ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
July 2022 / 3rd Quarter

Our concern is that the stock market decline we saw in the first half of the year, driven by rising interest rates, will be followed in the back half of the year by a second leg down, driven by falling earnings estimates.

POLICY MISTAKE

Until March of this year, Fed chairman Powell had talked a fairly dovish game regarding the Fed's future interest rate moves—suggesting a measured, restrained approach, emphasizing the Fed's intention to engineer a "soft landing" for the economy while cooling off inflation. That dovish rhetoric largely disappeared as the second quarter of 2022 unfolded. A very hawkish Powell recently said that if the Fed is going to make a policy mistake—by raising rates too much or too little—he strongly favors overdoing it. That is, Powell sees recession as a lesser evil than runaway inflation.

The Fed then raised short-term rates by 75 basis points (0.75%) in June and said it expected to do the same in July. The Fed hasn't raised rates by 75 basis points in a single move since 1994.

MARKET RESPONSE

In the second quarter of 2022, investors responded to the newly hawkish Fed by sending the S&P 500 down 16%, bringing its decline for the first half of the year to 21%.

The bond market, generally considered a haven from stock market volatility, also fell sharply, with US Treasury issues declining roughly 10% in the first half. By sharply raising the expected path of short-term rates, the Fed also triggered higher long-term yields, which, by definition, meant that bond prices fell.

As we noted last quarter, the only winner in this market has been the traditional energy sector, that is, oil and gas stocks, which accounts for just 4% of the S&P 500 by capitalization. For the first six months of 2022, energy was the only sector to post gains, returning 29% for the period vs. the 21% decline for the S&P 500. The remaining ten sectors—representing 96% of the S&P—all showed losses for the first half.

As Arjuna's stock strategies are fossil-fuel-free, they didn't benefit from exposure to oil and gas shares. In light of that, we're encouraged that our US stock strategy, Arjuna 350, lagged the S&P 500 by just 1%, declining 22% for the first half. We're more encouraged by the performance of our global stock strategy, Arjuna Global Impact, whose 19% decline bested the 21% decline in its MSCI World Index benchmark.

LISTENING

As we've noted in our last two *Market Outlooks*, the stock market's preference for the defensive staples sector over the past few months signaled a perceived increased risk of a slowdown/recession ahead. That signal has grown stronger as both healthcare and utilities—two other defensive, non-cyclical sectors of the market—have also gained favor.

Until recently, the bond market hadn't been confirming that recessionary message, as credit spreads between lower- and higher-quality bonds remained relatively narrow. No longer. Credit spreads widened dramatically over the second quarter, particularly in the more cyclical sectors of the economy. And so, now, the message we hear from both the stock and bond markets is that a slowdown—and possible recession—is coming.

TAG TEAM

Stock prices are set by two factors: corporate earnings and the price people will pay for them. This is referred to as the price-to-earnings or P/E multiple. Changes in either factor will change stock prices. In the first half of 2022, the S&P 500 declined 21% and all of that was driven by a decline in the "P" in P/E. That is, the multiple investors were willing to pay for a dollar of expected earnings fell sharply—by 27%. During the same period, estimated earnings for the S&P over the coming 12 months—the "E" —actually *increased* by 6%. So, the "P" fell 27% and the "E" rose 6% for an overall 21% decline.

Interest rates and the "P" in the P/E multiple are generally inversely related. If rates go up, the multiple typically goes down. There are lots of reasons for this, but the simplest is that as interest rates go up, bond returns become more competitive with those from stocks and so stocks lose some appeal.

It seems, then, that during the first half of 2022, investors were anticipating rising inflation and the rising interest rates the Fed would impose to contain it—the "P" in P/E. But they weren't yet concerned about the hit earnings would take come a recession—the "E."

As the market is signaling that the "soft landing" narrative is losing credibility and the likelihood of recession is rising, our concern is that forward earnings expectations for the S&P 500 will soon start to decline. And that the market decline we saw in the first half of 2022—driven by a shrinking "P"—will be followed by a second leg down in the back half of the year, driven by a shrinking "E."

POSITIONING

We began reducing clients' exposure to the stock market, where appropriate, in December of 2021. As the stock market had done so extremely well over the prior three years—doubling in value—stock exposure in our portfolios had expanded dramatically. (Worth keeping in mind: including the 21% decline in the first half of 2022, the S&P 500 has still returned 60% for the past three and a half years or 14% annualized.) We were fine with this as long as the Fed kept the threat of rising rates off the table. But when the Fed signaled rate hikes ahead in 2022, we began to reduce stock exposure.

We further reduced stock exposure in February of this year when the risks posed by the Fed's intentions to hike rates were complicated by Russia's invasion of Ukraine. We explained at the time that rather than posing a definable risk, Russia's actions injected a level of uncertainty that warranted further caution.

So, over the course of three months, we took balanced portfolios from an aggressive to a defensive posture vis-à-vis the stock market. This has reduced the impact of stock declines on our balanced portfolios.

Within our stock holdings, we have dialed up an emphasis on defensive sectors—staples, healthcare, and utilities—while de-emphasizing more cyclical sectors such as technology, consumer discretionary, and materials. As the market's focus continues to shift from inflation to recession, energy shares should begin to lag, as they have for the past month, ceding market leadership to more defensive shares. While our lack of energy exposure was a headwind to our relative performance in the first half, we expect it to be a tailwind in the second.

A MARKET BOTTOM?

If we do, indeed, suffer a second leg down in the market, driven by reduced expectations for S&P earnings, how far down can the market go? And what will make it turn back up?

There is no preordained answer to the first question. The market can go down as long as the forward outlook grows dimmer. It's not a matter of reaching some magic level at which the market is so "cheap" that investors can't resist buying. The market can get "cheaper" until the outlook improves.

And what will make the outlook improve? If history is any guide, the answer is: the Fed. The Fed pivoting from a restrictive to a stimulative monetary policy, that is, from raising to cutting interest rates, historically has been what turns the tide in the market. And what makes the Fed pivot?

First, when inflation cools convincingly, the Fed will take its foot off the brake (stop raising rates). We think this will happen late this year or early next year as recession takes hold, pulling inflation down with the economy. Second, should the economy tip into recession, as we think it will, the Fed will step on the gas (start cutting rates), probably around mid-2023, in order to pull the economy out of the doldrums. This is pretty much what the futures markets are predicting over the coming year.

So, what do we do? Sit tight. We've already done what was needed as the outlook grew cloudy back near the turn of the year. We significantly pulled back exposure to stocks, thus reducing the impact of stock declines on balanced portfolios. Then, within our remaining stock holdings, we emphasized defensive sectors and de-emphasized more cyclical sectors, so that going forward our stocks should do better than the broad market.

Historically, US recessions last about a year. If we're not already in one, we think we will be soon. This will not be fun for stock investors, but hanging in through the rough weather is part of successful long-term investing. One thing we can be sure of: the stock market will recover before the economy does. This is because the market is more like a barometer than a thermometer. It anticipates future weather conditions rather than measuring the weather today.

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