

Dear friends of Arcus Capital Partners,

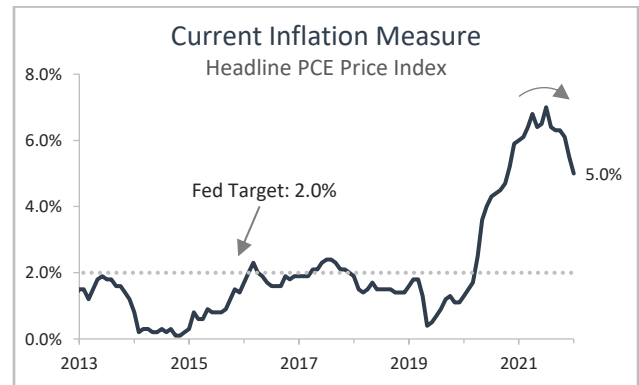
We hope this letter finds you well and that you are having a great start to the year. The past twelve months were particularly challenging for investors as global stocks and bonds declined double-digits. The lackluster performance was the result of unprecedented amounts of central bank tightening intended to reign in decades-high inflation. Throughout 2022, the Federal Reserve (Fed) and other central banks tightened financial conditions by raising interest rates and ending monetary stimulus programs. In turn, this led to deteriorating economic data and applied downward pressure to asset prices. Equities fell as investors priced in higher interest rates and increased recessionary risks. Interest rates climbed to levels not seen in over a decade and weighed heavily on bond prices. Finally, commodities, led by energy, were positive even as the US dollar strengthened. We maintain a positive view of equities and credit over the next twelve months; however, near-term headwinds could create periods of 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. On a side note, our commentary is updating to a new reader-friendly format that includes more charts and tables.

I. Market & Economic Overview

Inflation and central bank tightening were the main topics of discussion throughout 2022; however, by the end of the year, these themes morphed into questions surrounding peak inflation and the timing of central bank rate cuts. As noted in past commentaries, most experts, including the Federal Reserve, expected the post-pandemic inflation pressures to be transitory. Unfortunately, supply-chain bottlenecks, labor shortages, and a host of other factors created stickier prices and forced central banks to react with aggressive tightening measures. Fortunately, several inflation gauges

have started to decline from peak levels. The Federal Reserve's preferred measure, the Personal Consumption Expenditures index, has quickly begun receding from its recent highs but remains above its target level of 2.0% (Chart 1).

Chart 1



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

Market expectations for inflation five years from now have also declined, suggesting that investors anticipate it will gradually move toward the Fed's target (Chart 2).

Chart 2

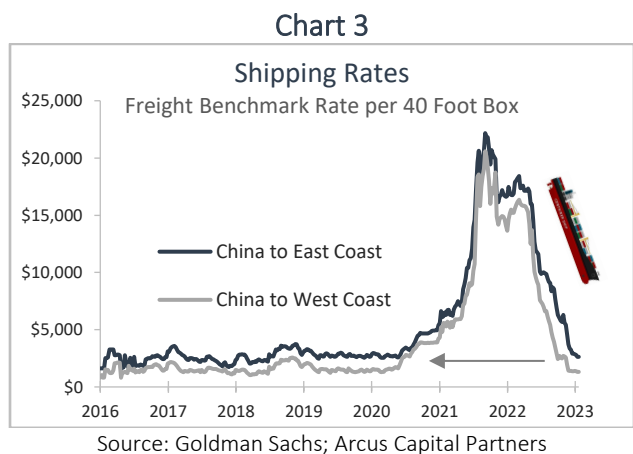


Source: Bloomberg; Arcus Capital Partners

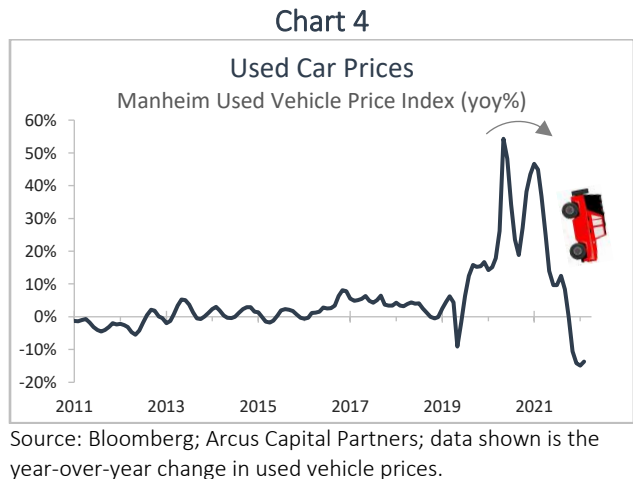
Several inputs have relieved pricing pressures, including the gradual healing of global supply chains. This positive development is best conveyed



