ARCUS CAPITAL PARTNERS

Q4 | 2023 Market Commentary

Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you had a wonderful holiday season. The year ended with a bang as global equities rocketed higher on the back of a surprisingly dovish Federal Reserve (the Fed). Falling inflation and a normalizing labor market provided the backdrop the Fed needed to forecast the start of rate cuts in 2024. Investors quickly piled into global equities and sent many markets to year-to-date highs by the end of December. Interest rates also declined from multi-decade highs and propelled bond prices higher. Lastly, commodities (ex-gold) were the only losers, as they were pushed to the side in favor of other asset classes. We maintain a positive view of equities but expect higher volatility and more modest returns this year. Within fixed income, we still prefer private credit to public markets. Finally, we believe investors must keep a long-term perspective and focus on adding to positions on material weakness.

I. Market & Economic Overview

At the start of 2023, the outlook for most economists and market prognosticators was for an impending recession and a continuation of the equity bear market (Charts 1-2). On the surface, these forecasts made sense – global economic data were deteriorating, and corporate earnings expectations were under pressure. Additionally, the Federal Reserve remained staunch in its view that its policy would remain restrictive until inflation cooled and the labor market improved. In fact, the Fed had just raised short-term interest rates by over 4% over the prior year, and its quantitative tightening (QT) program had recently commenced (Charts 3-4). Nonetheless, even as the Federal Reserve raised rates by another 1%, the resiliency of the US economy and equity markets forced most pundits to do an about-face on their dire predictions.

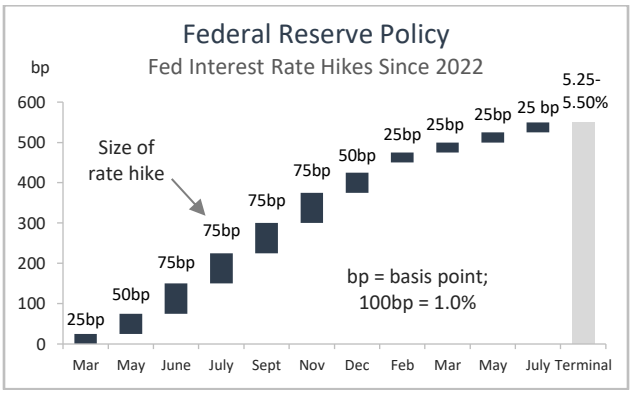
Chart 1

Source: Google; Bloomberg

Chart 2

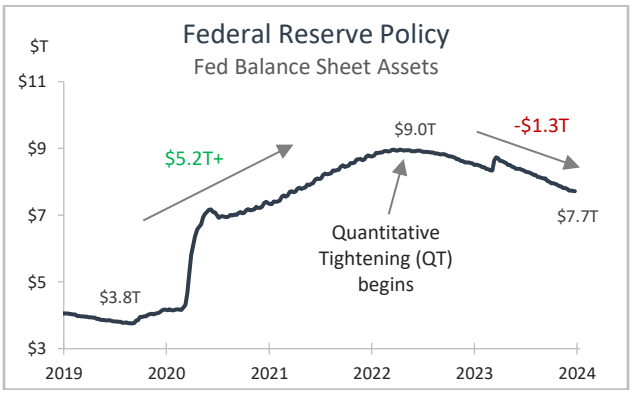
Source: Google; Bloomberg

Chart 3



Source: Bloomberg; Arcus Capital Partners

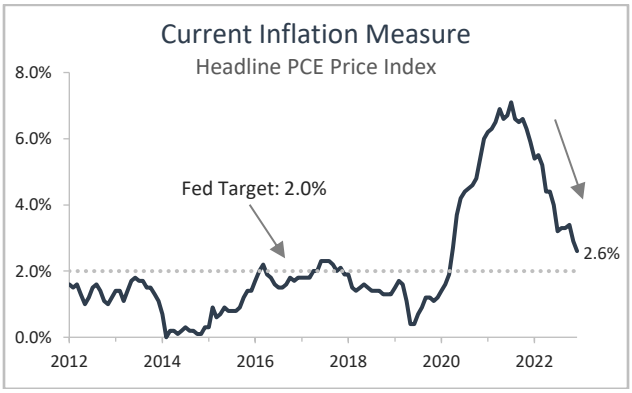
Chart 4



Source: Bloomberg; Arcus Capital Partners; $T = trillions.

