ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
October 2022 / 4th Quarter

We continue to believe the US economy will slip into recession sometime over the coming six-to-nine months and that the stock market has yet to fully discount this prospect.

IDENTITY CRISIS

As soon as the (digital) ink dried on July's *Market Outlook*—one of the most negative *Outlook*s we've published—the stock market launched toward the heavens like a rocket. It didn't slow down until it had gained over 17% in just two months. This is the sort of powerful upward thrust you see as a new bull market takes hold after a bear market has found a bottom and come to an end (see March 2020).

While potentially embarrassing—a new bull market taking off just as we had forecast more downside to come in the back half of 2022—we welcomed the prospect of being proven wrong.

We also knew, however, that it's very hard to tell the start of a new bull market from the very common phenomenon of a bear-market or counter-trend rally. Within an ongoing bear market, you often get impressive, if brief, rallies that ultimately fail, with the market then falling to new lows. And that's what we saw in the third quarter.

Despite the brief moonshot in stocks, the S&P 500 still lost 5% in the third quarter, bringing its loss for the first nine months of the year to 24%. Of the 11 sectors that make up the S&P 500, only Energy showed positive returns through 9-30-22 with an eye-popping 35% gain. The second-best performing sector was Utilities, which lost 7% for the period. The remaining nine sectors plunged deeper into the red.

As Arjuna's investment strategies are all fossil-fuel-free, our portfolios didn't participate in the market's only winning sector, Energy. So, we were gratified, in a strictly relative sense, that our Arjuna 350 domestic stock strategy performed in line with the S&P 500, down 24% for the first nine months of the year. Our Arjuna Global Impact stock strategy declined 26% for the period, slightly behind the 25% decline in its benchmark, the MSCI World stock index.

ALL ABOUT THE FED

The brief rally in stocks during the third quarter was fueled by a narrative that the Fed would "pivot" away from its policy of aggressively hiking interest rates and take a more measured approach going forward. This was taken to improve the odds of the Fed raising rates just enough to cool inflation without driving the economy into recession—the so-called "soft landing" scenario.

However, as economic reports for the months of August and September rolled out, the Fed made it clear there was no pivot on the horizon and they would have to do more to cool the economy. Persistent, high US inflation such as we haven't seen in 40 years combined with a strong labor market and historically low unemployment laid the soft-landing scenario to rest. And with it the brief bear-market rally.

So far, the Fed has hiked interest rates five times in 2022, taking the Federal Funds rate (at which banks borrow and lend to each other overnight) from near 0% at the end of 2021 to the current 3.00%-3.25% level. This sort of dramatic rate-hike regime hasn't been seen since the 1980s. And they're not done. The Fed has announced its intentions to raise rates further by year-end to the 4.25%-4.5% level and likely even further in 2023.

CANARY IN THE COAL MINE

While the Fed directly controls only the overnight Fed Funds rate, their moves influence all lending rates. If you're in the market to buy a house, you've likely been taken aback by the sharp rise in the average 30-year, fixed-rate mortgage, which stands at 7.04%. At the beginning of 2022, it was 3.25%. So, the monthly cost of carrying any given amount of a standard mortgage has risen by roughly 50% in less than a year.

The housing sector is the canary in the coal mine of a rising interest-rate environment. With mortgage rates skyrocketing, new construction permits have fallen in four of the past five months. In August, existing home sales were down 20% vs. a year ago. In July, average home prices declined compared to June, the first time this has happened since 2012. Applications to refinance existing mortgages fell to a 22-year low.

These developments mean construction workers will get laid off once current projects are complete; mortgage firms will lay off brokers; realtors will see a sharp drop in commission income; homeowners can't tap their home equity for cash through refi's. All of this spells reduced consumer spending, which accounts for roughly 70% of the US economy, and so slower overall US growth.

We continue to believe that the US economy will slip into recession sometime over the coming six-to-nine months and that the stock market has yet to fully discount this prospect.

ARE WE THERE YET?

An informal definition of recession is two consecutive quarters of negative GDP growth, meaning, economic contraction. And, indeed, we've already met that definition with the first and second quarters of 2022 showing negative growth. But a recession is also taken to entail a material increase in the unemployment rate. And that simply has not happened. Today, the US unemployment rate stands at 3.5%, its lowest level in over 20 years.

The Fed doesn't gauge its expected success at curbing inflation by economic contraction. It gauges expected success by raising the unemployment rate. This is because the core inflation the Fed cares about is ultimately driven by wage growth. As long as labor markets are tight—as indicated by low unemployment — wage growth will be strong. So, the Fed will keep raising rates until it's convinced unemployment is rising materially, wage gains are slowing, and inflation is falling significantly.

LONG BALL

The tricky part of the Fed's job, however, is that the full impact of its rate hikes won't be felt in the economy for several months. And yet it calibrates that policy based upon current data, largely on inflation and unemployment. The mismatch here is that current readings of inflation and unemployment are what economists call "lagging economic indicators." That is, they tell you what happened in the economic past. So, the Fed makes interest rate changes that won't take full effect for several months in the *future* based upon economic indicators of what happened several months in the *past*.

In football, a quarterback making a long pass needs to base its trajectory on where the receiver will be down the field, not where they are now. The Fed is like a quarterback gauging a long pass based on where the receiver is now--or was several plays ago. This is why the Fed usually gets it wrong, often overdoing it, driving the economy into recession with unemployment rising materially. As we think they will this time.

As we said above, we don't think the stock market has fully "priced in" this possibility and consequently believe there is further downside for stocks as corporate profits erode with the economy.

POSITIONING

We have been concerned about the economy and the stock market since late last year when the Fed began talking about raising interest rates. With Russia's invasion of Ukraine in February, our concerns grew more urgent. Since then, we have positioned our portfolios defensively, reducing both their exposure to the stock market, where appropriate, and the economic sensitivity of their stock holdings.

That said, this year has added insult to injury by having both stocks *and* bonds sell-off. Historically, when stocks sell off dramatically, you typically see bonds appreciate as investors flee from stocks into the presumed safety of bonds. Not this year. With interest rates across all maturities rising, this means bond prices have been falling, too. Granted, bonds have declined about 10% during the first nine months of 2022, which is a lot less than stocks' decline. So, they have provided a hedging function, just not as robust a hedge as history would lead you to expect.

The silver lining here is that bond yields have climbed out of the basement where the Fed held them through the pandemic crisis and are now paying something worthwhile. In August of 2020, the 10-year US Treasury Note paid an annual yield of 0.52%. It's now paying 4%.

As we've said before, we have no way to confidently forecast when this bear market will end. What we do know is that the stock market will bottom and turn up, likely sharply, well before the economy recovers. It always does. Until then, we will remain defensively positioned and alert to opportunities as they arise.

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