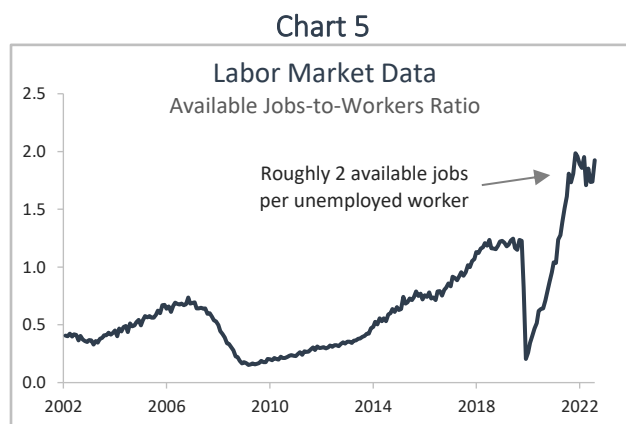
in shipping rates, which have returned to pre-pandemic levels (Chart 3). In addition to reduced shipping costs, delivery times have markedly decreased year-over-year and continue to decline.



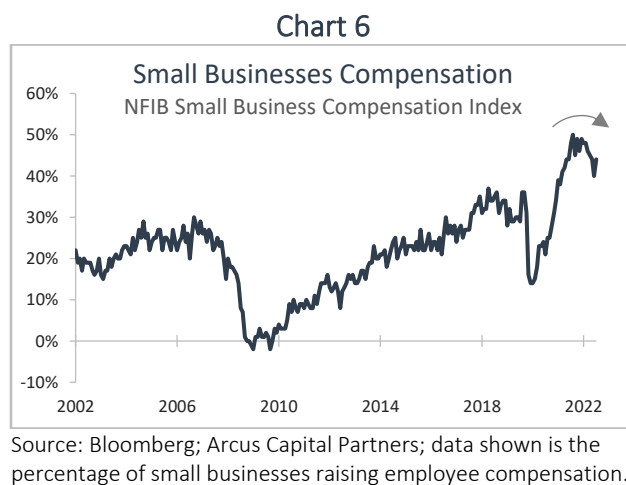
Supply chain improvements have helped prices begin normalizing within the markets most affected by the pandemic, such as used automobiles (Chart 4). Prices remain above pre-pandemic levels but continue falling as dealerships rebuild their new auto inventories.



Labor shortages have been another important catalyst behind the uptick in inflation. Today, there are roughly two open jobs per unemployed worker in the US (Chart 5). Several factors have led to the smaller labor force, including declining demographics (i.e. excess retirements during the pandemic), reduced legal immigration, and workers leaving the job market to start businesses.



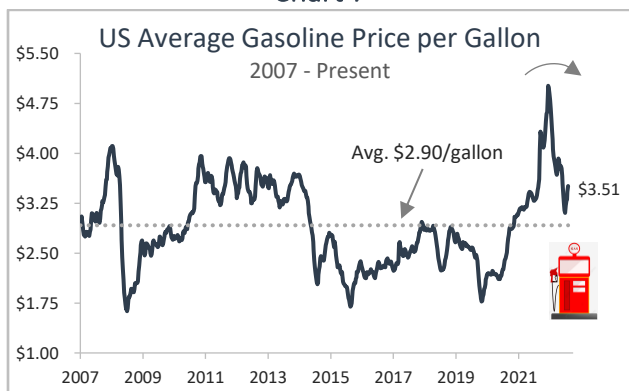
Fewer available workers have forced employers to raise wages to attract quality talent. Unfortunately, these increased costs tend to get passed through to the consumer via higher prices. That said, recent data show that employment costs may be plateauing, and the percentage of small businesses raising employee pay has inflected lower (Chart 6).¹ Wages tend to be sticky but should move lower as the labor market heals.



Commodity prices have also declined from their highs and stabilized at lower levels. For instance, gasoline prices reached \$5/gallon in mid-2022 before returning to the mid-\$3s. Lumber, a major input into residential construction, tripled in price during the pandemic but has since declined to pre-pandemic levels (Charts 7-8). Lower commodity prices and related input costs should also help alleviate pricing pressures over time.

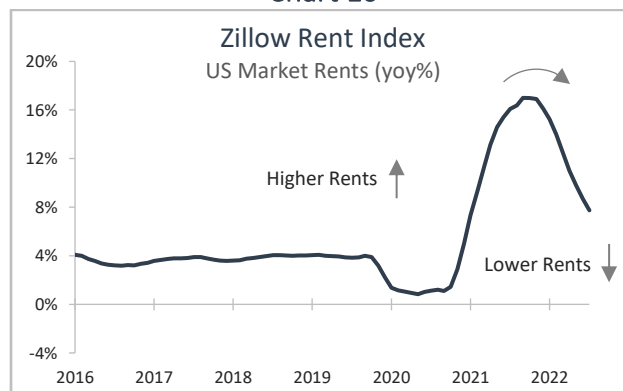


Chart 7



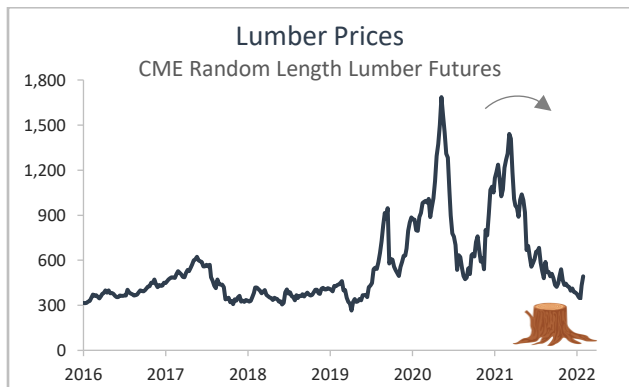
Source: Bloomberg; Arcus Capital Partners

