One thing we're sure of: the stock markets will heal before the economy. They always do. Because they're pricing what the economy will look like six months down the road, not what it looks like now.

PANDEMIC

The first quarter of 2020 is one we'll all remember—with a shudder. As the global scope of the pandemic began to register along with the extremity of the measures required to fight it, stock markets around the world crashed. First in China, then Italy, then Spain and finally in the US. From the S&P 500's peak on February 19 to the low it made for the quarter on March 23, the index fell 34%. That's the fastest decline of that magnitude on record.

As the market had been rising through most of February, the sharp decline in March left the S&P 500 with a negative return for the full quarter of 20%. Arjuna's Core Equity strategy showed a negative return of 17% while Arjuna's 350 Equity strategy had a negative return of 16%. We'd like to underline how extremely well our two domestic equity strategies held up during what was one of the fastest declines in stock market history.

Why did they do so well? This will take some explaining but it will also illuminate what's been driving the markets.

ENERGY

The stock market faced three separate, quite serious risks in quick succession during March. The first was the potential economic impact of the pandemic. This initially took the stock market down 13% from its February peak. Second, the Russians refused to go along with OPEC's desire to restrict the supply of oil and thereby support its price. The Saudis wanted to support oil prices because the pandemic had already taken prices down from around $60 a barrel to around $40 a barrel. When the Russians refused, Saudi Arabia countered by dumping 3 million barrels of oil on the market, driving down the price of oil from the $40s to the $20s per barrel.

Why this game of chicken? The most plausible explanation we've seen is that US shale-oil producers have become one of Russia's chief competitors. The Russians knew that US shale-oil producers a) had issued vast amounts of high-yield (junk) debt to finance their capital-intensive business and b) operated with razor-thin profit margins as extracting shale oil is a very expensive process. By letting oil prices fall, Russia would drive down shale-oil producers' revenues and profits, and this, Russia hoped, would force US shale-oil operators to default on their debt *en masse*. Which would cripple much of Russia's US competition. Saudi Arabia called Russia's bluff, driving prices down beyond Russia's pain point and the two countries have now come to agreement to support oil prices.

As fear of a debt crisis in the oil patch spread and oil prices plunged, the fossil-fuel energy sector of the US stock market got crushed. While the S&P 500 was down 20% in the first quarter, the fossil-fuel sector as a whole was down 50%.

Both of our domestic stock strategies are fossil-fuel free, meaning, in part, that we own no fossil-fuel energy stocks and so didn't participate in the collapse of the sector. That's part of why our strategies did so relatively well. But it's not the whole story.

LIQUIDITY

The third threat was a liquidity crisis where the plumbing of our debt-financing system and thus of our economy seizes up and stops functioning. In mid-March, the trading of everything from overnight commercial loans to US Treasury obligations began getting balky. The system was showing signs of strain as too many sellers overwhelmed not enough buyers, so pricing was going down the tubes, driving up interest rates, thus raising the cost of borrowing throughout the economy. This, in turn, would further severely hamper the economy, compounding the impact from the pandemic.

TWO FACTORS

Here we arrive at two other factors in our strategies' strong relative performance: Which companies are most vulnerable to a credit crunch where borrowing becomes more difficult and more expensive—difficult because less available due to market dysfunction and expensive because of higher interest rates? Answer: Companies with low profitability, who are forced to borrow to stay afloat, and companies with lots of debt that they usually rollover when it comes time to pay off some of it.

We use sophisticated performance attribution models to tell us what our portfolios got right and what they got wrong for a given period in the market. In addition to superior stock selection, the three factors the analysis identified as responsible for our strong performance this past quarter were that we owned no energy stocks and the companies whose shares are in our portfolios on average have both higher profitability and lower debt than those in the S&P 500.

Why are the companies we invest in more profitable and less burdened with debt? Our ESG analytical framework makes us especially attuned to environmental, social, and governance risks and opportunities. It biases our universe toward companies that are better run (G), more diverse (S), and more environmentally responsible (E).

Well-run companies tend to be more profitable and less burdened with debt. Socially diverse companies, particularly their leadership, have been shown as a group to be more profitable. And environmentally responsible firms are less vulnerable to regulatory or legal penalties for environmental problems. While that oversimplifies the way ESG analysis shapes the universe of stocks we consider investible, it illustrates why we tend to own higher quality, more stable, better run, more diverse, less leveraged, and more profitable companies.

When you consider the three drivers of this horrendous stock market—pandemic, oil price war, and illiquidity in the debt markets—you see that this market crash was almost perfectly designed to highlight the strengths of our approach.

TO BE FAIR…

That said, when the global economy comes back online, oil prices will rise as will energy stocks. Not owning them will penalize us for a spell. And, indeed, in April oil prices and energy shares spiked on news that Russia and Saudi Arabia had struck a deal to support oil prices. We're okay with that because we're long-term investors.

Prior to the pandemic, the fossil-fuel energy sector as a whole had gained just 2% over the prior decade—and that's not 2% per year. It's just plain 2%. And this while the stock market nearly tripled in value. Why did energy perform so poorly? Because the economics of the fossil-fuel industry aren't sustainable. So, we're quite confident that not owning fossil-fuel companies' stocks will continue to be a tailwind to performance over the long term.

Also, when the global economy comes back online, you could well see companies with low profitability and large debt burdens perform very well. This often happens coming out of a recession because those companies and their shares have been so beaten down that an upturn in the general economy gives them a larger boost than it does more stable, higher-quality companies that weathered the recession better. Again, this is a short-term phenomenon that could penalize us. But it's not an argument for long-term investing in debt-burdened companies with low profitability.

WHERE FROM HERE?

As we've sent out four Market Updates to clients via email over the past month, we won't recapitulate those reflections. But as of April 10 the market is up about 25% from its March 23 low. This is, in part, because the Federal Reserve's bold actions have dramatically reduced the risk of a liquidity crisis in the debt markets, one of the three drivers of the decline. It's also, in part, because Congress, with shocking speed, is delivering powerful fiscal initiatives that will mitigate the economic impact of the pandemic.

Most importantly, the market is encouraged by the flattening of the infection curve in the US, with peak infections expected in April. Fatality projections are coming down, in many regions sharply. Projected fatalities in my home state of North Carolina were recently cut by 79%—from 2400 to 500.

While forecasting the economy and the markets is usually a humbling exercise at best, we're in uncharted waters here. But we do know two things: First, the infection curve is bending and we have enough data to know that if social isolation is observed, infections will peak, then fatalities will peak, then fatalities will fall sharply, and infections will tail off—a process that appears to take weeks, not months. Only then can the US economy begin to heal and recover.

The other thing we know is that the stock markets will heal before the economy. We obviously don't know when that will be or from what level. But they always do. Because the stock market is looking six months or so down the road. Stock prices will rise in prediction of economic recovery well before recovery begins.

Farnum Brown, Chief Strategist