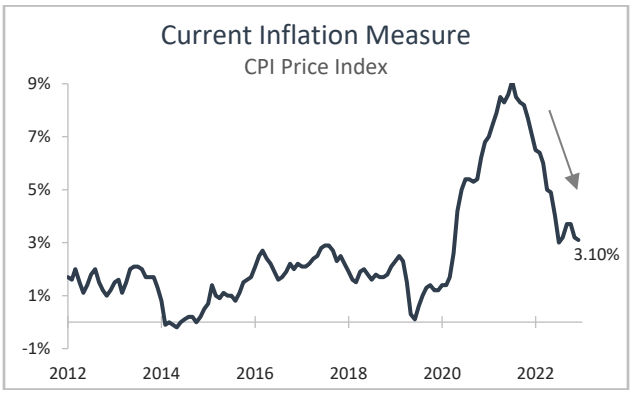
By the end of 2023, it appeared the Federal Reserve had pulled off the perfect landing that no one thought possible. The US economy avoided recession and saw a meaningful decline in nearly every inflation measure (Charts 5-8). Although some areas, such as rents and used car prices, remain elevated, they are trending lower.

Chart 5



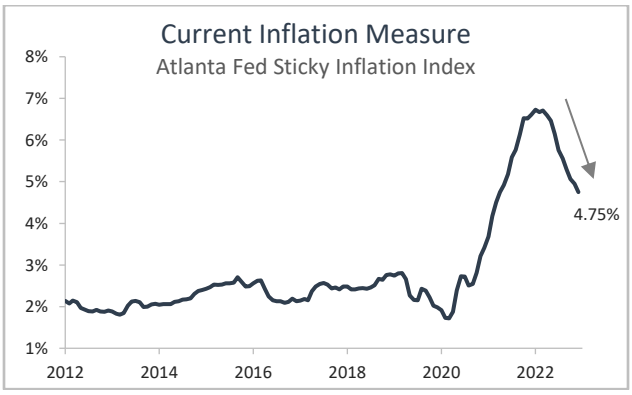
Source: Bloomberg; Arcus Capital Partners; PCE or Personal Consumption Expenditure

Chart 6



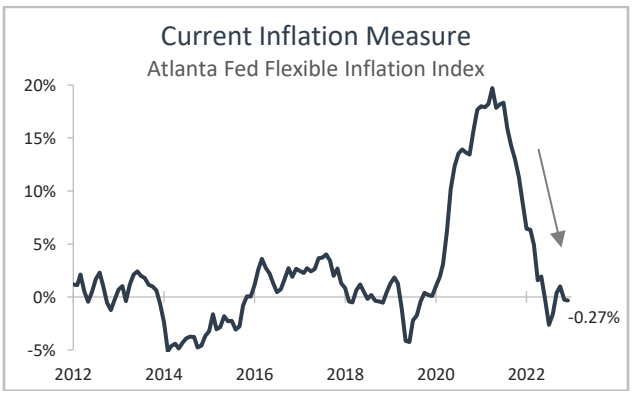
Source: Bloomberg; Arcus Capital Partners; CPI or Consumer Price Index