Chart 10



Source: Bloomberg; Arcus Capital Partners

Chart 8

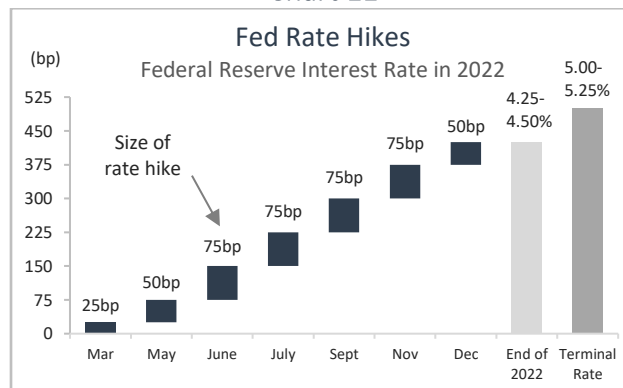


Source: Goldman Sachs; Arcus Capital Partners

During 2022, the Fed hiked interest rates at every meeting and increased the federal funds rate by 4.25% (Chart 11). This policy response led to a rapid tightening of financial conditions and caused asset prices to reprice lower (Chart 12). This year, the Fed is expected to raise rates by another 75bps, taking the terminal rate to the 5.00-5.25% level.²

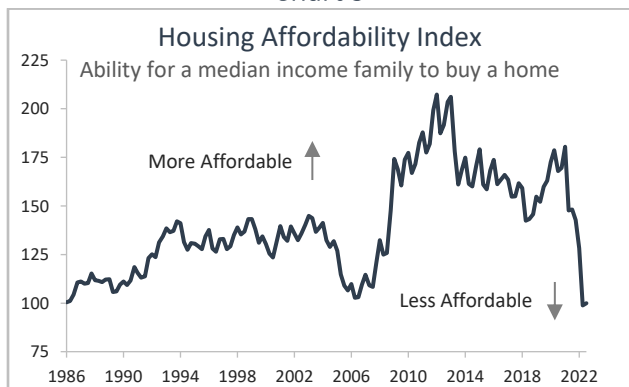
Shelter prices have remained stubbornly high due to record-level home prices that forced many potential homebuyers to rent (Chart 9). In turn, the influx of renters and lack of available apartments sent rents soaring. Nevertheless, real-time data from Zillow highlight that rents are declining (Chart 10). This trend should continue as new apartment units and houses become available.

Chart 11



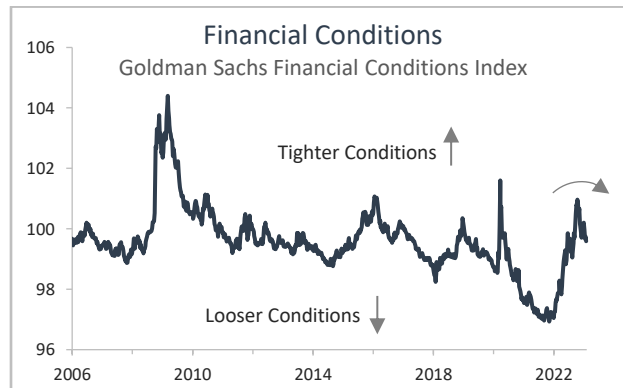
Source: Bloomberg; Arcus Capital Partners; 100bp = 1.0%

Chart 9



Source: Bloomberg; Arcus Capital Partners

Chart 12

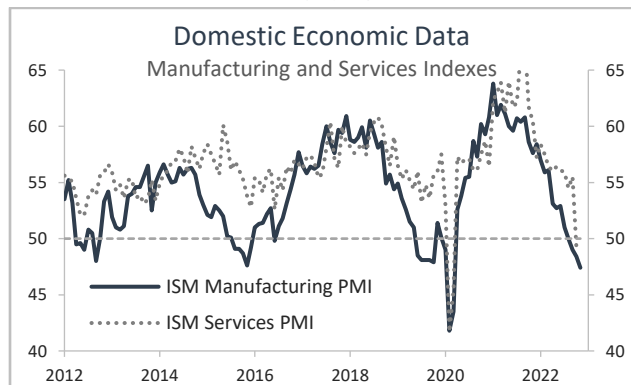


Source: Bloomberg; Arcus Capital Partners; the GS FCI Index is the weighted average of riskless interest rates (49.5%), exchange rates (6%), equity valuations (4.9%), and credit spreads (39.6%).



