ARJUNA CAPITAL

ENLIGHTENED INVESTING

MARKET OUTLOOK

April 2023 / 2nd Quarter

It's not our job to make a definitive forecast of the economy and the markets. Our job is to navigate our clients' portfolios carefully through whatever the prevailing weather. Today the cross-currents are unusually strong.

SWIMMING NAKED

There's a saying attributed to the sage investor Warren Buffett that you don't know who's swimming naked until the tide goes out. What he means is that whenever the Federal Reserve starts raising interest rates, it reduces the overall liquidity in the US economy.

This is the tide going out. And you never know in advance of that outgoing tide where a vulnerability in the economy will be revealed—i.e., who's swimming naked. But someone almost always is.

This time it was Silicon Valley Bank that was swimming naked, along with Signature Bank in NYC. SVB served the start-up tech community while Signature served the cryptocurrency crowd. Both banks suffered classic bank runs where too many depositors wanted to withdraw too much money at the same time. (We discussed this at length in our Friday, March 14th email to all clients.)

Long story short, the Federal Reserve and the US Treasury stepped in and guaranteed all deposits, regardless of size, effectively halting the run. Typically, the Federal Deposit Insurance Corporation (FDIC) guarantees only $250,000 of any depositor's holdings at a bank. In this case, the US Government guaranteed all deposits, no limit.

Why this unusual treatment of what were only mid-sized banks, whose size didn't suggest they posed a systemic threat to the overall financial system? The simple answer is that bank runs are psychological phenomena that needn't be based in fact and yet are highly contagious. Fear of not being able to access one's cash spreads and sparks a herd stampede of depositor withdrawals.

In the case of SVB and Signature, they happened to be stampedes out of highly visible banks serving very socially connected communities of tech entrepreneurs and cryptocurrency cultists. The Fed, US Treasury and FDIC stepped in because they didn't want this psychological contagion to spread more widely. In this they were almost surely right, in our opinion, whatever the unintended consequences may be.

ANOTHER ADAGE

It's also said around Wall Street that the Fed raises interest rates until inflation slows or something breaks. In the current instance, it was SVB and Signature that broke. They broke because as interest rates rose dramatically last year, the prices of their extensive bond holdings fell dramatically (bond prices fall in the secondary market when interest rates rise). As banks sometimes need to sell bond holdings to meet depositor withdrawals, falling bond prices meant banks had less ability to cover withdrawals. And that's what sparked the bank run at both institutions.

This put the Fed in a somewhat conflicted position: Should they stop raising rates to halt the decline in bond prices—and so reduce the threat of more banks failing—or keep raising rates to fight so-far untamed inflation?

The Fed hedged this conflict in its March meeting by raising rates by just a quarter percent (0.25%)—while some recent hikes had been half or three quarters of a percent. They took this cautious approach because the shivers sent through the banking system by SVB and Signature will themselves act on the economy in much the way rising interest rates do: banks will tighten lending standards, make fewer loans, thus reducing liquidity in the economy. Rising rates and tightening lending standards both make the tide go out, which should ease inflation (a good thing) by slowing the economy (possibly a bad thing if it slows too much, a.k.a. recession).

THE MARKET SHRUGS

So, what did the US stock market as measured by the S&P 500 do during all this *sturm und drang* in the first quarter? It shot up 7.5%, a banner quarter by any measure. And as the shivers running through the banking system engulfed Credit Suisse in Europe, the MSCI World stock index rose 7.7%. By comparison, both our Arjuna 350 US stock strategy and our Arjuna Global Impact stock strategy rose 6.4%. (Much of the performance lag in both strategies came from not owning microchip maker NVIDIA, which was down 50% last year but up 90% in the first quarter—putting its price almost back to where it was at the start of 2022.)

There are two conflicting readings of the stock market's performance in the first quarter and they largely represent the two main disciplines of investment analysis: fundamental and technical analysis.

Fundamental analysis seeks to forecast asset prices based on an assessment of the asset's proper valuation. This is done through a careful scrutiny of the asset (whether a firm, sector, or market) and its economic fundamentals. A central assumption of this approach is that pricing in the stock market is often, even usually, wrong, as assets are considered to be regularly over- or undervalued in the market.

A corollary assumption is that individual analysts can be smarter than the market. This is the approach taken by the vast majority of Wall Street analysts. This camp thinks the current market's advance amidst such turmoil is simply a mistake, one that will be corrected—painfully—in the near future by recession.

Technical analysis treats any asset (stock, sector, market) as a pure commodity and forecasts its future price based on an analysis of the supply and demand for the asset in question. This school is concerned with the way that supply and demand are "clearing" in the market and so setting prices. Are they clearing (agreeing on a trade price) at higher or lower prices, indicating that demand or supply, respectively, has the upper hand?

A central assumption of this approach is that the market is "efficient," i.e., it reflects all information available in its pricing function. Technical analysis sees the stock market as a vast economic prediction wiki where billions of investors bet trillions of dollars on economic outcomes based upon all of their best information. In this way, the market delivers "the wisdom of crowds" in its pricing function. A corollary assumption is that the market is smarter than you.

This camp sees the first quarter's market action as "knowing" something the fundamentalist camp doesn't. And by "knowing" they mean *the market's price action reflects information that is not yet evident* to fundamental analysis. Supporting that notion, the S&P 500's price action has long been considered a sound leading economic indicator, one that fallibly but more often reliably foretells the economic future.

HEDGING OUR BETS

At Arjuna, we respect and have extensive training in both disciplines. We keep their conflicting analyses in clear view and form our investment thinking in the tension between them. In the present case (as is often the case), this yields a fairly hedged posture. We've allowed the rising stock market to increase our portfolios' stock exposure while reducing their bond exposure. That is, we have a bit more sail out to the stock market in case the technicians are right, while remaining cautiously positioned in case the fundamentalists are.

If this seems inconclusive, it is. It's not our job to make a definitive forecast of the economy and the markets. Our job is to navigate our clients' portfolios carefully through whatever the prevailing weather. Today the cross-currents are unusually strong.

Farnum Brown
Chief Strategist

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