Chart 7



Source: Bloomberg; Arcus Capital Partners

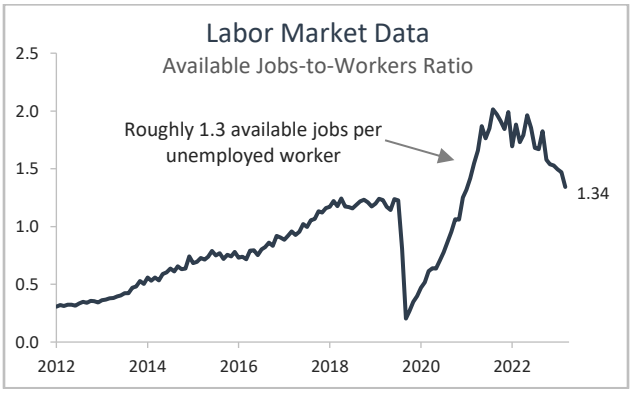
Chart 8



Source: Bloomberg; Arcus Capital Partners

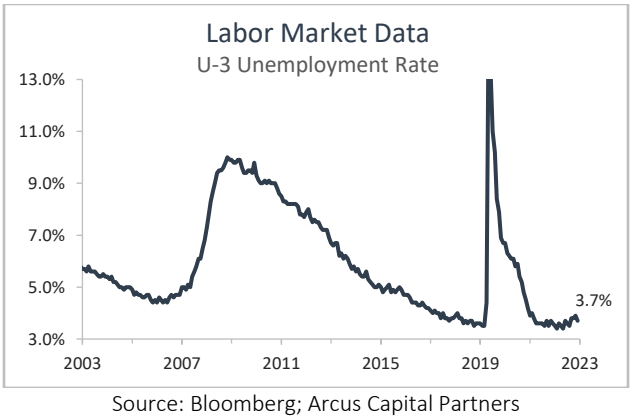
Additionally, the labor market moved towards pre-pandemic levels and did so in the most ideal fashion – reducing the number of available jobs, not outright job losses (Chart 9). The unemployment rate currently sits at 3.7%, indicating the economy's underlying strength (Chart 10).

Chart 9



Source: Bloomberg; Arcus Capital Partners; data shown is the ratio of US JOLTs Job Openings and total unemployed workers.

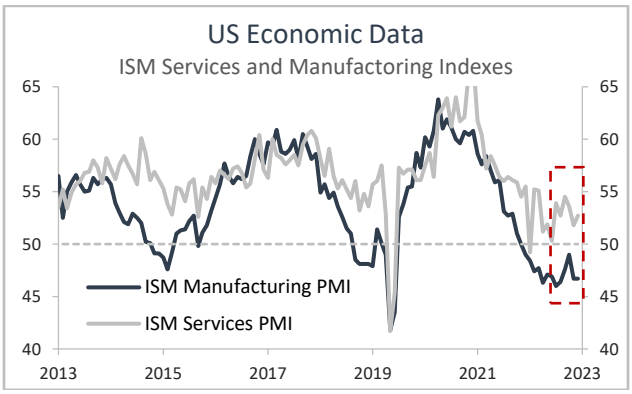
Chart 10



Source: Bloomberg; Arcus Capital Partners

Although the general condition of the economy remains firm, it is worth noting some areas of stress that are appearing under the surface. The manufacturing sector has stagnated for several quarters and remains weak (Chart 11). Part of this is due to the US gradually becoming a service-based economy over the last few decades (i.e. globalization); however, the service sector also remains well below levels seen during previous expansions. We are closely watching these indicators for any further deterioration.

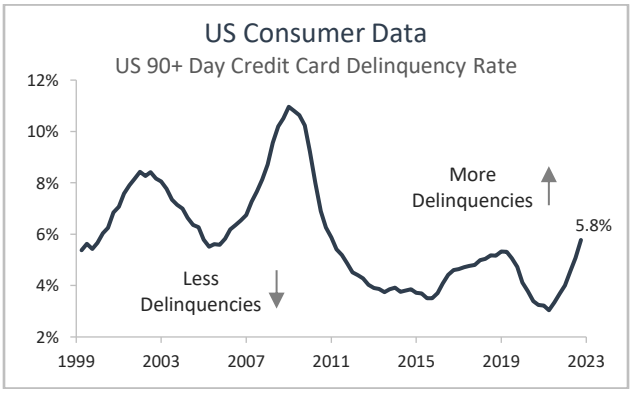
Chart 11



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

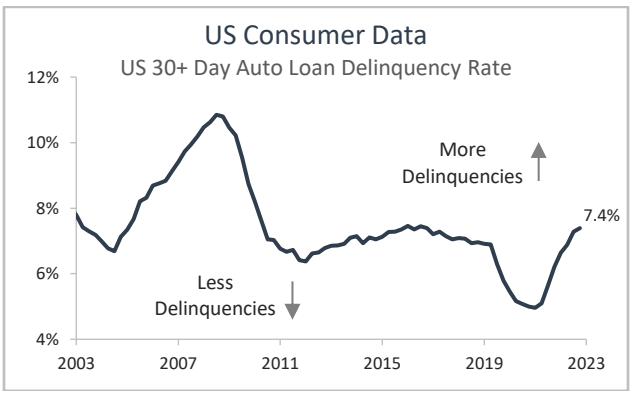
Second, the consumer is beginning to show signs of strain based on credit card and auto loan delinquency rates (Charts 12-13). The recent trends are concerning at first glance; however, most of the weakness has come from the lowest-income borrower pools and more recent vintages (i.e. post-pandemic). These data suggest lenders loosened credit standards too far after the pandemic when borrowers were flush with stimulus money.