We believe inflation has peaked, which should allow the Fed to end its hiking cycle in 2023. We do not anticipate any rate cuts this year unless domestic data deteriorate meaningfully. That said, the odds of a recession occurring over the next year remain elevated. Several indicators have moved into contractionary territory and need to trough, or the economy risks going into recession (Chart 13). Nevertheless, the labor market remains strong and suggests any potential slowdown could be mild.

Chart 13



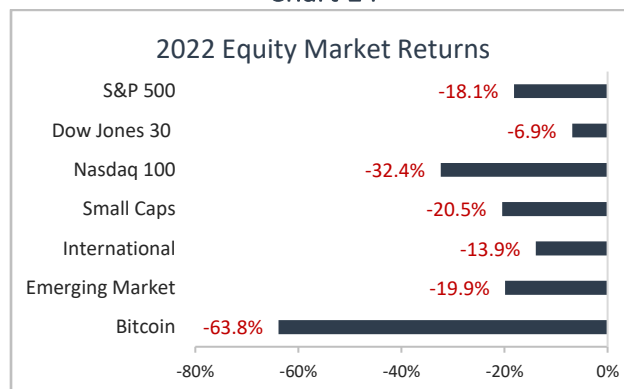
Source: Bloomberg; Arcus Capital Partners; index moves above 50 = expansion and below 50 = contraction.

The macro backdrop remains mixed, but the domestic economy has been resilient and could be turning a corner. The Federal Reserve is committed to breaking inflation but has likely entered the final innings of its current hiking cycle. Finally, the capital markets appear optimistic and are currently pricing in a soft landing (i.e. mild recession); however, stretched valuation, declining earnings, and eventual margin contraction could create headwinds for stocks in 2023.

II. Global Equities

Global equities and other risk assets (e.g. cryptocurrencies) ended the year firmly in the red, even after staging a rally during the fourth quarter (Chart 14). Much of the lackluster performance resulted from the Federal Reserve aggressively withdrawing monetary support throughout the year. Unfortunately, the size and pace of the rate hikes were unexpected and unprecedented, forcing the markets to quickly reprice lower.

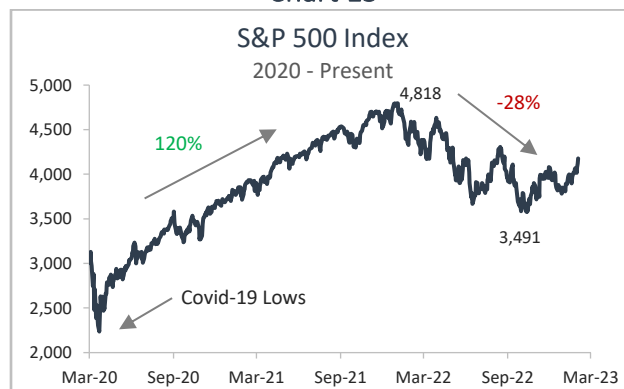
Chart 14



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends.

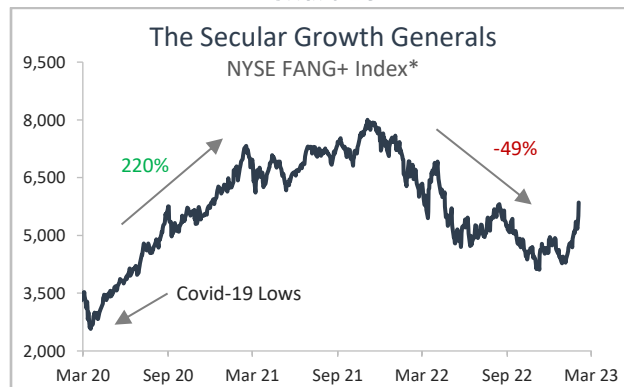
The broad indexes declined meaningfully; however, many parts of the market, such as mega-cap growth (e.g. AMZN), were cut in half (Charts 15-16). In fact, many of the stocks that rallied the most off the pandemic lows underperformed the worst in 2022.

Chart 15



Source: Bloomberg; Arcus Capital Partners

Chart 16

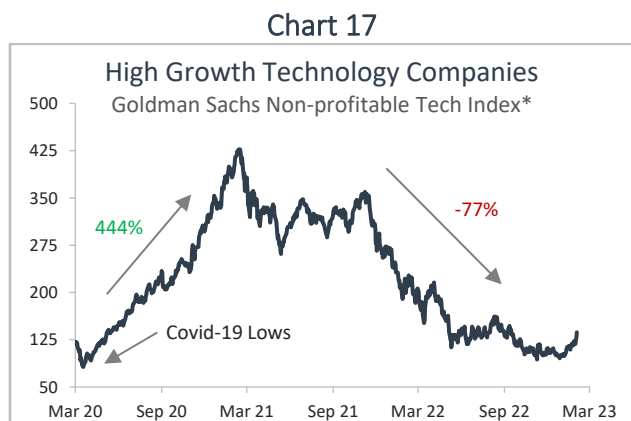


Source: Bloomberg; Arcus Capital Partners; *NYSE FANG+ Index definition available at the end of the commentary.

