ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
January 2020 / 1st Quarter

Market action in both stocks and bonds during the fourth quarter suggests investors have shifted from pessimism to optimism about the global economy—including the US.

TUG OF WAR

While we're delighted that the S&P 500 closed up 29% for 2019, we also realize this is an increase of just 10% from where the S&P was in late September of 2018. You'll recall that in the fourth quarter of 2018, the S&P fell 20%, bottoming on Christmas Eve. So most of 2019's gain was just digging out of that hole. Granted, a 10% price gain over 15 months is nothing to sniff at, but it's not exactly a pop-the-champagne moment either.

We say this not to be churlish but to keep in perspective the tremendous volatility investors endured for the gains made over the past year and a quarter. That volatility resulted from the market being caught in a tug-of-war between a decent US economy—with low inflation, low unemployment, tepid but positive growth—and global stresses created by the erratic trade policy emanating from the White House.

PRESIDENTIAL FIAT

We underlined this dichotomy in our Market Outlooks throughout last year, offering the possibly unhelpful prognostication that the stock market could do very well in 2019 if the President would just get out of the way.

As the year wore on, it looked increasingly like he wouldn't, as he actively stoked trade tensions with China, among other countries. Ever since Trump was elected, we've pointed out that the US Presidency is vested with tremendous authority in trade policy and that this posed a material risk to the US economy and stock market.

As the year progressed, Trump's trade war began to take a bite out of the global economy as the manufacturing sector—both in the US and abroad—began showing signs of a sharp slowdown. This isn't surprising as one of the chief effects of Trump's tariffs was to disrupt manufacturing supply chains that stretch around the globe.

To be fair, leading economic indicators here and abroad had been softening gradually since 2017. Trump's trade tariffs, however, turbocharged those trends, pushing leading indicators into the red and replacing concerns over slowing growth with the threat of outright recession—or at least a recession in corporate profits. This led us to expect a correction in the stock market, which, happily, never came.

It didn't because in the fourth quarter Trump suddenly backed off his trade war with China and stock markets around the world snapped back as leading economic indicators improved. That our impetuous President has so much sway over the global economy and stock markets continues to frustrate those of us trying to navigate the turbulent waters he creates.

IRAN

No sooner had trade tensions with China eased than Trump launched a drone strike on Iran's second in command at an airport in Baghdad, violating Iraq's sovereign air space while killing an admittedly murderous figure, who was nonetheless widely revered in Iran. Thus far, stock markets have shrugged off the conflict as it appears both Trump and Iran's leadership have no appetite for escalation. Time will tell.

Historically, the main threat posed by conflagrations in the Middle East has been spiking oil prices in response to the threat of a shut-off of supply. In the past, an oil-price spike threatened US consumption—and thereby the overall US economy—by diverting consumer spending from domestic vendors to foreign ones, i.e., countries that exported oil to the US. In 2020 the US energy sector—for the first time—will provide virtually all of the oil needed to meet domestic demand. So consumer dollars spent on oil—at whatever price—stay in the US, which means that domestic consumer demand would get reshuffled but not materially reduced by rising oil prices.

This energy independence makes the US far less vulnerable to oil-price shocks than in the past. This isn't to discount entirely the economic risks posed by a potential conflict with Iran. It is to say that geopolitical troubles in the Middle East no longer pose the economic threat to the US economy they once did.

THE FUNDAMENTALS

While geopolitical drama will grab the headlines and set pundits a-chatter, ultimately the stock market is driven by investors' expectations for the economic fundamentals going forward. As we see them, the fundamentals for 2020 as a whole are positive. The question on our minds is whether the global and the US economies have *already* turned the corner from the slowdown experienced in 2019.

Recall that since coming out of the Great Recession in 2009, there have now been four US economic slowdowns—in 2011, 2013, 2015 and now 2019. We're confident that this latest slowdown, like the previous three, will not turn into recession. Why?

First, the lagged, stimulative effects of lower interest rates both here and abroad are coming to bear on the global economy. Second, an easing of trade tensions with China removes a major headwind to global growth. Third, leading economic indicators around the globe, though mixed, are, on balance, starting to turn up. Fourth, with inflation low in the US, there's no reason for the Federal Reserve to raise rates for the foreseeable future. And the Fed raising rates has been the cause of every recession in modern memory.

THE "V" TURN

Inflection points where economic prospects (think leading indicators) turn from dimming to improving are often sudden, tracing out a "V" in the sharp turn from pessimism to optimism. Market consensus seems to be that we've already made that turn and the worst—both for stocks and the economy—is behind us. And that may well be.

The sharp 9% rally in the market in the fourth quarter of 2019 is just the sort of thing you see when this kind of turn is made—because the market reprices all stocks for an expected lower-risk environment. So, too, is the sudden shift in market leadership, which we also saw, where less economically sensitive stocks ceded the lead to more economically sensitive stocks. And while it's a more esoteric indicator, the narrowing of the "spread" (the difference in yields) between lower- and higher-quality bonds is also characteristic of such a turn. The risk of lower-quality bonds declines as the economy improves and so their prices rise and their yields decline, moving closer to the yields of higher-quality bonds.

Each of these moves—sharply rising stock prices, rising low-quality bond prices, leadership by more economically sensitive sectors of the market—indicate a turn for the better in investors' expectations for the economy going forward. Generally, we listen to what the market is telling us as it is far smarter than we are.

The one fly in the ointment is that the ISM Manufacturing Index, one of our favorite US leading economic indicators, fell to a new low of 47.2 for December—its lowest reading since 2009—and, being below 50, indicating continued contraction in the manufacturing sector. This is in contrast to many of the other leading indicators we follow, which are improving. But it gives us pause, nonetheless, and leaves us wondering if we may not be out of the woods economically quite yet. If not, we should be sometime in the first half of 2020. Based on these fundamentals, we expect positive market returns for the whole of 2020.

ELECTIONS

As this is an election year, we have to consider the possible impact on the markets of Democrats' electoral success. Politically, we would like nothing better than a Democratic sweep of the House, Senate, and White House. The stock market, on the other hand, might be less enthused. Investors would rightly expect a rollback of the tax cuts passed by the Republicans in 2017. A rollback of the corporate tax cuts passed in that legislation would hit corporate profits across the board. The market would need to reprice stocks lower to reflect this lower level of profitability. Short of a Democratic sweep, the market's reaction may be more muted as stalemate between the House and the Senate or between Congress and the White House could leave the tax legislation intact.

Farnum Brown, Chief Strategist

*The opinions expressed herein are those of Arjuna Capital, LLC ("Arjuna Capital") and are subject to change without notice. This material is not financial advice or an offer to sell any product. Arjuna Capital reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. This is not a recommendation to buy or sell a particular security. Arjuna Capital strategy returns are shown gross of wealth management fees. The **S&P 500® Index** is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices. Arjuna Capital is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Arjuna Capital including our investment strategies, fees and objectives can be found in our ADV Part 2, which is available upon request. AJC-20-02*