Chart 12



Source: Bloomberg; Arcus Capital Partners

Chart 13

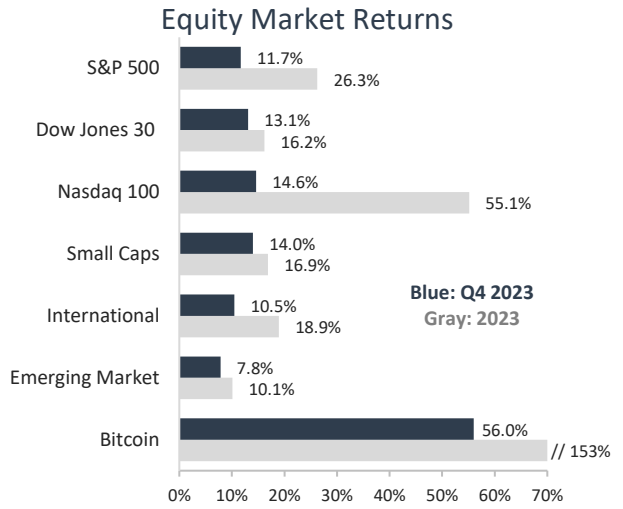


Source: Bloomberg; Arcus Capital Partners

The macro backdrop for the US remains healthy, and the Federal Reserve deserves praise for its work. As of now, it appears they pulled off the nearly impossible feat of breaking inflation without causing a recession. Assuming the current trends continue, it is likely that they will start cutting rates in 2024. That said, there are several looming speedbumps that investors will be forced to deal with this year, including: US and global elections; continued geopolitical conflicts; and elevated equity valuations.

II. Global Equities

Global equities and other risk assets ended the quarter and the year higher on the back of positive earnings revisions, improving inflation data, and the potential for interest rate cuts in 2024.



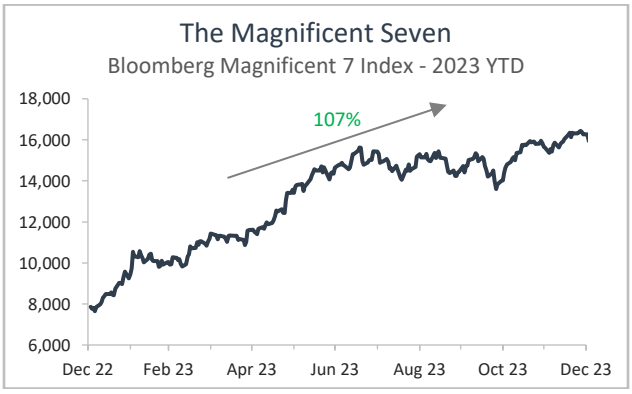
Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q4 23; gray = 2023.

Most global markets finished 2023 well in the green, but it was a tail of two tapes under the surface. For the first three quarters, the market was led higher by a small group of US mega-cap growth stocks (e.g. Nvidia). It was only until the fourth quarter that the rest of the market played catchup and generated most of its year-to-date returns (Charts 14-17).

The S&P 500 ended up 26.3% for the year and produced some interesting performance stats[1]:

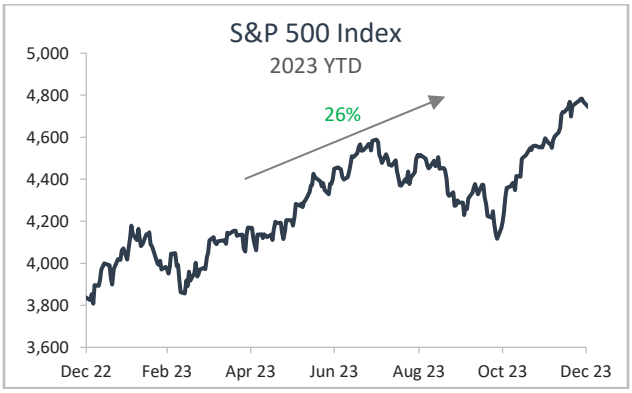
- Top 7 index weightings: **+77%**
- Remaining 493 names: **+14%**
- Best Sector: Technology **+58%**
- Worst Sector: Utilities **-7%**
- Number of stocks up 50% or more: **62**
- Largest peak-to-trough drawdown: **10%**
- Days the market ended up over 2%: **1 day**
- Days the market ended down over 2%: **0 days**

