ARJUNA CAPITAL

ENLIGHTENED INVESTING

MARKET OUTLOOK

April 2022 / 2nd Quarter

*Futures markets are betting the Fed has to slam on the brakes (raise rates) to cool inflation this year but then tap the gas pedal (cut rates) to keep the economy moving late next year. Frankly, that seems like a lot to get right.*

## MURPHY'S LAW

Having enjoyed stellar returns from the stock market for the past three years, in January we ventured the opinion that "what lies ahead is almost surely less rewarding." Little did we know. In the first quarter of 2022, the S&P 500 fell a steep 5%, logging its first quarterly decline since the onset of the pandemic.

It seemed like everything that could go wrong, did. Last October, the markets were predicting the Fed would raise interest rates, at most, once in late 2022. By early March, markets expected the Fed would hike rates a total of seven times this year—a process the Fed began by hiking rates 0.25% at their March meeting.

This shift reflected a growing realization that inflation had run up further and faster than the markets or the Fed anticipated. Indeed, inflation is running at levels (8.5%) not seen in 40 years.

As we've underlined, perhaps *ad nauseum*, the primary risk to the stock market has long been the Fed overdoing rate hikes in an effort to cool inflation—and thereby driving the economy into recession. So, that's the first thing the markets didn't like.

Second, of course, was Russia's brutal invasion of Ukraine, which sent oil prices skyrocketing—thus worsening an already bad inflation picture—and injected a degree of uncertainty into markets not seen since the early days of the pandemic. Indeed, by some measures, investor sentiment grew more pessimistic during the first quarter of this year than it did during the pandemic in 2020.

Third was the outbreak of an Omicron wave of Covid infections in China. China has pursued a zero-tolerance policy toward Covid that, after the initial Wuhan regional lockdown, succeeded in containing the spread of earlier coronavirus variants without hampering the overall Chinese economy.

Omicron, however, is 70 times more infectious than the Delta variant and has forced China into renewed large-scale lockdowns involving tens of millions of people—shuttering parts of China's manufacturing sector. This threatens to further snarl global supply chains, which, in turn, threatens further shortages of goods and, thus, worsening inflation.

## ENERGY

Under these conditions, it should come as no surprise that the only stocks that benefited were energy names. For the first quarter of the year, stocks in the energy sector gained 38%. The only other sector in the black for the quarter was utilities, which gained 4%. The remaining nine sectors of the S&P were all down. Energy and utilities account for only 7% of the S&P 500. The other 93% of the benchmark by sector showed losses.

As we've remarked before, our fossil-fuel-free posture will at times work against us. The quarter just past is one of them as our Arjuna 350 US stock strategy returned a negative 6% vs. the S&P's 5% loss. Similarly, our Arjuna Global Impact stock strategy showed a negative return of 6% for the quarter while its benchmark, the MSCI World stock index, returned negative 5%.

The performance of stocks in the energy sector is driven by oil prices. It's that simple. Two years ago, oil prices briefly went negative—that is, oil producers would pay buyers to take oil off their hands—as the pandemic shut down travel in much of the global economy. Recently, oil sold for a stratospheric $120 a barrel. Which serves to illustrate that oil production is a boom and bust industry. One can try to profit from trading energy stocks through the swings in oil prices, but investing in the sector for the long-term has been a losing proposition for years. In aggregate, shares in the energy sector today are priced exactly where they were eight years ago. We avoid them not only because energy shares are the poster children for climate change. They also happen to be a lousy long-term investment.

## RISK VS. UNCERTAINTY

As we noted in January, we first reduced our portfolios' exposure to the stock market, where appropriate, for two reasons: one, stocks had done so well over the prior three years—more than doubling in value—that stocks had grown much larger as a portion of balanced portfolios. Trimming them was, in part, simply rebalancing.

