ARJUNA CAPITAL
ENLIGHTENED INVESTING

MARKET OUTLOOK
July 2020 / 3rd Quarter

With no signs of inflation in sight and a Federal Reserve committed to ongoing monetary stimulus, we should expect a very long period of economic expansion ahead. And that may well be part of the message the stock market is sending.

ROLLER COASTER

It's been quite a wild ride in the markets over the first half of 2020. In the first quarter of the year, the S&P 500 fell 20%. In the second quarter, it rose 21%. For the full six months, the S&P was down 3%. I'm happy to report that Arjuna's US stocks gained 1% in the first half.

We explained in our last *Market Outlook* why our stocks have done so much better than the market. It bears repeating as it not only explains our performance but illuminates the market action in the first half.

THREE THREATS

From the market's high on February 19th to its nadir on March 23rd, the S&P fell 34%. It did so in response to a cascade of threats, the pandemic being only the most obvious.

In fairly quick succession, it first became clear that the measures required to fight the coronavirus would have devastating economic consequences. Then a trade war over oil broke out between Russia and Saudi Arabia, driving an already weak oil market to its knees and dragging the price of a barrel of oil from $60ish in January to $12ish in April. As many oil producers have thin profit margins while carrying large amounts of debt, this plunge in revenues threatened widespread bond defaults across the oil patch. Lastly, with debt markets of all sorts getting balky, it looked like the plumbing of the US financial system could freeze up, causing a global liquidity crisis.

This last threat of a liquidity crisis posed at least as dire and far more immediate a threat to the economy than the pandemic. All three of these threats combined to pull the stock market down 34% in a month.

WHY WE DID SO WELL

The most obvious reason is that Arjuna's stock strategies do not invest in fossil-fuel companies. And while the S&P was down 20% in the first quarter, the fossil-fuel energy sector was down 50%. So, we missed all that.

A less obvious reason is that we own stocks in companies that on-average are more profitable and less debt burdened than those in the S&P. This is a natural result of our research focus on Environmental, Social, and Governance (ESG) risk factors in analyzing the appeal of a given company. To oversimplify things, companies with strong governance tend to be more profitable and less debt burdened.

The risk of a liquidity crisis posed the most dire threat to debt-burdened and low-profitability companies as their access to debt markets is crucial for their survival. Such companies were punished severely in the decline—and we don't own them.

So, in sum, our stocks did so well, relatively speaking, because two of the three key threats driving the decline—plunging oil prices and a potential liquidity crisis—posed less risk to our holdings than they did to the market overall.

V REBOUND

In one of our email Market Updates back in April, we said that after a steep decline, the market will usually not turn on a dime and rocket back up—a so-called V-shaped recovery. Rather, it usually chops up and down in a sideways range for a while before turning up durably—more of a W-shaped recovery. And that's true about 70% of the time. Not this time. This stock market recovery so far looks like a V. How come?

First, the Federal Reserve moved boldly and aggressively to unfreeze the debt markets, where sellers had overwhelmed buyers, causing the markets to seize up. Fed Chairman Powell announced that there was no limit to the support (= cash) the Fed could and would deploy in the debt markets to insure their smooth functioning. He followed that up with a quick $2 trillion of bond purchases to prove his bona fides. The debt markets believed him and fairly quickly resumed more normal functioning.

With the striking speed and scope of its actions—actions that dwarfed those during the Great Recession—the Fed effectively took the most immediate and most dire threat to the economy off the table. And that's when the stock market stopped going down. The low in the market was on March 23rd. On March 24th, the market rose 9%. By March 26th, it had risen 18%. It did this by way of repricing the risks the market faced and the worst of them had been removed.

Another V recovery came in the oil markets, where futures contracts for oil had briefly been priced below $0, meaning those with oil to sell would pay you to take it off their hands. But then Russia and the Saudis made up and, with economies reopening, the demand for oil rose, its price crawled out of the basement and today stands around $40. So, another of the three threats has been greatly mitigated if not eliminated. Pricing out that risk also drove the sharp recovery in stocks.