Chart 14



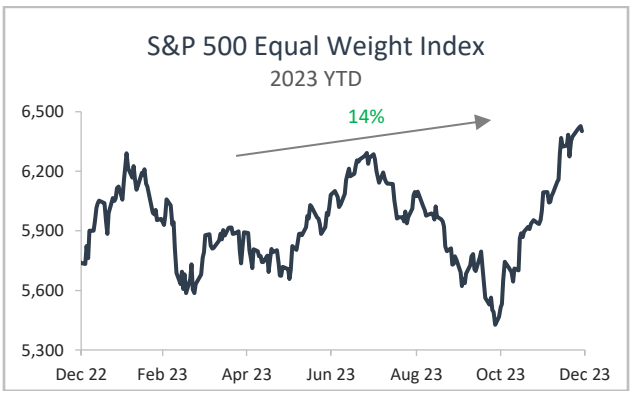
Source: Bloomberg; Arcus Capital Partners; Index constituents: GOOGL; AMZN; AAPL; META; MSFT; NVDA; TSLA

Chart 15



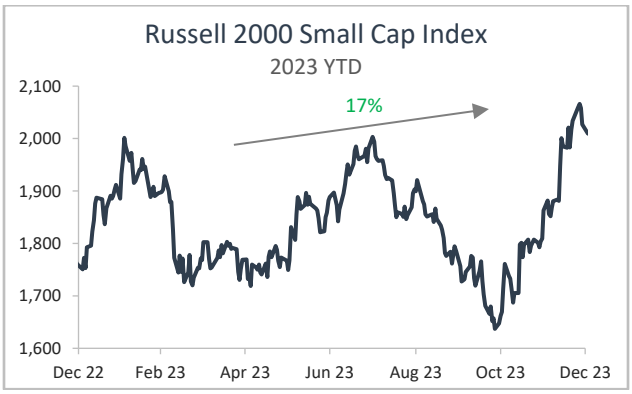
Source: Bloomberg; Arcus Capital Partners

Chart 16



Source: Bloomberg; Arcus Capital Partners

Chart 17



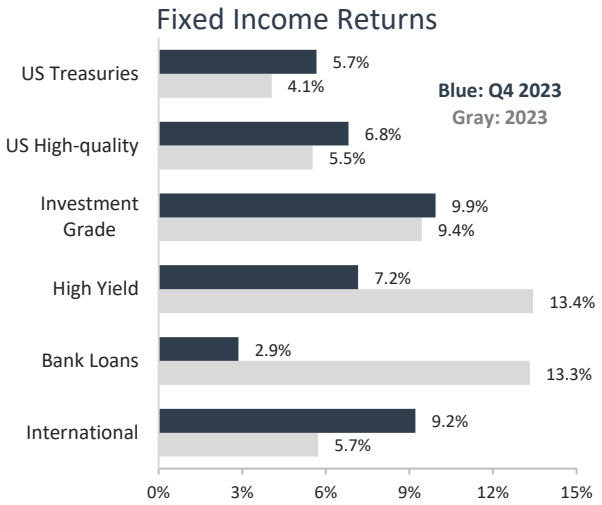
Source: Bloomberg; Arcus Capital Partners

For 2024, the setup for equities is far more balanced than it was coming into last year. Although the current macro backdrop is more favorable (e.g. better growth outlook and the potential for rate cuts), stretched valuations and overly optimistic investor sentiment may leave index investors with average returns. The broad market is "priced for perfection" and does not leave much room for error. The good news is that several areas within the market offer value (e.g. dividend-paying stocks).

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 but expect more volatility this year. Outside the US, we remain cautiously optimistic about developed and emerging market stocks but need to see more improvements before becoming bullish. A sign that the US dollar was turning lower would be a major tailwind for non-US equities.

