ARCUS CAPITAL PARTNERS

Q1 | 2025 Market Commentary

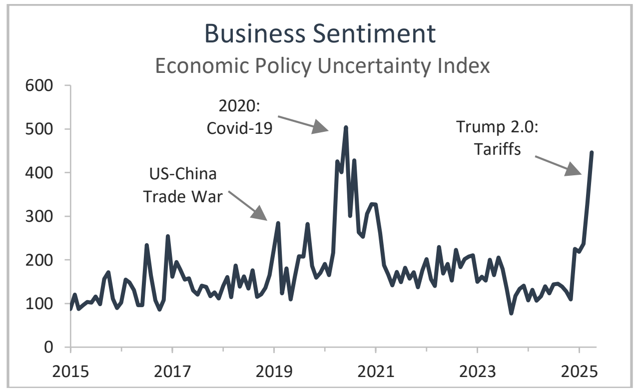
Dear friends of Arcus Capital Partners,

We hope this letter finds you well and that you are having a great start to the year. The first quarter was full of market-moving headlines and was best summed up by one word: uncertainty. After two years of strong returns and low volatility, the US equity market showed signs of internal stress and finished lower. That said, international stocks bucked their recent trend of underperformance and ended the quarter in the green. Interest rates across all tenors moved lower as investors sought hedges against equity volatility, and global growth data came in soft. Lastly, commodities remained volatile but benefited from the weaker US dollar and market volatility. We hold a cautiously optimistic view of equities and expect continued volatility this year. We still prefer private credit to public markets within fixed income, but we think some high-quality sectors (e.g. US Treasuries) are attractive. Finally, we encourage investors to keep a long-term perspective and stand ready to add to positions during times of weakness.

I. Market & Economic Overview

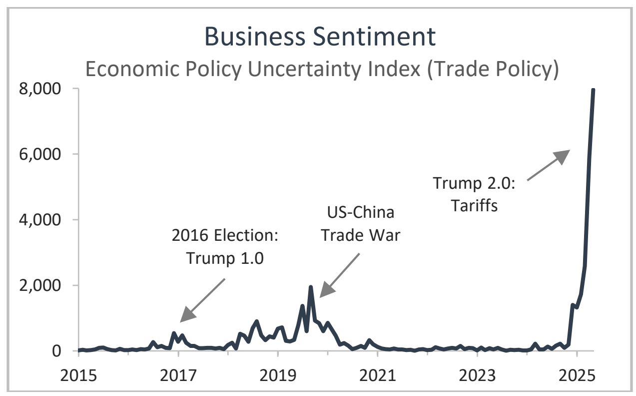
The positive market momentum and optimism from late 2024 carried over into the first quarter but was quickly replaced by fear and uncertainty related to the new administration's economic policy (Chart 1). Although President Trump consistently conveyed his plan to implement tariffs, the sheer size and scale of the figures announced on Liberation Day created significant angst among market participants and global business leaders (Chart 2). It also weighed heavily on small businesses still reeling from supply-chain issues, rapidly rising interest rates, and blistering inflation. Unfortunately, they will soon face even higher costs and increased ambiguity tied to the global trade war (Chart 3).

Chart 1



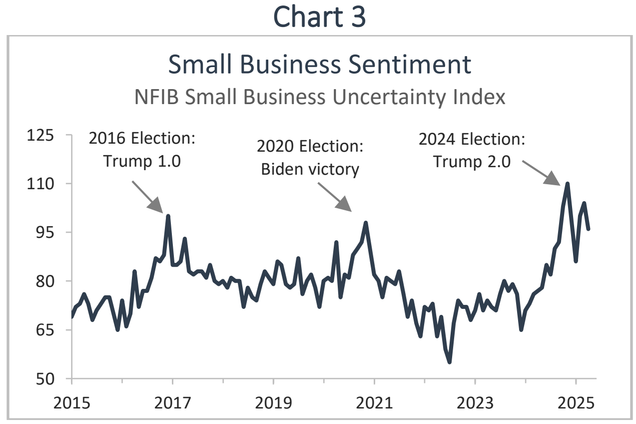
Source: Bloomberg; Arcus Capital Partners

Chart 2



Source: Bloomberg; Arcus Capital Partners

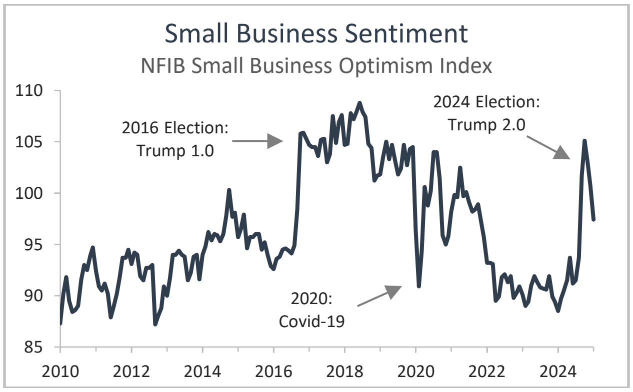
Chart 3



Source: Bloomberg; Arcus Capital Partners

Initially, business owners were optimistic that President Trump's business-friendly platform would lower taxes, reduce regulation, and foster economic growth. Unfortunately, this rosy outlook has faded as small businesses now have more questions than answers and fail to see the benefit of the tariffs (Chart 4).

