ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
January 2023 / 1st Quarter

Our outlook for a coming recession and further downside in stocks is very much the consensus view. When everyone is focused on what should go wrong, it's worth wondering what they – and we – are missing that could go right.

GOOD RIDDANCE

With the S&P 500 declining 18%, 2022 was the worst year for the stock market since 2008 and the Great Recession. It was also the worst year since 2008 for portfolios comprised of stocks and bonds: a hypothetical "balanced" portfolio invested 60% in stocks and 40% in bonds lost 15% in 2022. It was a nowhere-to-run-nowhere-to-hide kind of market. That is, except for stocks in the fossil-fuel Energy sector, which gained 66% for the year thanks to Vladimir Putin's invasion of Ukraine, which violently disrupted global oil supplies and fattened oil companies' bottom lines.

Of the remaining 10 sectors of the S&P 500, only one, Utilities, showed a positive return—a meager 1%. So, the Energy sector was the only game in town for stocks.

As our Arjuna 350 U.S. stock strategy is fossil-fuel-free, our domestic stock portfolios didn't benefit from Mr. Putin's aggressions and as a result lagged the S&P 500, declining 20% for the year. We've often noted that avoiding fossil-fuel stocks at times will penalize our stock returns. 2022 was one of those times. We remain confident that avoiding these shares provides portfolios with a long-term performance tailwind as — even with Energy's stellar 2022 returns—the sector has dramatically lagged the S&P 500 over the past decade. From 12-31-12 through 12-31-22, the Energy sector gained 79% vs. the S&P 500's 227% return. That is, the Energy sector's return was just 35% of the S&P 500's. We rest our case.

Arjuna's Global Impact stock strategy overcame this year's fossil-fuel handicap, matching the MSCI World Index return of -18%. While also fossil-fuel-free, Arjuna Global's stock selection benefited from access to shares in Western Europe, notably a solar-power firm in Germany and a biotech company in Denmark.

PERSPECTIVE

For all the misery meted out to investors in 2022, it's worth noting that for the trailing three years, the Arjuna 350 US stock strategy returned a cumulative 27% or 8% per year, matching the S&P 500's returns. And for the trailing five years, the 350 strategy returned 67% or 11% per year vs. the S&P 500's 57% return or 9% per year. The main point here is that even including the worst year of the past 14 for stocks, "the market" has generated quite respectable returns for the last three and five years. The secondary point is that our Arjuna 350 strategy has shown as good or better returns compared to the market over these longer periods.

This illustrates why stock investing is a long-term proposition, not a year-to-year decision. As we've said many times: you have to stay in it to win it.

A WORD ON BONDS

Adding bonds to a stock portfolio is intended to provide portfolios with a "hedge" against stock declines as stock and bond prices tend to be negatively correlated—that is, when stock prices go down, bond prices tend to go up. This is because when stocks go down significantly, investors typically seek out the relative safety of bonds, and this incremental demand drives up their prices. In this way, a "balanced" portfolio of stocks and bonds is designed to reduce the overall volatility of a portfolio.

This year was an exception to the rule due to a) exceptionally high inflation and b) an exceptionally aggressive Fed interest-rate policy to fight it. That is, the Fed raised interest rates more aggressively than it has in 40 years in order to fight a level of inflation not seen in 40 years. And sharply rising interest rates mean sharply falling bond prices, regardless of what stocks are doing.

That said, our portfolios' bond exposure is intentionally very high quality and only intermediate in maturity. Both of these factors limit the impact of rising rates on our bond portfolios relative to the overall bond market. As a result, our bond portfolios were down just 5-6% for the year vs. a 13% decline for the overall bond market. Thus, our bonds still provided a significant hedge against stock declines in the 18%-20% range.

POSITIONING

As noted last quarter, our portfolios have been defensively positioned since February of last year. This means that in portfolios where we have discretion to tactically allocate among asset classes—stocks, bonds, cash, private debt, private equity—we lowered exposure to stocks and raised exposure to bonds and cash, as well as to private debt for clients who qualify. These moves were intended to "hedge" or limit the impact of stock declines on overall portfolios by increasing exposure to asset classes whose returns aren't highly correlated with those of stocks.

As noted above, bonds provided this hedging function in 2022, if not quite as robustly as we would've liked. Similarly, our private debt fund, Income & Impact, hedged portfolios by showing an estimated 2% positive return (private market investments report returns with a significant lag). Cash—meaning short-term US Treasury bills and money market funds—also served this role simply by showing a fractional positive return.

All of these moves—reducing stocks while increasing bonds, private debt, and cash—were done early enough last year to prove effective at reducing the impact of stock declines on our portfolios. There are times when successful investing requires playing defense. 2022 was one of them.

LOOKING FORWARD

We hope we're wrong, but we think 2023 will also be a year for playing defense. While there have been some encouraging signs that the worst of inflation is behind us—both headline and core inflation measures appear to have peaked, home prices and rents have eased a bit—the driver behind the stock market's decline has been the Fed's policy of sharply raising interest rates. And while the Fed's goal is bringing inflation under control, it sees the root cause of inflation as exceptionally rapid wage growth resulting from a too-tight job market.

On that front, the Fed is not yet seeing what it considers necessary to cool inflation. The U.S. unemployment rate today remains at a record low 3.5%. The Fed sees that rising to 4.6% by the end of this year as its continued rate hikes slow the economy. A slowing economy means lower corporate revenues and profits and that, in turn, spells job layoffs as firms reduce overhead to protect profit margins. Economists estimate that, based on the Fed's unemployment projections, up to a million jobs will be lost from current levels. And that, however perverse it may seem, is precisely what the Fed is after.

Fed Chair Powell acknowledged this painful outcome but argued that it's necessary to avoid an even worse outcome of spiralling inflation that robs everyone—employed and unemployed—of their buying power.

As investors, it's important to understand the causal chain of events the Fed is seeking to engender. In order to cool inflation, the Fed believes it must a) slow the economy sufficiently to b) lower corporate profits enough to c) induce layoffs on a scale that d) materially jacks up the unemployment rate. Only then, in the Fed's opinion, will wage growth slow to a pace consistent with the Fed's target of 2% annual inflation. To be clear: the Fed is mapping out quite a rough road ahead and one that likely runs through the stock market by way of a recession.

POSITIONING 2.0

As we noted last quarter, the silver lining to all this is that bond-market yields have climbed out of the basement (where the Fed held them through the pandemic crisis) and are now paying something worthwhile. Everything from tax-free, short-term money market funds to the 10-year US Treasury Note is currently paying around 4% annually. A year ago, money market funds paid virtually nothing and a 10-year Treasury Note paid 1.5%. This makes defensive hedging measures much more profitable and thus much more effective today.

A FINAL CONTRARIAN WORD

Our 2023 outlook for a recession in the economy and further downside in the stock market is very much the consensus view. Should a recession unfold and stocks fall, they will fulfill the most widely held predictions in the history of economic and market forecasting. And that should give us pause. When everyone is focused on the same things that should go wrong, it's worth wondering what they—and we—are missing that could go right.

Farnum Brown
Chief Strategist

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