraged Loan Index ended up **0.73%**.<sup>16</sup> Yields



within the high yield sector have hit multi-decade lows, and the space appears fully valued. The lowest yield on the index is currently a paltry ~4.32%, compared to the 15-year average of ~7.50% (Chart 20).<sup>17</sup> For now, credit markets are not flashing any warning signs, but this is an area we are watching closely for signs of stress.

Chart 20



Source: Bloomberg; Arcus Capital Partners

**We expect the Fed to raise short-term interest rates 3-4 times during 2022. We continue to think higher-quality bonds are unattractive due to their inverse relationship with rates. Within credit, we prefer floating rate sectors and private credits that have a lower correlation to interest rates.**

## V. Commodities

Commodities underperformed during the quarter as the US dollar (DXY) strengthened, and fears over the omicron variant's economic impact weighed on prices. The Bloomberg Commodity TR Index finished the quarter down -4.45%.<sup>18</sup> That said, the recent weakness should be temporary as we embark on a new Commodity Supercycle driven by strong demand and limited supply.

Several structural factors have led to the current situation. Green economic policies from global governments and the preference for ESG investing (Environmental, Social, and Governance) have led many investors, large and small, to shun hydrocarbons and mining in favor of green energy (e.g. solar). This shift has led to declining investment in these industries and left producers unable to meet global demand. Unfortunately, the

lack of supply has created shortages and led to massive price spikes in regions such as Europe. Over the last twelve months, Liquefied Natural Gas (LNG) prices reached record levels as winter shortages loomed (Chart 21). Temporary relief only came when the US sent a convoy of LNG cargoes to replenish their supply; however, longer-term structural problems remain.<sup>19</sup>

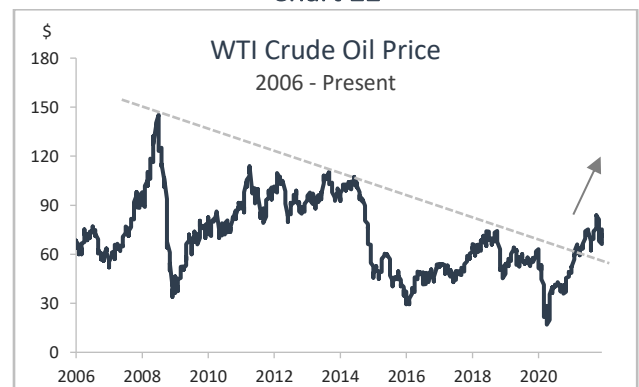
Chart 21



Source: Bloomberg; Arcus Capital Partners

Higher prices have also occurred within the oil and gasoline markets, which have broken through their long-term downtrends and are trading at multi-year highs (Charts 22 & 23). Although producers will likely respond with increased supply, it is unclear how much impact it will have on containing prices. The International Energy Agency estimates that global demand for crude oil is nearing pre-covid levels and rising.<sup>20</sup> Assuming global growth continues to strengthen, demand could outstrip current supply and send energy prices soaring. In turn, this will result in higher prices for businesses and consumers.

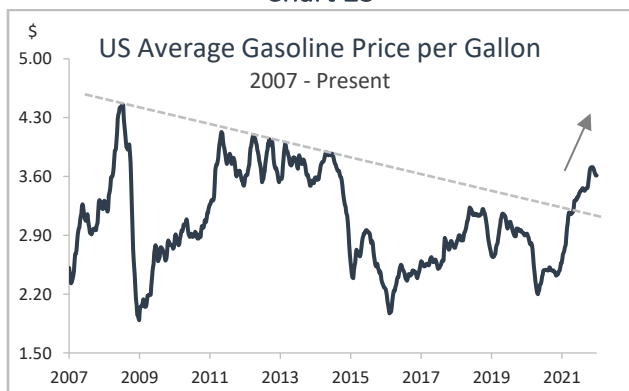
Chart 22



Source: Bloomberg; Arcus Capital Partners



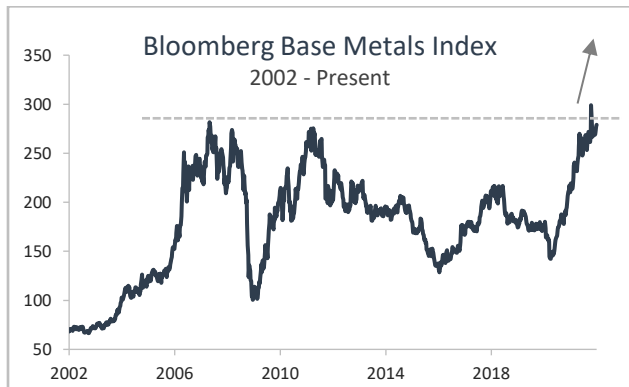
Chart 23



Source: Bloomberg; Arcus Capital Partners

The base metals have experienced similar price increases due to supply-demand imbalances. Demand varying from copper for electric vehicles to aluminum for building supplies has put upward pressure on the entire metals sub-index and pushed it to new all-time highs (Chart 24). Again, as the global economy regains its footing, base metal demand could increase further. This is especially true within China, where growth has started improving and should accelerate in 2022.