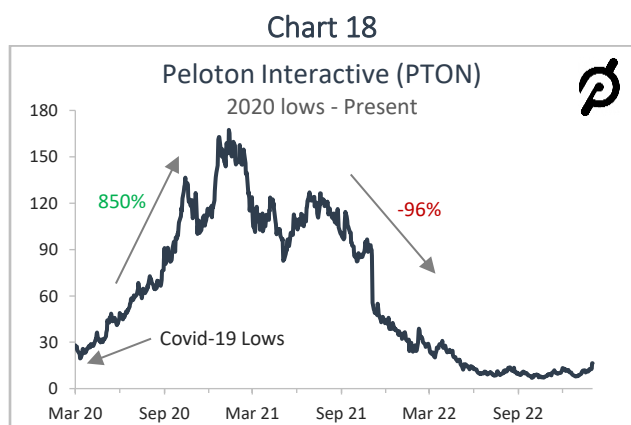


Companies further down the risk spectrum fared the worst in 2022. These corporations are typically dependent on continual funding from outside capital and benefit when rates are low (i.e. cheap debt). Unfortunately, the opposite occurs when the Fed raises rates, liquidity dries up, and economic growth slows (Charts 17-19).

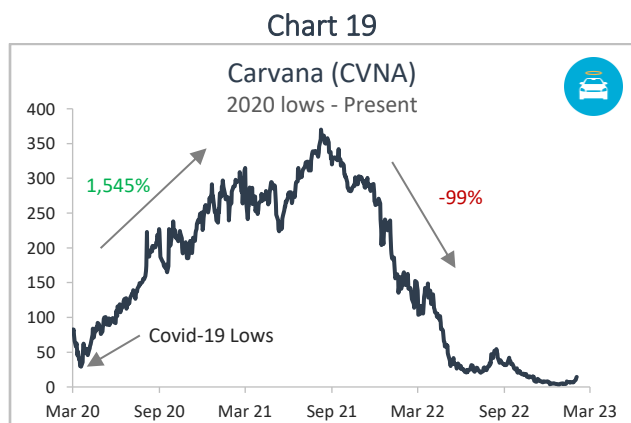
Non-US equities and cryptocurrencies were not immune and declined markedly; however, many areas have since rallied off the lows (Charts 20-22).



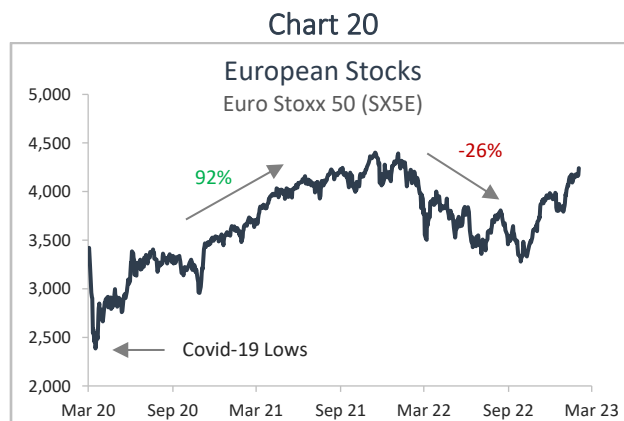
Source: Bloomberg; Arcus Capital Partners; * GS Non-profitable Tech Index definition available at the end of the commentary.



Source: Bloomberg; Arcus Capital Partners



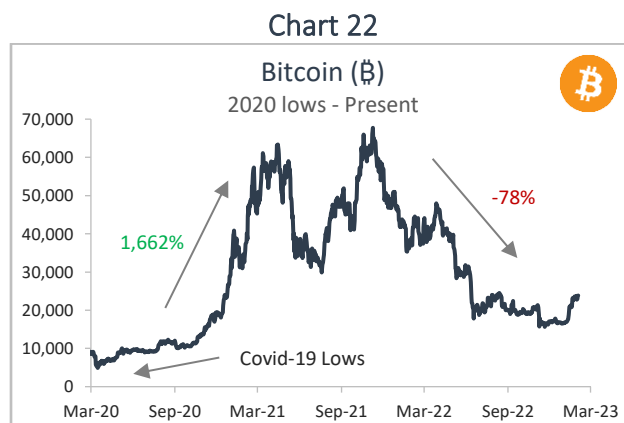
Source: Bloomberg; Arcus Capital Partners



Source: Bloomberg; Arcus Capital Partners



Source: Bloomberg; Arcus Capital Partners



Source: Bloomberg; Arcus Capital Partners

For 2023, equities have several hurdles to overcome, including additional interest rate hikes, elevated valuations, declining earnings, margin compression, and slowing economic growth.