We also trimmed stock exposure because the Fed began giving signals that they would raise interest rates in 2022. We had been comfortable letting stocks run, if you will, as a portion of portfolios as long as the Fed was committed to holding rates in the basement. This meant the primary risk to stocks was off the table. Once the Fed put that risk back on the table, our risk/reward calculations shifted and it seemed prudent to move portfolios from a more aggressive posture toward stocks to a more neutral posture.

With Russia's invasion of Ukraine, those calculations became more difficult. As we explained in the email we sent to clients in March, titled "The Fog of War," the invasion injected a high degree of uncertainty into any market forecast. And uncertainty is different from risk. You can rationally assign probabilities to risks. Under conditions of extreme uncertainty, you can't. In our email, we likened uncertainty to driving down the road and having your car suddenly enveloped by fog. Your problem isn't that you can see trouble (risks) ahead. The problem is that you can hardly see what's ahead at all.

Under such conditions, the prudent thing to do is slow down until visibility improves. This is why we further reduced our portfolios' exposure to equities, where appropriate, moving them from a neutral to a slightly defensive posture. We did this not because we are confident that stock prices are moving lower. We did this because our confidence in making forecasts in general was reduced.

We hope these defensive measures in hindsight prove unnecessary—like insurance premiums you pay and then don't get sick. But as our first duty is to protect our clients' wealth, for now, prudence calls for caution.

To be clear, we will always have exposure to the stock market. As we've emphasized in the past, for success in long-term stock investing, you have to stay in it to win it. But there are times to be more aggressive and times to be more conservative. It's like in football (the US version), you always have a team on the field, but sometimes you're playing offense and sometimes you're playing defense. Both are necessary to win the game. For now, we're playing defense.

## SLOWDOWN OR RECESSION?

What has become clear—and clearly aggravated by the war in Ukraine—is that inflation in the US has gotten ahead of the Fed. Chairman Powell has openly admitted this, saying the Fed should have started raising rates sooner.

Recall that the Fed was letting the US economy run hot, with more inflation, in order to achieve full employment. The Fed expected to reach this goal—specifically, an unemployment rate of 3.5%—by the end of 2022. As the US unemployment rate fell to 3.6% in March, the Fed effectively hit its employment goal three quarters ahead of schedule. Which means it could've started fighting inflation sooner and, given current raging inflation, should have.

This is why the markets now expect a more aggressive Fed, with seven rate hikes expected in 2022. The fact is, the Fed is playing catch-up with inflation and will to have to work harder to tamp down demand to cool inflation. So, instead of tapping the brakes lightly on the economy (raising rates gradually), the Fed is going to have to press harder on the brakes. This increases the risk that the Fed raises rates too aggressively and slows the economy to a standstill, a.k.a., recession.

In this regard, it's worth noting that interest-rate futures markets are predicting that the Fed will raise rates six more times in 2022, twice more in 2023, but, then, reverse course and cut rates twice in late 2023/early 2024. That is, futures markets are betting the Fed has to slam on the brakes to cool inflation but then tap the gas pedal to keep the economy moving. Frankly, to us, that seems like a lot to get right.

## STILL LISTENING

In January we noted that consumer staples names—like food and beverage companies—were gaining favor, indicating that investors were seeking exposure to companies that do relatively better in a recession. Since then, such "defensive" shares have continued to gain favor, as the healthcare and utilities sectors joined staples in attracting investors' interest. This tells us that the stock market sees the risks of recession rising.

However, as was the case in January, the bond markets are sending a different message. While credit spreads widened earlier in the quarter, they narrowed sharply most recently. As credit spreads are the difference in yields between higher and lower quality bonds, such spreads widen when perceived recession risks are rising and narrow when they're falling. While recession fears rose in the bond markets earlier this quarter, it appears they've been calmed for now.

So, we're still getting mixed messages from the markets about the path forward for the US economy. And that remains a message in itself: namely, that the outlook is very uncertain and caution is warranted.

Farnum Brown
Chief Strategist