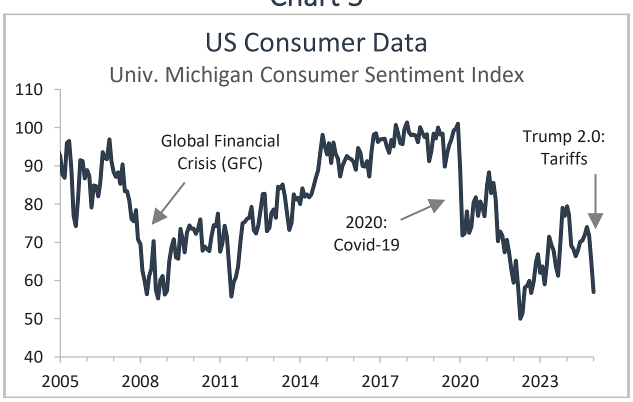
Chart 4



Source: Bloomberg; Arcus Capital Partners

Consumers also feel the uncertainty, as reflected by consumer sentiment, which is now at the lowest levels since 2022 when inflation and interest rates were close to peaking (Chart 5). With consumer spending driving nearly two-thirds of domestic growth, any slowdown from this cohort could create a significant headwind for the economy.

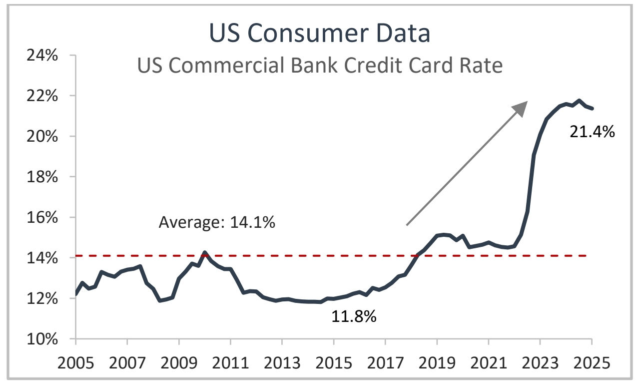
Chart 5



Source: Bloomberg; Arcus Capital Partners

Aside from the tariffs, consumers remain heavily reliant on debt and face elevated borrowing costs, despite the Federal Reserve's three interest rate cuts last year. In fact, credit card and other borrowing rates are still near all-time highs and do not appear likely to decline anytime soon (Chart 6).

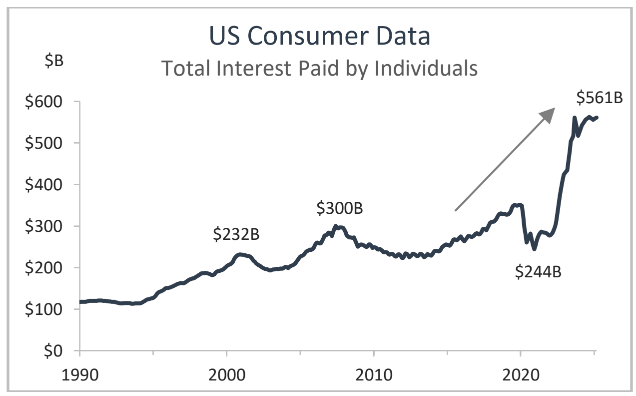
Chart 6



Source: Bloomberg; Arcus Capital Partners

Unfortunately, higher rates have led to a record amount of interest payments owed by individuals (Chart 7). With tariffs likely to push prices higher and interest rates unlikely to fall, this problem could persist and weigh on consumers.

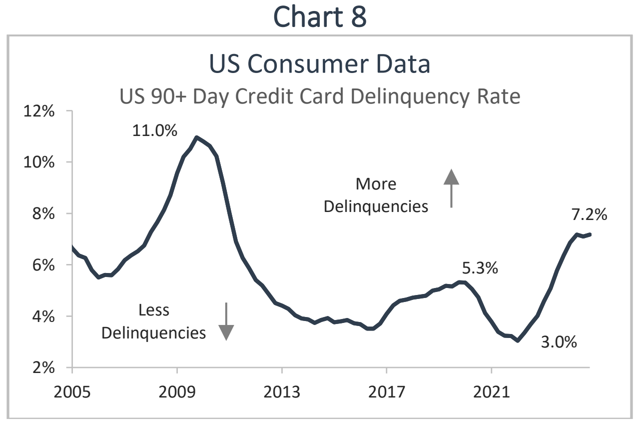
Chart 7



Source: Bloomberg; Arcus Capital Partners

This enormous debt burden has resulted in credit card delinquency rates rising as borrowers simply cannot pay down their debt fast enough (Chart 8).

