ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
1st Quarter 2019

In the fourth quarter of last year, investors, in effect, priced the stock market as if there would be a recession in the US in 2019. We think this was an overshoot, as the markets seem to agree.

GOLDILOCKS

There's a lot for investors to like about the US economy. The unemployment rate recently hit a 50-year low while the participation rate in the workforce is climbing for the first time in years. This means that as demand for labor has been rising, so has supply. In such unusual circumstances, wage inflation—and inflation in general—remains moderate, which keeps the Federal Reserve calm. And a calm Fed means an interest-rate environment that supports continued economic expansion.

This is a Goldilocks scenario: an economy that's not too hot and not too cold.

Through September, 2018 was shaping up as a very rewarding year for investors. The S&P 500 was up 11% as investors focused on Goldilocks and liked what they saw.

Then came the fourth quarter and a jarring mix of what ordinarily would be real but not grave economic concerns, turbocharged by the bluster of a volatile President.

GROWTH, RATES AND TWEETS

Despite the benign US outlook, global growth, particularly in China, was cooling in the second half of 2018, raising concerns that a global slowdown could eventually infect the US economy. Cooling foreign economies also drove up the value of the US dollar, making US exports pricier, creating a headwind for the US export sector.

Also cropping up were interest-rate worries at home. Federal Reserve chair Jerome Powell made some infelicitous comments suggesting the Fed was on "autopilot" with anticipated future interest-rate hikes. This rattled investors, who feared an unwitting Fed would be more aggressive than the US economy could handle.

This prospect of a too-aggressive Fed also pushed up longer-term interest rates, with the 10-year US Treasury Note yield rising to 3.23% in the fourth quarter (from 2.65% in the first quarter). As many lending rates in the US are tied to the T-Note yield, everything from home mortgages to credit cards to car loans got more expensive. More expensive borrowing means less consumption, and consumption accounts for roughly two-thirds of the US economy.

With global growth slowing and worries over interest rates, stocks pulled back during October and November, a not-surprising development given the strong run up to that point.

Then, in December, the real blood-letting began. Trump chose to call himself "Tariff Man" just as the jitters over a trade war with China had cooled. He threatened to fire Fed chair Powell because the Fed raised interest rates in December. Topping it off, Trump forced a government shutdown in his efforts to fund a wall across the southern border of the US. The markets, already a bit disquieted, fell sharply.

The sell-off took the S&P 500 down 19.7% from its September 21 high, hitting its low point on Christmas Eve. While the threshold for a bear market in stocks is a full 20% decline, we consider 19.7% close enough.

With the fourth quarter's sharp decline, the S&P 500 wound up the year with a -4.38% return. Both the Arjuna Core equity strategy and our 350 fossil-fuel-free equity strategy registered less than half the market's decline for the year.

OVERSHOOT

As anyone following the markets knows, from that Christmas Eve low to the middle of January the stock market went pretty much straight up, with the S&P 500 climbing 13% in less than a month. What changed?

On the interest-rate front, Fed chair Powell reassured markets the Fed was not on autopilot and would be very

sensitive to the unfolding economic and stock market data. As January progressed markets grew comfortable with the notion that rather than raising rates too aggressively, the Fed would actually pause raising rates for an indefinite period. This calmed investors' concerns while also helping ease the 10-year T-Note yield, which fell back to a less-troubling 2.65% (= January 2018 levels).

Simultaneously, the picture in China began to brighten a bit, as the Chinese government aggressively stoked the stimulus fires of its economy. One thing to keep in mind: Chinese monetary and fiscal policy is incredibly volatile. The Chinese tend to alternate between stomping on the gas to stimulate their economy and then slamming on the brakes to slow it down.

In 2015 the Chinese economy slowed, much as it did in 2018, prompting the Chinese to stomp on the gas by lowering interest rates and boosting government spending. This led to a Chinese recovery in 2016/2017, which grew too hot, prompting the Chinese to slam on the brakes, which led to a slowdown in 2018.

In response, China is once again flooring the gas pedal, and global markets are taking notice. The Chinese stock market has bottomed and turned up, along with many other emerging stock markets. The price of commodities—like oil—that are driven by Chinese demand have turned up. And, of particular note, the US dollar appears to have peaked. Each of these suggests investors think the picture in China will improve in 2019 and with it that of the global economy.

In short, the fundamental worries that troubled investors late last year all appear to be fading. Add to that a chastened White House that reopened the federal government and you have a climate that's much less angst-inducing.

AND NOW?

In the fourth quarter of last year, investors, in effect, priced the stock market as if there would be a recession in the US in 2019. One can debate the rationality of the move and its causes, but the fact is we suffered a bear market in the fourth quarter. We think this was an overshoot, as the markets seem to agree.

Going forward, the Federal Reserve has clearly signaled a benign policy stance for the foreseeable future. The Fed has done so because the outlook for inflation remains benign. Indeed, inflation may cool a bit as 2019 progresses. As overheating inflation and aggressive tightening by the Fed are common causes of recessions and bear markets, having these risks largely off the table is a major positive for stocks.

The remaining concern, then, is the durability of the US economic expansion. We do expect the pace of US economic growth to slow in 2019, but we don't expect it to turn negative, that is, enter recession. We don't for a couple of reasons.

Domestically, leading indicators of the US economy (like the ISM Manufacturing Index) remain comfortably positive, though they've come off their highs notched last year. Employment growth is still remarkably strong and wage growth in 2018, while not overheating, showed its strongest year-over-year gain in a decade. With consumers accounting for two-thirds of the US economy, it's difficult to extrapolate a recession from these data.

On the foreign front, as noted above, we think the Chinese government will succeed in its efforts to boost economic growth in China. It did so after the 2015 slowdown and its stimulative efforts today exceed those successfully deployed in 2016. So, we expect China to give the global economy a lift later this year, improving prospects for US exports in the process.

The unquantifiable risk here, of course, is Trump's trade policy toward China, which could throw a wrench into the works. Absent such unforced trade-policy errors, we think the outlook for US stocks in 2019 remains fairly positive.

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