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A CRUCIAL LESSON REVISITED

Well, here we are and grateful for it. The worst of the pandemic is behind us. The economy is rapidly recovering thanks in no small part to powerful interventions by the federal government. And the stock market is healthy and rising. Indeed, the S&P 500 gained 6% in the first quarter of 2021. That puts its gain since the low point made last year at 78%.

A year ago, who woulda thunk it?

We sent our clients an email on March 18th of last year, to share our thoughts on a market that had fallen sharply from its prior peak a month earlier. Five days later, on March 23rd, the market had fallen 34% from its peak. And this in just over a month. Never before had the market fallen so far so fast.

And then it stopped falling. We know what's happened since.

In the email, we shared a study by J.P. Morgan Chase, which revealed some rather startling results: For the 20 years through 2018, an investor continuously invested in the S&P 500 saw $10,000 grow to $29,845. An investor *who missed the 10 best market days in those 20 years* saw $10,000 grow to just $14,895—that is, their returns were cut in half. And an investor *who missed the 20 best market days in those 20 years* saw $10,000 shrink to $9,359.

The crucial lesson of this study was: When investing in the stock market, you have to stay in it to win it. Which is what our email encouraged clients to do. Happily, they all did. Never has this lesson been more dramatically proven out. On the three days following the low on March 23rd, the S&P gained 18%. You have to be in the market when those days come—and they don't send out invitations in advance.

PERFORMANCE AND OIL PRICES

As we reported in January, our portfolios' performance benefited last year from the collapse in oil prices, precipitated by the global lockdown. As the price of energy shares closely tracks the price of oil, the energy sector of the market was crushed last year, a blow our portfolios side-stepped by being fossil-fuel-free. With the S&P 500 up 18% for 2020, our Arjuna 350 US stock strategy returned 21%.

We said at the time that when the global economy began to recover, rising demand for oil—from airplanes, automobiles, trucking, etc.—would drive up oil prices and with them the price of energy shares. This, obviously, would be a performance headwind for fossil-fuel-free portfolios. And, indeed, while the S&P 500 gained 6% in the first quarter, energy sector shares rose 29% for the period.

Against that backdrop, we were very pleased to see our Arjuna 350 US equity strategy return 7% for the quarter, despite the headwind from fossil fuels. We were also gratified to see our Arjuna Global Impact stock strategy, also fossil-fuel-free, return 6% vs. its MSCI World Index benchmark's return of 5%.

As the global economic recovery continues to gain steam, oil prices and energy shares should remain strong for a while. As the saying goes, every dog has its day. But, long-term, it's still a dog, and we're not going to own it.

DOUBLE-BARRELED RECOVERY

Nancy Lazar, a widely renowned economist we follow, is looking for the US economy to grow this year at its fastest pace since 1953. We're talking explosive growth. How come?

In part, it's just math. Her expected 9% annual growth rate (after inflation) is based off of the contracting economy in 2020. But it is also very much the result of the federal government using its two primary economic policy tools to full effect. Those are monetary (interest rates) and fiscal (spending) policy.

Most are aware that the fiscal support provided by Congress over the past year, first under Trump and now under President Biden, dwarfs the spending Congress authorized in response to the Great Recession of 2007-2008. Apparently, lessons have been learned. Had Congress responded to the earlier crisis with the vigor of its COVID-relief efforts, the Great Recession would have been much shorter and shallower.

Less widely appreciated is the fairly dramatic change in the Federal Reserve's approach to monetary policy. To boil this change down to its crux, the Fed by law has a dual mandate: contain inflation and promote full employment. However, since the raging inflation of the 1970s to early '80s, the Fed has been mostly focused on fighting inflation. Which has meant being much quicker to raise interest rates in anticipation of rising inflation. This, in practice, has meant being much quicker to unintentionally push the economy into recession and the stock market into steep decline.

Under Fed Chairman Powell, the Fed has now tilted its focus to promoting full employment while openly tolerating the possibility of rising inflation. This latter, effectively, is an admission that for over a decade now inflation hasn't been a problem. Indeed, the Fed would prefer to see inflation pick up a bit as some inflation is healthy for the economy.

WHAT IT MEANS FOR STOCKS

Since 1945, most US recessions have been caused by the Fed tightening monetary policy (raising short-term interest rates) in order to quell anticipated inflation. This, of course, means that most US bear markets in stocks have the same cause.

As part of Powell's shift in the Fed's focus to promoting full employment, he has said the Fed doesn't anticipate raising interest rates until 2023 at the earliest. The Fed is now officially targeting a 2% *average* annual rate of core inflation rather than a 2% fixed pace and so would like to see inflation *above* 2% for a spell as it has been running below that pace.

In a word, the Fed wants to run the US economy hot to promote full employment, and it will worry about inflation if and when it becomes a problem. This is a MAJOR shift in the Fed's priorities and one investors as well as social progressives should welcome.

As we've noted in previous *Outlooks*, with the Fed taking THE major risk to stock prices (Fed tightening) off the table for a couple of years, at least, the visibility of corporate earnings streams today is unusually good. And the longer the perceived earnings stream investors are buying into through stocks, the more they're willing to pay for it. We think that's part of what this exuberant market has been telling us.

WHERE ARE WE?

With the stock market up 78% from its 2020 low, it's natural to ask if the party's almost over. We are fairly confident that it's not. We follow a host of indicators that signal the health of both the economy and of the stock market and none are flashing warning signals. For example:

When the economy is in the later stages of an expansion, the "spread" or difference between the interest rates paid by less-safe bonds rises relative to the rates paid by their safer counterparts. This reflects the rising default risk that a weakening economy poses to lower-quality debt. Today, those spreads are stable-to-shrinking, which isn't what you typically see when the party's winding down.

Similarly (to mix our metaphors), as the stock market enters the last innings of the game, the kind of stocks performing best rotates away from more cyclical names like homebuilders toward more defensive names like utilities—that is, away from those more sensitive to the economy to those less sensitive. Again, this isn't happening.

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Farnum Brown, Chief Strategist

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