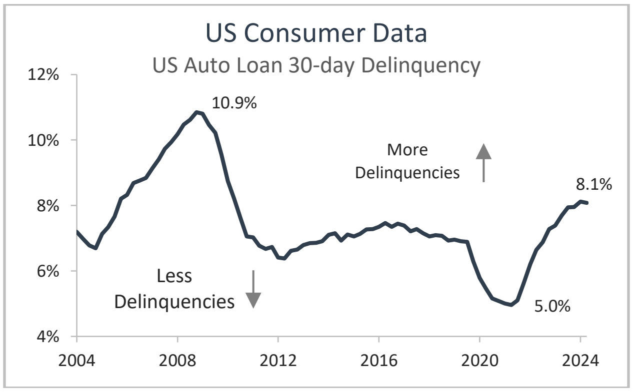
Chart 8



Source: Bloomberg; Arcus Capital Partners

Auto loan delinquencies have also increased for similar reasons: elevated borrowing costs and record-high new and used auto prices (Chart 9).

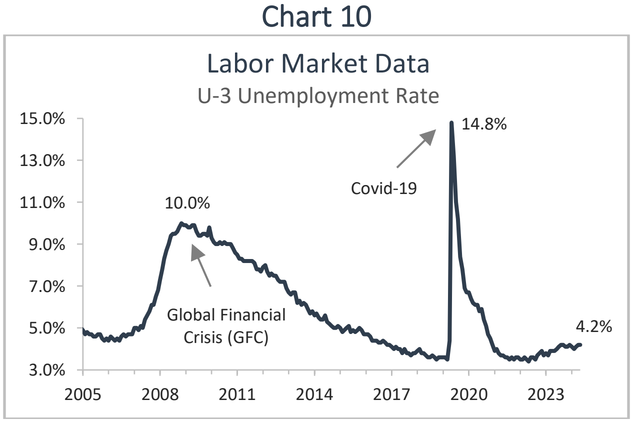
Chart 9



Source: Bloomberg; Arcus Capital Partners

One bright spot within the economy continues to be the labor market. The unemployment rate has gradually increased over the last few years but remains below levels that indicate stress (Chart 10). This indicator serves as a good barometer for the overall economy and consumer health (i.e. consumers need income to purchase goods and services).

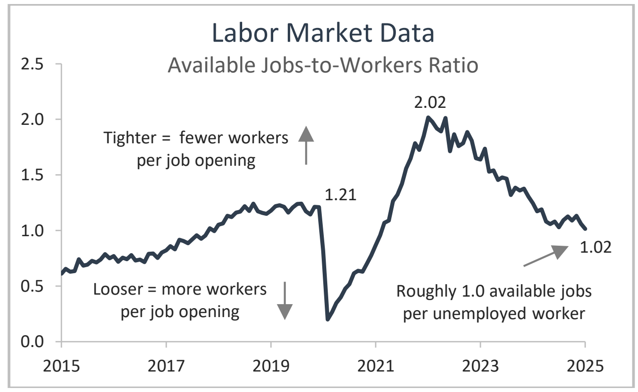
Chart 10



Source: Bloomberg; Arcus Capital Partners

Although the job market remains stable, it is no longer tight, as shown by the jobs-to-workers ratio (Chart 11). This data highlights that the labor supply has gradually increased while job openings have decreased. The current reading suggests a balanced labor market; however, any further deterioration could indicate that employers are starting to cut back on spending by hiring fewer workers or laying off existing employees.

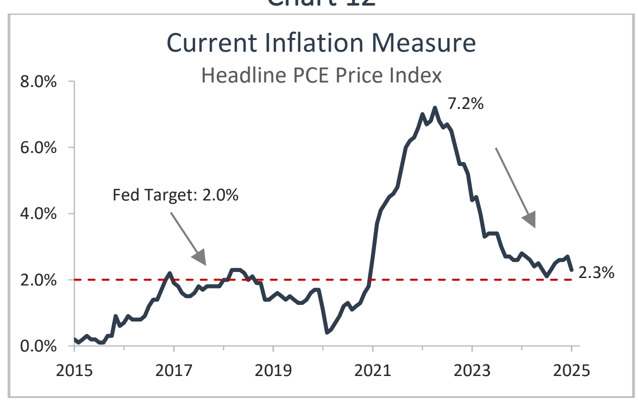
Chart 11



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

Moderating inflation has been another notable development. Improving labor dynamics, fewer supply-chain disruptions, and moderating demand have all contributed to cooling the white-hot price increases seen a few years ago. The Fed's preferred gauge is hovering around its target level, supporting the potential for additional rate cuts (Chart 12). That said, it remains unclear how the new tariffs will affect prices, and a second wave of inflation could occur over the next few quarters.