IV. Fixed Income

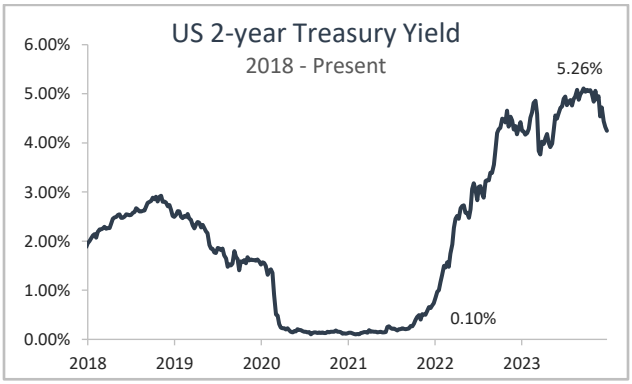
After roughly three years of grinding higher, interest rates finally saw some reprieve, which helped most areas of the bond market post impressive returns.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q4 23; gray = 2023.

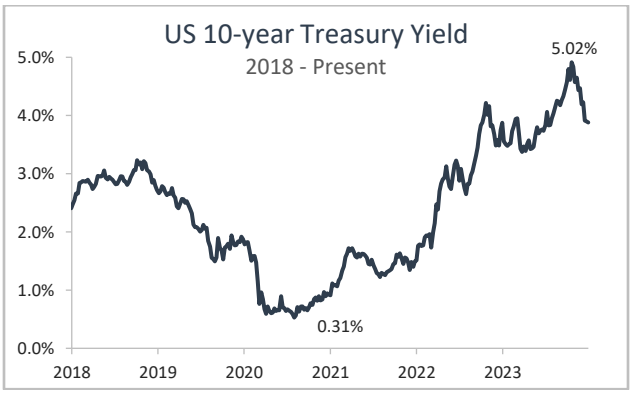
During the quarter, the US 2-year treasury yield reached as high as **5.26%** before retracing to **4.25%** by year-end, while the 10-year yield touched **5.02%** before ending at **3.87%** (Charts 18-19).[2] Interestingly, the 10-year yield ended the year almost exactly where it started. The dramatic move lower into year-end was primarily driven by a more dovish tone from the Federal Reserve and led to outsized returns in the longer-term parts of the bond market (Chart 20). As previously noted, softer inflation data and improving labor conditions should allow the Fed to start cutting rates this year. Nevertheless, the market's expectations for the number of rate cuts during 2024 may be too optimistic. At its meeting in December, the Federal Reserve's forecast showed three cuts (or 0.75%) in 2024; however, the market is currently pricing in around six.[3] It is unclear who will be correct, but the outcome will undoubtedly affect the markets. In our view, yields have likely peaked for the cycle but could see a near-term retracement of the recent declines on the long end (e.g. 10-year). Assuming longer-term yields move higher from here, we believe rate-sensitive bonds will again provide an attractive income source and hedge against downside equity risk and volatility.

Chart 18



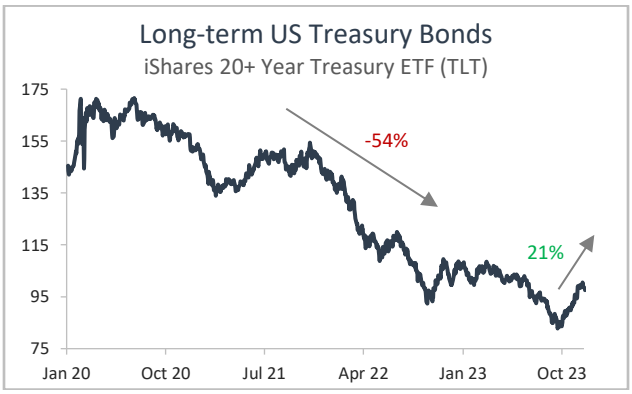
Source: Bloomberg; Arcus Capital Partners

Chart 19



Source: Bloomberg; Arcus Capital Partners

Chart 20

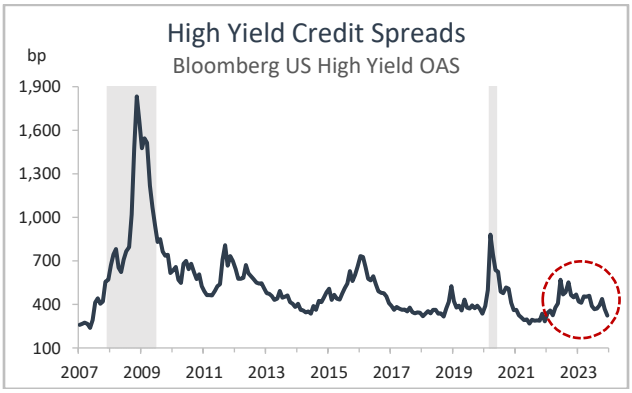


Source: Bloomberg; Arcus Capital Partners

Credit spreads, a way to measure the health of the fixed-rate corporate bond market, remain well below recessionary levels and have recently narrowed further – indicating limited stress for borrowers (Chart 21). Leverage loan prices, representing floating-rate borrowers, also trade above levels that have historically hinted at borrower stress (Chart 22). Although defaults in the high yield and leveraged loan index remain

