ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK

January 2022 / 1st Quarter

Since the middle of 2020, we've been quite positive on stocks as we believed the market's upside potential far outweighed its downside risk. Today, we see these two as more balanced.

TAKING STOCK

We'll be the first to admit that squaring our emotional experience of the past couple of years with the stock market's eye-popping performance can be a challenge. Last year the S&P 500 posted a total return of 29% while our Arjuna 350 US stock strategy returned 30%.* Over the past three years, the S&P 500 returned 100% or 26% per year annualized while Arjuna 350 returned 109% or 28% annualized.

Looking to the global markets, you find a similar, if only slightly more muted story. For the three years through 2021, the MSCI World Equity index returned 80% or 22% annualized, while our Arjuna Global Impact stock strategy returned 103% or 27% annualized.

We're extremely pleased with these returns, which were delivered by fossil-fuel-free portfolios constructed with a vigilant eye to the challenges and opportunities of building a sustainable future.

That said, we'll stick our neck out here and predict that what lies ahead is almost surely less rewarding. How much less rewarding has recently become a much tougher call.

FED VOLTE-FACE?

As readers of these *Market Outlooks* know, we have for some time underlined that a sea-change in the Federal Reserve's priorities has driven much of the enthusiasm in the stock markets. Specifically, for over a year Fed Chairman Powell has emphasized that the Fed would place the highest priority on achieving full employment while being more tolerant of inflation. This marked a sharp reversal of the Fed's priorities over the past 40 years. It implied that the Fed would be more patient in raising interest rates in order to allow the US economy to run hotter—with more inflation—and thereby achieve full employment.

Another point we've underlined repeatedly is that the Fed's raising interest rates has typically represented the chief threat to the stock market—as raising interest rates to cool inflation has tended to have the unintended consequence of driving the US economy into recession. Consequently, a Fed that's slower to raise interest rates means a stock market that's free to climb higher—as it has.

For much of last year, the Fed's emphasis on promoting full employment was read as signaling there would be no interest rate increases until 2023. As recently as last October, futures markets were predicting the Fed would raise interest rates once, at most, towards the end of 2022. By year-end, all of that had changed. Now, the market consensus expects the Fed to start raising interest rates at its March meeting and do so three more times in 2022. What happened?

SOME LIKE IT HOT

In the fourth quarter, surging inflation drove the consumer price index up 7% for 2021. That was the highest inflation reading in 39 years. Simultaneously, the US unemployment rate plummeted to 3.9% from a pandemic high of 14.7%. That 3.9% was just 0.4% above the lowest unemployment reading of the past 20 years. At the pace unemployment is now falling, the Fed's target for "full employment" (3.5%) will be reached before the end of the first quarter of this year. Which is to say, the US economy should reach "full employment" nine months ahead of the Fed's anticipated schedule.

Having reached its goal of full employment sooner than expected, the Fed is now both free ***and forced*** to address inflation. For while very low unemployment has produced strong wage gains for employees—up 4.7% in 2021—inflation has run even stronger—up 7%—with the result that consumers' buying power is shrinking. As consumption accounts for roughly 2/3 of the total US economy, a consumer with less buying power means an economy with slower growth. Slower growth in the economy, in turn, then threatens full employment—a potentially vicious cycle.

This is why Fed Chairman Powell in early December pivoted to say that at this point, fighting inflation, rather than competing with full employment, is a necessary means of sustaining it. Full employment and lower inflation are no longer an either/or. They must be a both/and.

BE CAREFUL WHAT YOU WISH FOR

Powell now finds himself faced with the delicate task of cooling inflation without killing the economic expansion. It should be noted that this is a task previous Fed Chairs have often failed to pull off. Hence the sell-off in the stock market in January.

Going forward, the interplay of inflation data and Fed policy will continue to drive stock returns. The more sanguine view holds that as supply chains unclog and the tsunami of Fed stimulus payments tapers off, inflationary pressures will ease, and the Fed can be less aggressive in raising interest rates. This could lead to a so-called "soft landing" in the economy, where growth stabilizes at a pace that sustains full employment while keeping inflation in check. This would be a Goldilocks outcome—not too hot, not too cold—that the stock market would heartily applaud.

The more pessimistic view sees two paths to an unpleasant outcome: On one, inflation eases but the Fed raises rates too aggressively, needlessly driving the economy into recession—a hard landing. On the other, inflation continues to surge, and the Fed is forced to raise rates aggressively, driving the economy into recession in order to quell inflation. On either scenario, the stock market would not be pleased.

LISTENING

We look at the financial markets as a vast economic prediction wiki, where millions of people, based on their best information, bet trillions of dollars on various economic outcomes. That is, we consider markets to be one of the very best examples of the so-called hive mind. This is why the stock market is, itself, considered one of the best, if fallible, leading indicators of future economic activity. As such, we spend a lot of time trying to listen to what the market is telling us.

On a concerning note, we've noticed that the Consumer Staples sector of the market has started to perk-up in terms of its relative performance. Consumer Staples are a classic example of stocks that perform best when the economy is heading into or already in a recession. Why? Because demand for staples like toilet paper and breakfast cereal tends to be fairly constant, regardless of the economy's swings. So, they're viewed as defensive stock positions that hold up relatively well when the economy sags.

Not surprisingly, then, Consumer Staples performed best back in the teeth of the pandemic recession—namely, February through March of 2020. From April of that year forward, they fell increasingly out of favor as an economic recovery grew more likely—and their defensive characteristics less appealing. However, since mid-November of 2021, Consumer Staples have increasingly gained favor as the markets apparently have begun to find their defensive qualities once again appealing. That's a troubling message from the stock market.

The bond market, on the other hand, is so far not confirming that message. One of the best indicators of economic trouble ahead is the "credit spread" or difference between lower- and higher-quality bond yields. As the risk of default on bond payments rises with a slowing economy, recessions pose a risk for bond holders. Consequently, when the perceived risk of recession rises, the spread between lower- and higher-quality bond yields widens. This, because investors in lower-quality bonds demand a higher yield under such conditions.

So far, bond spreads remain quite narrow, suggesting that bond investors don't consider the risk of recession very significant.

These are just two examples of the sort of messages the markets are sending—and we could offer many more. At present the markets are sending mixed messages. But that, itself, is a message.

With its recent renewed interest in Consumer Staples, the market is telling us that investors are now "hedging" the more positive message they're getting, for example, from credit spreads. Not surprisingly, this renewed interest in Staples came shortly before Chairman Powell pivoted in his messaging, suggesting the Fed would take a more aggressive approach to inflation.

We, too, are tempering our outlook. Since the middle of 2020, we've been quite positive on stocks as we believed the market's upside potential far outweighed its downside risk. Today, we see these two as more balanced.

Farnum Brown, Chief Strategist

Arjuna Capital strategy returns are shown gross of wealth management fees. The opinions expressed herein are those of Arjuna Capital, LLC ("Arjuna Capital") and are subject to change without notice. This material is not financial advice or an offer to sell any product. Arjuna Capital reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. This is not a recommendation to buy or sell a particular security. The **S&P 500® Index is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices. The **MSCI World** is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries chosen for market size, liquidity, and industry group representation. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI World Index does not offer exposure to emerging markets. Impact Theme, Regional and Sector data as of Sept 30 Quarter 2021. Arjuna Capital is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Arjuna Capital including our investment strategies, fees and objectives can be found in our ADV Part 2, which is available upon request.* AJC-22-04