Chart 12



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

Overall, the backdrop for the US economy is mixed, and the odds of recession have increased. President Trump's trade policy is likely to slow growth and raise prices in the short term, potentially leading to a stagflationary environment. Additionally, the administration has put the Federal Reserve in a difficult position, as it must walk a tightrope to avoid keeping policy too tight, staving off

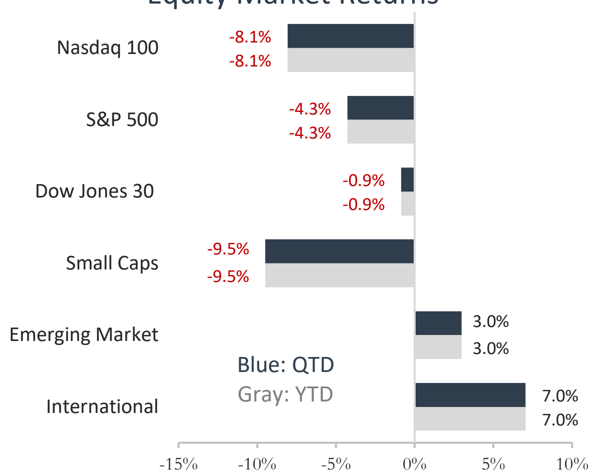
potential growth, or too loose, sparking a second wave of inflation. Our baseline expectation is for the Fed to lower interest rates two or three times in 2025 and conclude by mid-2026. Finally, we anticipate continued volatility in the equity market, which will require investors to remain patient and nimble.

II. Global Equities

Domestic equities ended the quarter lower and continued to exhibit higher levels of volatility relative to the last few years. The S&P 500 finished down **4.3%** in Q1 – here are some interesting stats from the quarter and the full year[1,2]:

- Best Sector in Q1: Energy **+10.2%**
- Worst Sector in Q1: Consumer Discretionary **-13.8%**
- Best stock in Q1: CVS Health Corp (CVS) **+53%**
- Worst stock in Q1: Deckers Outdoor (DECK) **-45%**
- Bitcoin total return for Q1: **-11.7%**
- Foreign investor share of US equity markets: **18%**

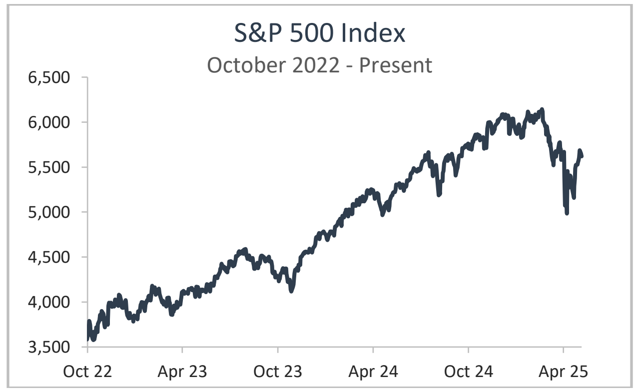
Equity Market Returns



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = QTD; gray = YTD.

Equity investors came into the year optimistic that President Trump's pro-growth policies would propel markets higher. Initially, this thesis played out as hoped, but a combination of weaker economic data, uncertainty over the tariffs, and other macro variables weighed on risk appetite. After making new all-time highs during the first half of Q1, the S&P 500 declined 10% in one of the fastest corrections in modern times (Chart 13).[3]

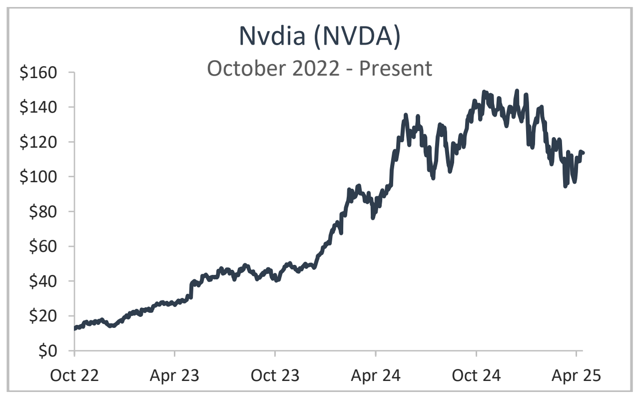
Chart 13



Source: Bloomberg; Arcus Capital Partners

Bellwether names like NVIDIA (NVDA), which had previously led the market higher, experienced sharp declines as competition from Chinese rivals made investors question their outlook for large US technology stocks (Chart 14).

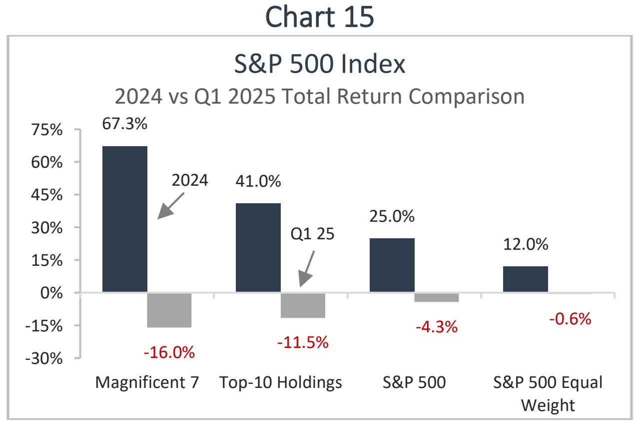
Chart 14



Source: Bloomberg; Arcus Capital Partners

Interestingly, last year's winners (i.e. Magnificent 7) lagged the most during the first quarter (Chart 15).