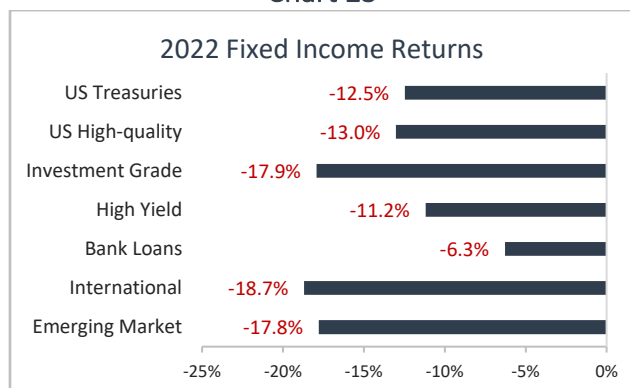


In our view, investors must remain patient and be willing to buy stocks when they feel the most out of favor. We maintain a positive long-term outlook for US equities and prefer higher-quality companies that pay dividends. Outside the US, we remain cautiously optimistic about developed and emerging market stocks but need to see more improvements before becoming bullish.

IV. Fixed Income

Throughout the year, increasingly hawkish Fed policy (e.g. rate hikes) sent interest rates to multi-decade highs and weighed heavily on the entire bond market (Chart 23).

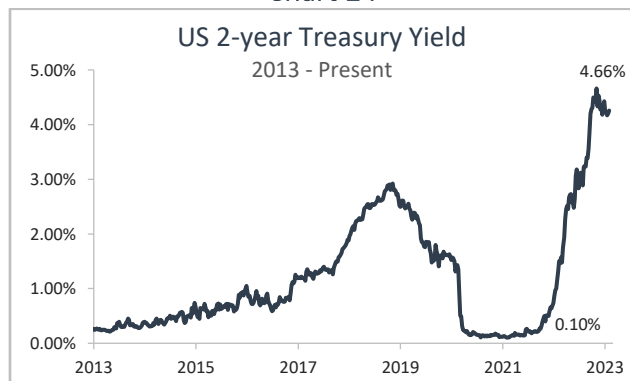
Chart 23



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends.

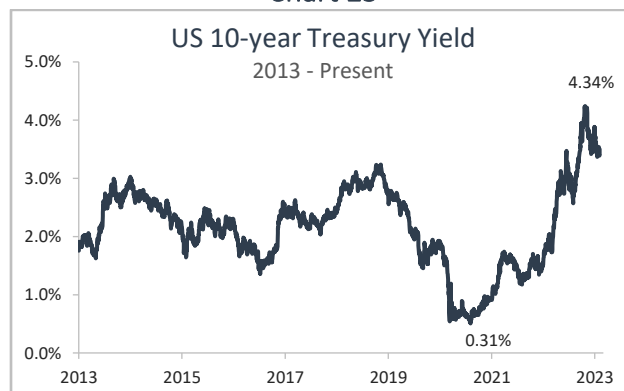
The US 2-year treasury yield got as high as **4.66%**, and the 10-year yield peaked at **4.34%** before modestly declining (Charts 24-25).³ For the year ahead, yields have the potential to move higher, but we have likely seen the cycle highs.

Chart 24



Source: Bloomberg; Arcus Capital Partners

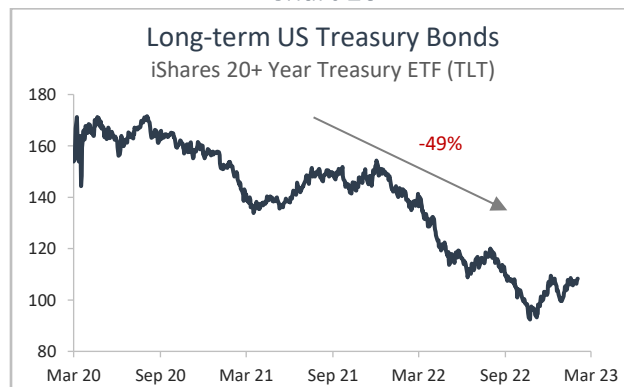
Chart 25



Source: Bloomberg; Arcus Capital Partners

The impact of higher interest rates was felt across the bond market and led to severe drawdowns in longer-duration sectors (Chart 26).

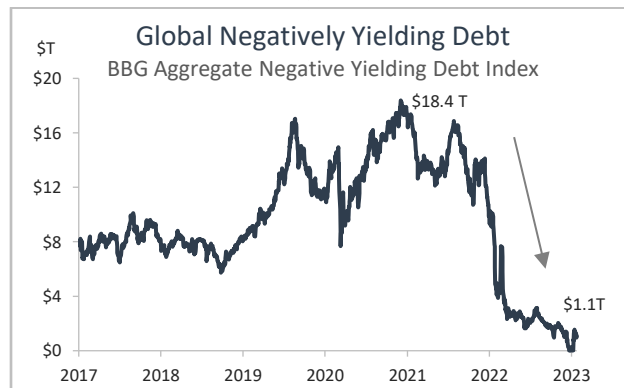
Chart 26



Source: Bloomberg; Arcus Capital Partners

The effect of rising rates was also seen outside the US, where the amount of global negatively yielding debt dropped to near zero for the first time in a decade (Chart 27).