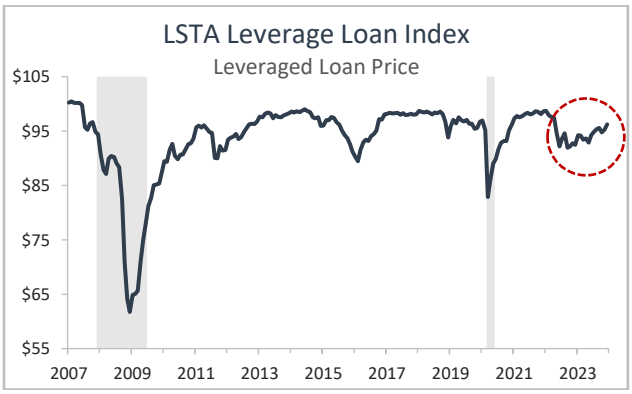
above pre-covid levels, the current issues appear manageable and should subside over the next few quarters. Potential headwinds to the credit markets include a sharp increase in rates above the recent highs, a softening economic backdrop, or an uptick in default rates.

Chart 21



Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

Chart 22

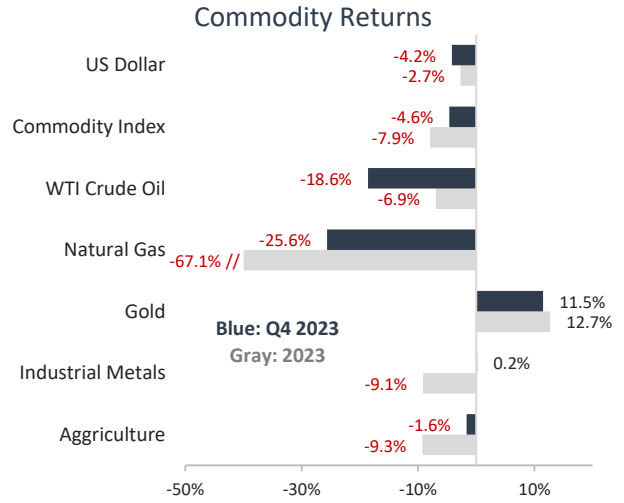


Source: Bloomberg; Arcus Capital Partners; gray shaded areas are National Bureau of Econ. Research (NBER) recessionary periods.

We believe the Fed has concluded its tightening cycle and will likely begin cutting short-term interest rates this year. We see value in high-quality bonds (e.g. Treasuries) but would wait until longer-term interest rates (e.g. 10-year) retrace some of their recent declines before buying. We are neutral on publicly traded credit (e.g. high yield), as current yields leave little room for error. Finally, we maintain a favorable view of the private credit market (e.g., middle market lending) due to its higher yields and less volatile return profile.

V. Commodities

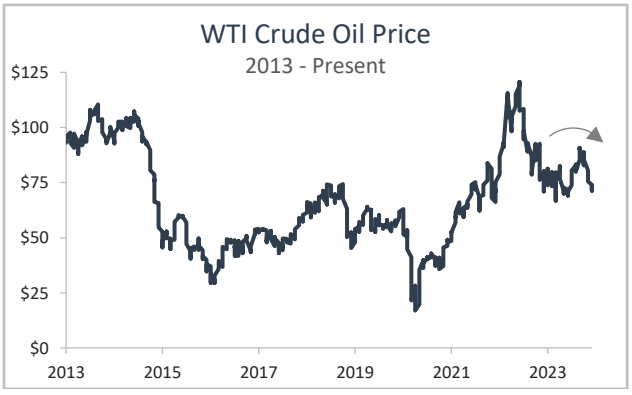
The commodity complex ended the quarter lower and was dragged down by the energy sectors, even as the US dollar weakened.