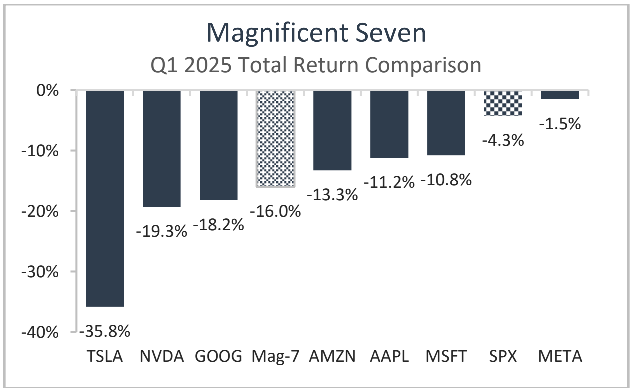
Chart 15



Source: Bloomberg, Goldman Sachs; Arcus Capital Partners

Within the Mag-7 index, all but one company (i.e. META) experienced double-digit declines and underperformed the market (Chart 16).

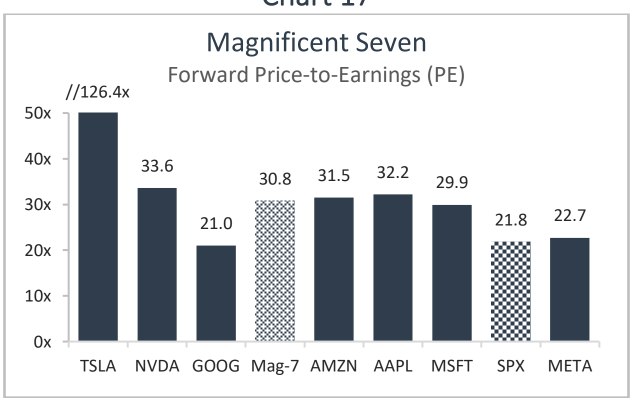
Chart 16



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; Mag-7 constituents = Nvidia (NVDA); Meta (Meta); Telsa (TSLA); Amazon (AMZN); Google (GOOG); Apple (AAPL); and Microsoft (MSFT)

After two years of strong relative and absolute performance, mean reversion likely played a part in the group's poor returns; however, several Mag-7 members started the year with elevated valuations, which set a high bar for continued strong performance (Chart 17).

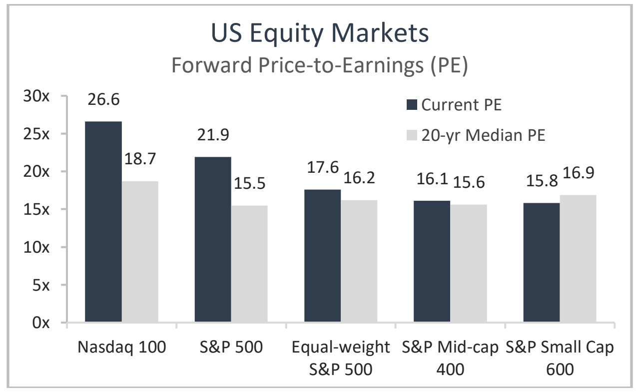
Chart 17



Source: Bloomberg; Arcus Capital Partners. The data shown represents forward PE based on EPS estimates over the next twelve months as of 1/1/25.

The same could be said for the broad markets, which traded well above their 20-year medians when the market peaked in February. Specifically, the S&P 500 traded at a price-to-earnings ratio (PE) of 21.9x compared to the 20-year median of 15.5x (Chart 18).

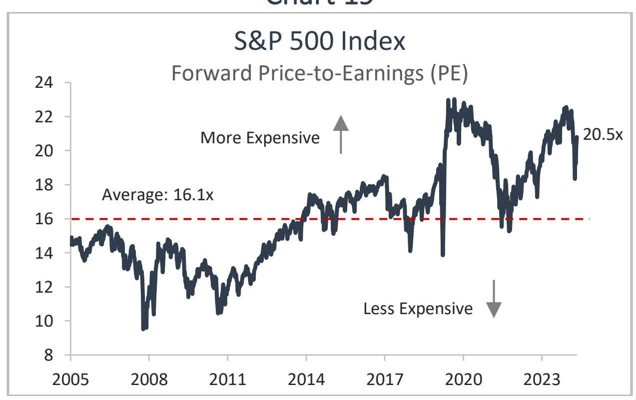
Chart 18



Source: Bloomberg; Arcus Capital Partners. The data shown represents forward PE based on EPS estimates over the next twelve months as of 2/21/25.

That said, the market has since declined, and first-quarter earnings surprised to the upside. This combination helped the market's forward multiple re-rate lower (Chart 19). Nevertheless, a return to the longer-term average PE ratio would require a decline of around 20% from the current level of ~5,800 – this is an observation, not a forecast.