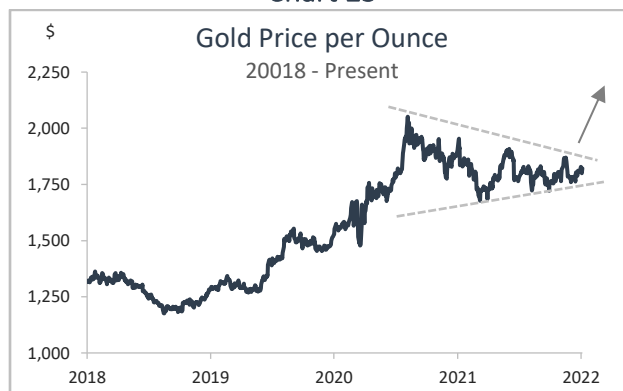
Chart 24



Source: Bloomberg; Arcus Capital Partners; Bloomberg Base Metals Spot Price Commodity Index weightings: Aluminum 45%, Copper 25%, Zinc 15%, Lead 12%, Nickel 2%, Tin 1%.

After a multi-year rally of nearly \$1000/oz., gold prices have consolidated sideways since mid-2020 (Chart 25). Rising interest rates, lower market volatility (i.e. less safe-haven demand), and a stronger US dollar contributed to the lackluster returns. That said, 2022 could present an opportunity for the yellow metal to break out to the upside as investors seek out investments to hedge against higher equity volatility.

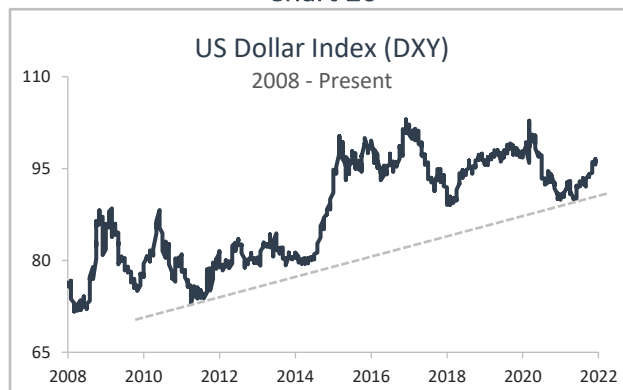
Chart 25



Source: Bloomberg; Arcus Capital Partners

Lastly, the US dollar (DXY) represents the biggest wildcard for commodity prices. Coming into 2021, most pundits and investors expected the dollar to continue depreciating. Nevertheless, domestic growth data remained firmer than the rest of the world and provided the catalyst needed for the dollar to rally (Chart 26). Cyclical commodities (e.g. base metals and energy) shrugged off the strength due to their structural supply issues, but the precious metals could not. For now, it is unclear which direction the US dollar will head next, but current data suggest it could weaken in 2022. This outcome would provide a tailwind for the commodity complex, including gold.

Chart 26



Source: Bloomberg; Arcus Capital Partners

**We remain bullish on economically sensitive commodities such as energy and base metals. We also think precious metals may provide a good diversifier if the US dollar depreciates or equity volatility increases.**



## VI. Looking Ahead

As we head into 2022, we remain bullish on equities and prefer sectors tied to the global reopening. As the Omicron variant starts to fade, sectors such as energy, small caps, and emerging markets should benefit the most from accelerating global growth. Even so, risks remain and need to be monitored. These include Fed tightening, the mid-term elections, complacent credit markets, and above-average equity allocations by retail investors. It is also worth noting that the market has not corrected by more than 10% since September 2020.<sup>21</sup> These factors are not a reason to sell equities; however, investors must be aware that the market is likely entering a volatile period relative to the last two years.

Within fixed income, firming economic data, inflationary pressures, reduced retail demand, and fading monetary policy support should lead to higher interest rates. In turn, rate-sensitive bonds such as Treasuries and high-quality corporate bonds will likely underperform. Credit spreads

remain very tight and don't offer attractive risk-adjusted returns. We prefer floating rate loans and private credit (e.g. middle-market lending) where yields are more attractive and less correlated to interest rates and the public markets.

Finally, as global macro data improves further, cyclical commodities tied to the reopening should continue rallying and act as a natural inflation hedge. Additionally, gold is starting to look interesting as a hedge against market volatility and macro risks. Looking ahead, we remain focused on locating attractive investment opportunities and continue to believe investors must stay 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**

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**Sources:**

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