Chart 27

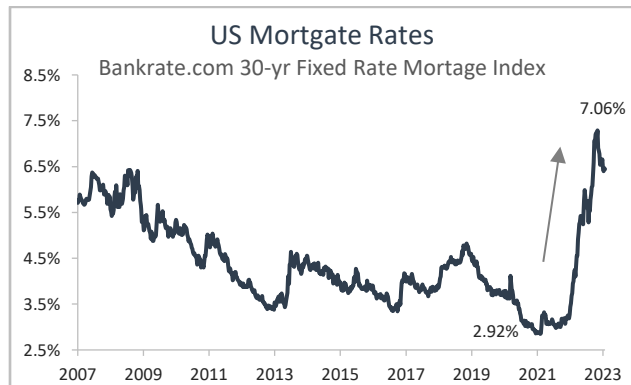


Source: Bloomberg; Arcus Capital Partners



Consumer borrowing costs increased dramatically as mortgage rates hit multi-decade highs (Chart 28). Luckily, many borrowers took advantage of the historically low interest rates and locked in at attractive levels before the spike.

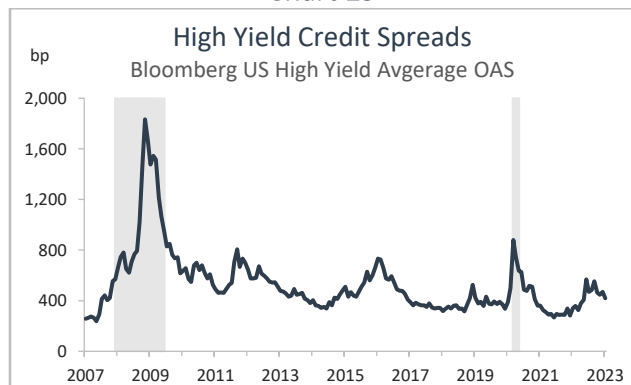
Chart 28



Source: Bloomberg; Arcus Capital Partners

Finally, credit spreads, a way to measure the health of the corporate bond market, remain below recessionary levels (Chart 29). This is a positive sign and suggests that the market feels secure about the ability of US corporations to repay their debts.

Chart 29



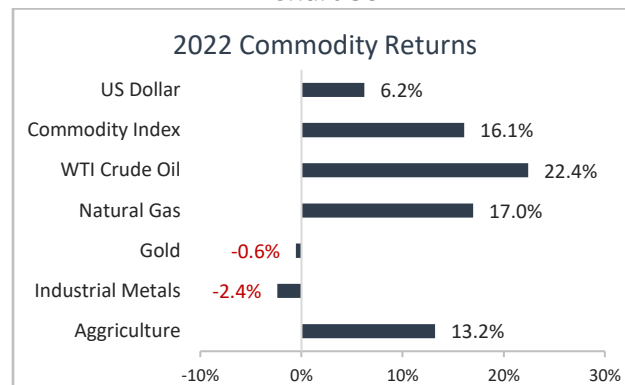
Source: Bloomberg; Arcus Capital Partners; grey shaded area are NBER recessionary periods.

We expect 2-3 more rate hikes in early 2023 before the Fed concludes its tightening cycle. In turn, we now see value in high-quality bonds (e.g. Treasuries). Within public credit (e.g. high yield), yields are attractive, but the market may need to further discount the prospect of a recession. Finally, we maintain a favorable view of the private credit market (e.g. middle market lending).

V. Commodities

Almost the entire commodity complex finished the year higher – only the metals posted small losses (Chart 30). Energy and agriculture were standout performers. Moreover, the index strength occurred even as the US dollar moved higher – commodities and the dollar typically trade inversely.

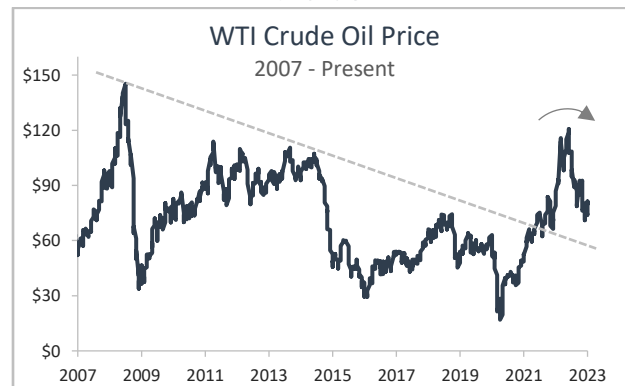
Chart 30



Source: Bloomberg; Arcus Capital Partners

Energy prices played an outsized role in 2022, as crude oil and natural gas benefitted from disruptions linked to the Ukraine-Russia conflict (Chart 31). However, some early-2022 gains reversed after Russian supply concerns faded and Europe had an abnormally warm start to its winter.