Chart 19



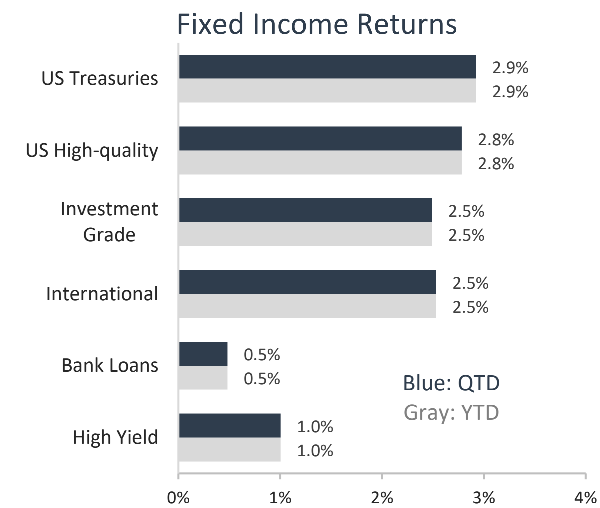
Source: Bloomberg; Arcus Capital Partners. The data shown represents forward PE based on EPS estimates over the next twelve months.

We continue favoring equities but recognize that volatility is here to stay for the foreseeable future. We prefer domestic stocks due to their higher-quality characteristics and growth potential. Specifically, we prefer companies that can repurchase shares or return cash to shareholders through dividends. Foreign equities have lagged the US over the last few years, but recent positive developments have created tailwinds that may help close the gap.

III. Fixed Income

Interest rates ended the quarter lower, as the previously optimistic tone within risk markets became less constructive and investors sought portfolio ballast. The US 10-year yield dropped by ~32 basis points (100 basis points (bp) = 1.0%) to finish at **4.25%** – here are some interesting comparative data points from the quarter[4]:

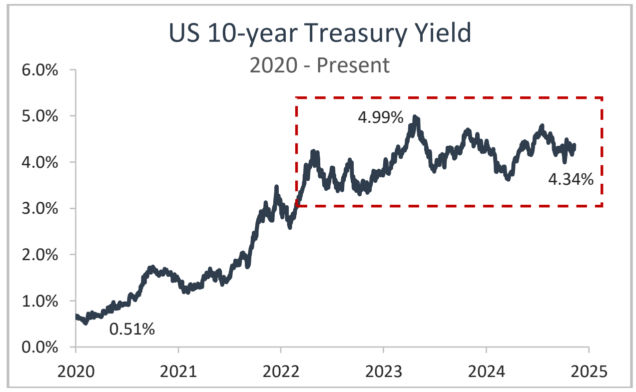
- High Yield Money Market Rate (today): **4.19%**
- High Yield Money Market Rate (2020): **0.01%**
- 30-year Mortgage Rate (today): **6.82 %**
- 30-year Mortgage Rate (2021): **2.82%**
- 60-month Auto Loan Rate (today): **7.28%**
- 60-month Auto Loan Rate (2021): **3.51%**



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = QTD; gray = YTD.

Weaker economic data, concerns surrounding President Trump's tariff agenda, and softer inflation readings contributed to a decline in rates during Q1. As a result, the US 10-year yield traversed towards the lower end of the well-defined range it has traded in since early 2022 (Chart 20). This decline was a welcome respite from the sharp rise in rates during the second half of 2024, when rates increased by over 100 basis points. Much of that transition higher was driven by expectations for fiscal stimulus from the Trump administration and the belief among many experts that the Federal Reserve had unnecessarily cut short-term interest rates during an economic expansion, which would further boost growth.

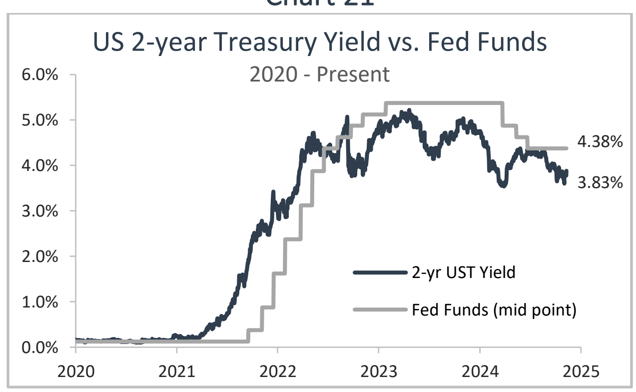
Chart 20



Source: Bloomberg; Arcus Capital Partners

Nevertheless, short-term interest rates (i.e. US 2-year yield) suggest that the Federal Reserve has room to cut the Fed Funds rate further (Chart 21). Many pundits believe that the 2-year yield is a good gauge for where Fed policy rates should reside.