PANDEMIC

That leaves us with the threat posed by the pandemic, which most casual observers consider the sole driver of 2020's market action. Per the above, it wasn't, not by a long shot. But, going forward, it largely will be.

Based on the economic data, it appears that the US COVID recession will be short and sharp, limited to the first and second quarters of 2020, with the economy turning up in the third quarter. Indeed, it appears the economy turned up in May. 2.5 million net new jobs were added in May versus the consensus expectation that the US would *lose* 7.5 million more jobs in May. (An additional five million jobs were added in June.) Auto sales jumped 42% and new home sales rose 21% in May vs. April. Mortgage applications for home purchases (not refinancings) are up 72% from their lows, having exceeded the pre-COVID highs. And mortgage applications are a good leading indicator of future construction activity and employment. Which explains why homebuilder stocks are soaring.

Why so short a recession, given its depth? One of the main reasons is that to date, total monetary and fiscal stimulus to the economy provided by the federal government equals 44% of annual US GDP. That number may rise to 50% when Congress passes its next stimulus bill, likely in July. This is massive stimulus, dwarfing what the federal government did in response to the Great Recession. Indeed, this level of stimulus is what the federal government *should* have provided back in 2008/2009 and because it didn't, the Great Recession was longer and deeper than it needed to be. Lesson learned.

Also supporting a short recession is the fact that total monetary and fiscal stimulus to date globally equals 29% of global GDP. Again, this is massive and a recovering global economy supports a recovering US economy.

Now, this emphatically is NOT to say that the US and global economies will soon be back to pre-COVID levels. Far from it. It's to say only that the US and global economies have turned the corner and are now embarked on a long, bumpy road to recovery.

TOO MUCH, TOO SOON?

Given that the stock market today is only 7% below its all-time high while the economy is just starting to recover, lots of folks are asking: Has the market gotten ahead of itself? Possibly. But remember that the market isn't pricing current conditions; it's pricing what investors think the economy will look like six or so months from now. This is why the market always heals before the economy does, as we've said many times.

The other thing to keep in mind is that a tsunami of fiscal and monetary stimulus has been introduced to the US and global economies. Monetary stimulus, in particular, always shows up in financial asset prices before it shows up in the real economy. This is one of the key reasons that the stock market is a leading indicator of the economy: stimulative or restrictive monetary policy (lowering or raising interest rates) affects stock prices months before it affects the economy. So, today's huge move up in stock prices is, in part, a reflection of the huge dose of stimulus the federal government has delivered.

WHERE FROM HERE?

We're confident the stock market lows we saw in March won't be revisited. Typically, the most dramatic moves up in stock prices come right after the bottom of a bear market, as we've seen this past quarter. So, we don't expect such a torrid pace of ascent to continue. And it wouldn't surprise us if stocks pulled back to digest their huge gains. But we do believe we're in a new bull market.

We also believe the deepest point of contraction in the US economy is behind us. Two of the three threats to the US economy have been largely neutralized. And while the forward path of COVID-19 is unpredictable, the US economy is reopening, though it will do so in fits and starts. Indeed, we're already seeing a new surge of infections and the rolling back of some reopening measures in some regions. But reopening will continue. There is a long and bumpy road of recovery ahead. But in some ways that is good news: With no signs of inflation in sight and a Federal Reserve committed to ongoing monetary stimulus, we should expect a very long period of economic expansion ahead. And that may well be part of the message the stock market is sending.

Investors are now turning their attention to the elections in November. A Biden win is now Wall Street's base case. And odds of a Democratic majority in the Senate are rising. While we would welcome such a Democratic sweep, a less pro-business agenda coming out of Washington may be unwelcome on Wall Street.

Farnum Brown, Chief Strategist