Chart 31



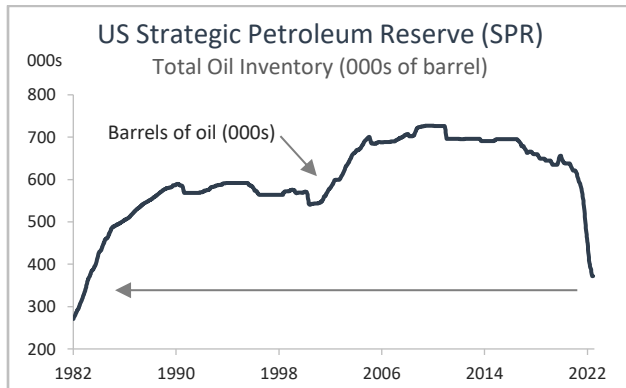
Source: Bloomberg; Arcus Capital Partners

The Biden administration's decision to release oil from the Strategic Petroleum Reserve (SPR) was another factor that kept a lid on oil prices. The SPR was designed to dampen the impact of global supply disruptions during periods of macro uncertainty. Today, the SPR inventory is at levels not seen since the mid-1980s (Chart 32). Assuming



the global economy avoids recession, stronger demand may buoy oil prices right as the administration attempts to refill the reserves – this could create a significant tailwind for oil prices.

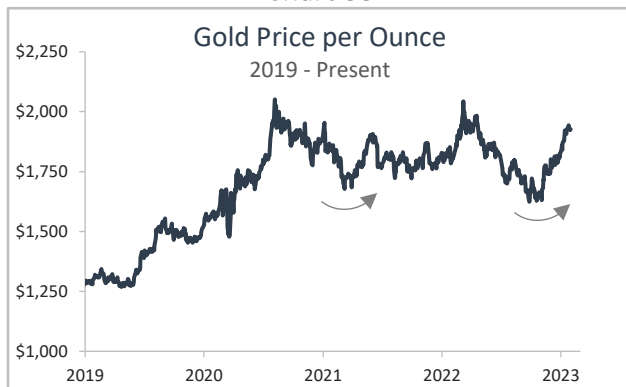
Chart 32



Source: Bloomberg; Arcus Capital Partners

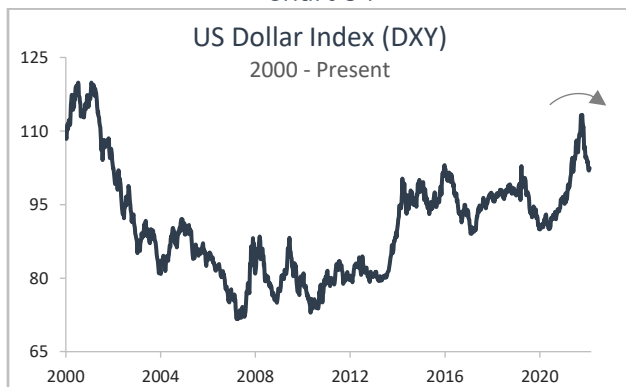
Gold ended the year flat but rallied into year-end due to the weakening US dollar and expectations for fewer future rate hikes (Charts 33-34).

Chart 33



Source: Bloomberg; Arcus Capital Partners

Chart 34



Source: Bloomberg; Arcus Capital Partners

We remain bullish on economically sensitive commodities (e.g. energy) but recognize that a recession would force us to reassess this view. Gold should continue acting as a good hedge but may provide a better entry point during the first quarter. Lastly, the US dollar appears ready to move higher in the near term before weakening over the balance of the year.

VI. Looking Ahead

We expect volatility to stay elevated during the first half of the year before gradually declining. The setup for equities has recently deteriorated due to stretched valuations, negative earnings revisions, and other headwinds that could cap any further rallies. We think investors will be able to buy at lower levels later in the coming months. For now, investors should focus on higher-quality companies that can withstand rising costs and return capital to shareholders through dividends.

After a full year of rising interest rates, we believe the highs are likely in for this cycle. Inflation is moderating, and the Federal Reserve should end its tightening campaign during the first or second quarter. This should reduce interest rate volatility and support rate-sensitive bonds such as Treasuries and high-quality corporates, which now offer attractive yields. High-yield credit spreads have widened but need more time to discount the possibility of a hard landing in 2023. We prefer the private credit market (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 if there is a recession. Additionally, gold has the potential to provide ballast during volatile periods.

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. Bloomberg

*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.

*The GS Non-Profitable Tech Basket consists of non-profitable US listed companies in innovative industries. Technology is defined quite broadly to include new economy companies across GICS industry groupings.

Important Risk and Disclosure Information

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