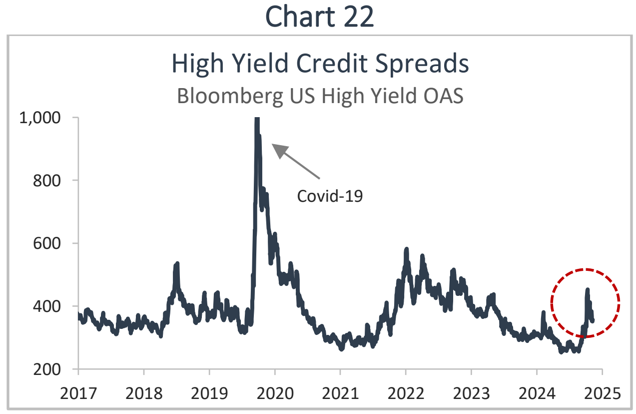
Chart 21



Source: Bloomberg; Arcus Capital Partners

Credit spreads (a barometer for the corporate bond market) also exhibited moderate signs of weakness and widening during the quarter (Chart 22).

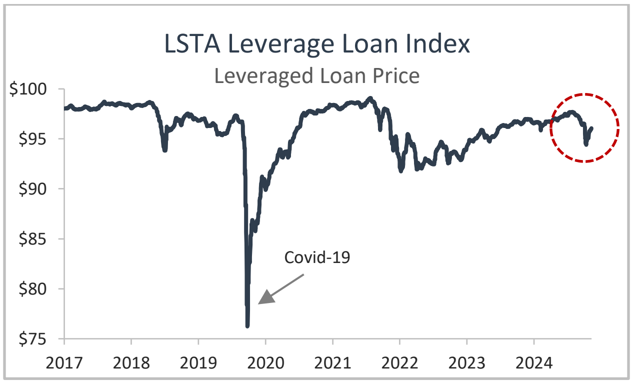
Chart 22



Source: Bloomberg; Arcus Capital Partners

Similarly, leveraged loan prices, representing floating-rate borrowers, moved modestly lower but remained well above levels seen during previous periods of stress (Chart 23).

Chart 23



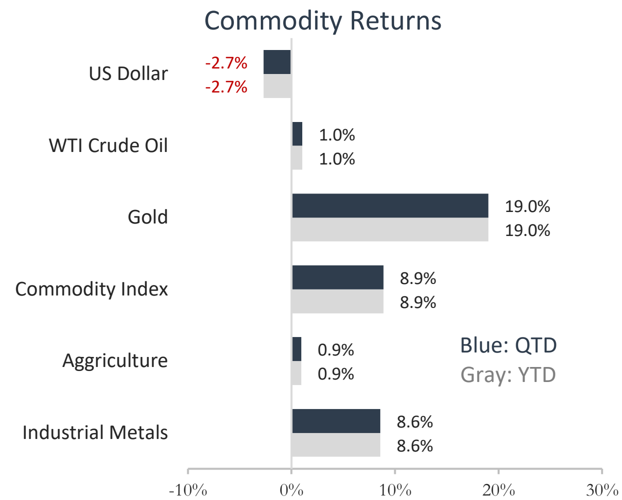
Source: Bloomberg; Arcus Capital Partners

We believe the Federal Reserve will remain on hold for now as it assesses the impact of the tariffs on inflation and job data; however, it will likely cut rates during the second half of the year. Barring any significant setbacks, longer-term interest rates should stay rangebound over the balance of the year. We have a favorable view of high-quality bonds (e.g. US Treasuries), which now offer attractive yields and may help hedge against equity risk. We are neutral on publicly traded credit (e.g. high yield), as current yields and spreads have retraced much of their recent move. Finally, we maintain a long-standing favorable view of the private credit market due to its higher all-in yields and less volatile return profile.

V. Commodities

The commodity complex rallied during the quarter and was propelled higher by a weaker US dollar. Within the index, precious and industrial metals saw the most strength – here are some interesting comparative stats from the quarter[5]:

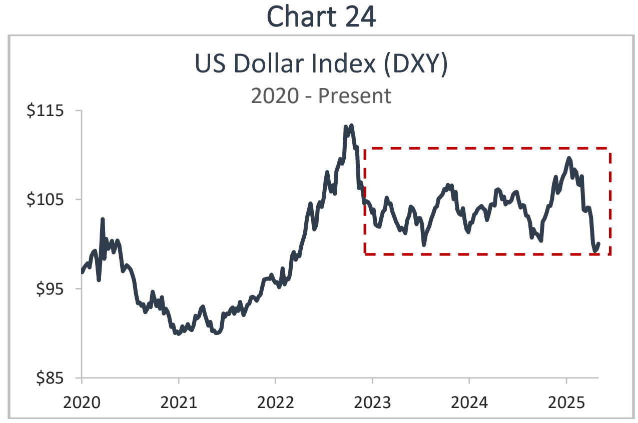
- Gold (2025-high): **$3,500/oz.**
- Gold (2020-low): **$1,450/oz.**
- Natural Gas (2025-high): **$4.90/ MMBtu**
- Natural Gas (2020-low): **$1.43/MMBtu**
- Coffee (2025-high): **$4.19/lbs.**
- Coffee (2020-low): **$0.95/lbs.**



Source: Bloomberg; Arcus Capital Partners; returns include the reinvestment of dividends; blue = QTD; gray = YTD.