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = Q4 23; gray = 2023.

Crude oil moved sideways for most of the year, albeit with volatile swings, as bullish and bearish dynamics weighed on prices (Chart 23). For the bulls, improving global growth, OPEC supply cuts, and geopolitical tensions in the Middle East supported prices. However, the bears leaned on increased output from US shale producers and less risk tied to the Russia-Ukraine war as reasons to sell. From here, prices seem likely to resolve lower this quarter before finding their footing. From there, firmer economic data and a weaker US dollar could propel crude back towards the recent highs.

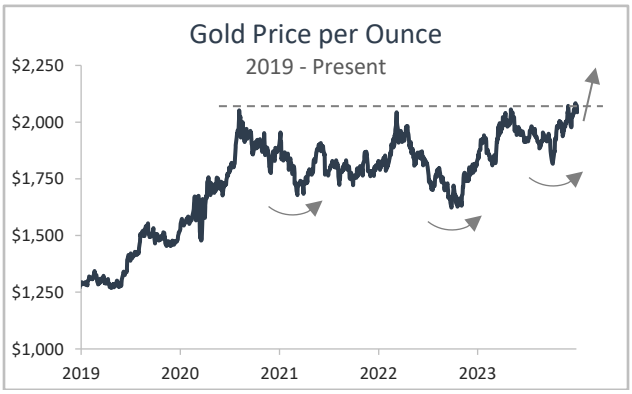
Chart 23



Source: Bloomberg; Arcus Capital Partners

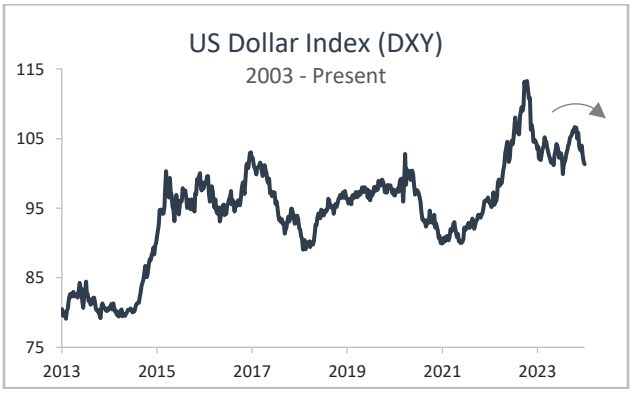
Gold ended the quarter higher and saw renewed buying interest once the Fed hinted at rate cuts in 2024. As noted, the dovish tone from the central bank sent interest rates and the US dollar lower and acted as a tailwind for the yellow metal (Charts 24-25). The strength was enough to briefly send gold to new all-time highs before the rally fizzled. That said, the longer-term setup for gold is positive as the metal should benefit from eventual rate cuts, further dollar weakness, or equity volatility – all of which seem likely to occur this year.

Chart 24



Source: Bloomberg; Arcus Capital Partners

Chart 25



Source: Bloomberg; Arcus Capital Partners

We are neutral on economically sensitive commodities (e.g. energy) but could adjust our outlook in the coming months. The setup for gold is bullish but could provide investors a better entry point later this quarter. Lastly, the US dollar may bounce before weakening over the balance of the year.

VI. Looking Ahead

After a stellar 2023, the outlook for equities over the next twelve months is far more balanced. A surprisingly dovish tone from the Federal Reserve helped propel stocks higher during the fourth quarter, but future rate cut expectations may have overshot and require a recalibration. However, falling inflation should help reduce costs, improve corporate margins, and lead to more robust earnings. Investors should focus on quality companies that can return capital to shareholders through dividends and buybacks.

After two years of rate hikes, we believe the Federal Reserve hiking cycle has ended and cuts should ensue. Longer-term interest rates (e.g. 10-year) could move higher over the short term but should eventually settle at lower levels. We like higher-quality bonds (e.g. Treasuries) but would wait to see if rates move higher before buying. Lastly, 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, crude oil and gold are structurally bullish but should provide better entry points over the coming quarters, especially if the US dollar weakens from current levels.

As always, we are available to discuss these items and address any questions. Thank you for the trust you place in our firm.

Sincerely,

Arcus Capital Partners

Sources:

1. Goldman Sachs
2. Bloomberg
3. Bloomberg

Important Risk and Disclosure Information

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