After breaking out to the upside during the fourth quarter, the US dollar dropped precipitously to test its lowest levels over the last three years (Chart 24). Much of the weakness can be attributed to global investors questioning their long-standing view of American exceptionalism, which was tested after President Trump implemented highly restrictive tariffs on all US trading partners. It is unclear how the dollar will resolve over the near term, but it does appear that the longer-term trend may be lower, which could act as a tailwind for commodities.

Chart 24

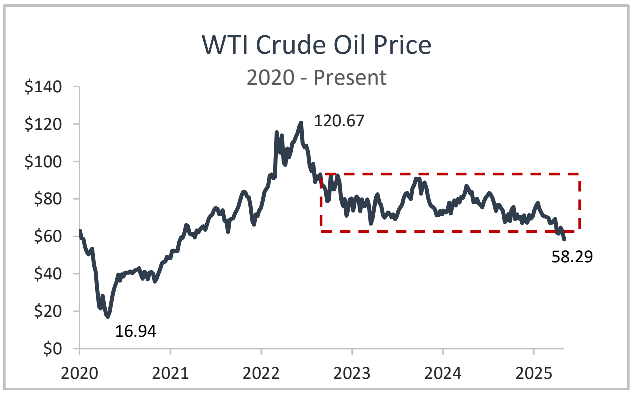


Source: Bloomberg; Arcus Capital Partners

Crude oil finally broke below the lower end of its multi-year range as tariff-related fears weighed on economic growth prospects (Chart 25). Unfortunately, crude prices continue to face several headwinds, and the outlook remains uncertain. Domestic supply is expected to rise as

President Trump deregulates the energy sector and US producers increase their production, adding more barrels to the global supply. Additionally, the increased likelihood of a deal with Iran and a truce between Russia and Ukraine will likely remove the war premium embedded in prices. These crosscurrents are net bearish for crude oil over the coming quarters.

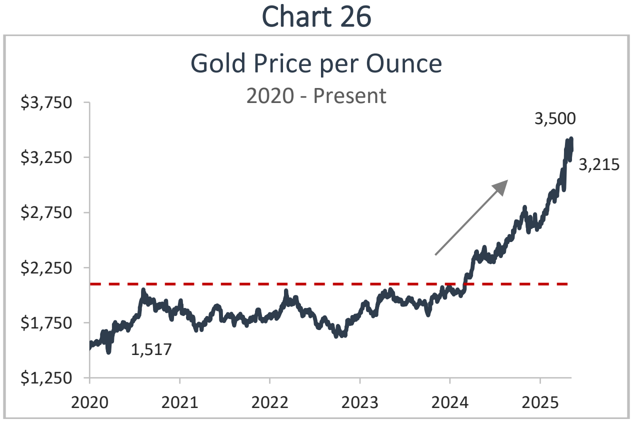
Chart 25



Source: Bloomberg; Arcus Capital Partners

Gold rallied during the first quarter and lived up to its safe-haven status. The combination of US dollar weakness, market volatility, and central bank buying sent the metal to new all-time highs (Chart 26). The current setup remains attractive, but a near-term consolidation might be necessary before the next leg higher can begin.

Chart 26



Source: Bloomberg; Arcus Capital Partners

We remain neutral on economically sensitive commodities as several lingering headwinds could weigh on prices over the near term. Gold's outlook leans bullish, but investors may get a better entry later in 2025. Lastly, the US dollar is likely to bounce in the near term; however, we expect it to start weakening during the second half of the year.

IV. Looking Ahead

The macro uncertainty surrounding the Trump administration's proposed tariffs has forced us to downgrade our near-term view on the economy and risk assets. Recession is not our base case, but heightened trade tensions and higher prices may weigh on corporate earnings and disappoint expectations that are already elevated. As a result, we expect above-average volatility in the coming quarters, requiring investors to remain patient and use equity weakness to add to their positions. We favor domestic companies trading at attractive valuations that can return capital to shareholders through dividends and share buybacks.

Longer-term interest rates have retraced part of their recent run higher but are expected to remain range-bound over the coming quarters. We foresee the Federal Reserve cutting interest rates 2-3 times in 2025 and again during the first half of 2026. We like higher-quality bonds (e.g. US Treasuries) that offer an attractive yield and may provide downside protection during equity corrections. Lastly, we prefer the private credit market (e.g. middle-market lending), which offers higher yields and less correlation to interest rates and the public markets.

Finally, cyclical commodities such as crude oil face several near-term headwinds and are biased to the downside. On the other hand, gold remains attractive and could offer upside potential if the US dollar declines further or equity market volatility continues.

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

Sincerely,

Arcus Capital Partners

Sources:

1. Strategas Research
2. Goldman Sachs
3. Fundstrat
4. Bloomberg
5. Bloomberg

Important Risk and Disclosure Information