Over the past 18 months the S&P 500 has returned 37% while the MSCI World index returned 31%. For the same period, our Arjuna 350 domestic stock strategy returned 40% while our Arjuna Global Impact strategy returned 44%.

RUNNING WITH THE BULLS

As the worst of the pandemic recedes into the rearview mirror and the US and world economies find their footing, stock markets have vigorously led the way. In the first half of 2021, the S&P 500 returned 15% and that on top of last year's 18% gain. The MSCI World stock index gained 13% in the first half of 2021 and 16% last year.

Total those 18 months up and you get a 37% return for the S&P 500 and a 31% return for the MSCI World index. Over the same span, our Arjuna 350 US equity strategy returned 40% while our Arjuna Global Impact equity strategy returned 44%.

As eye-catching as these returns are, the real drama starts at the market low made on March 23rd of last year. From that point through June 30th of this year, the S&P is up 93%—and that's not counting dividends.

While dramatic, these sorts of returns are characteristic of stocks following the bottom of a bear market. After the market bottomed back in 2009, as the Great Recession was abating, stocks returned 83% in just 11 months. Why such dramatic results?

PRICE AND EARNINGS

Two things drive stock prices: anticipated future profits (= earnings) and the price investors are willing to pay for them. The latter is called the price-to-earnings or P/E ratio. At the bottom of a bear market, typically the US economy has been in recession for a spell and the outlook for corporate earnings has collapsed along with the economy. As importantly, investor confidence has been crushed and with it the market's P/E ratio.

At such low points, stock prices are doubly penalized as they reflect both lower anticipated forward earnings and a depressed P/E ratio. It's worth underlining that at such stressed extremes in the market, investors become irrationally pessimistic and the future they anticipate is unrealistically dire.

When whatever glimmer of hope shifts investor sentiment away from the irrationally dire and back toward (however provisionally) improving reality, the negative double-barreled effects of depressed expected earnings and P/E ratios are reversed: anticipated future earnings are adjusted upward and, more importantly, the price investors are willing to pay for them—the P/E ratio—rises.

This is why the initial phase of a stock market recovery is so dramatic: both drivers of stock prices are improving from irrationally depressed levels, with P/E ratios often doing so dramatically.

P/E RATIOS AND THE FED

We think it best to think of P/E ratios as a measure of perceived risk, whether in regard to a stock, a sector of the market, or the market overall. As perceived risk eases, P/E ratios rise. As perceived risk increases, P/Es shrink. Conversely, we can also think of P/E ratios as a measure of investor confidence in a given stock, sector, or market. P/E ratios rise and fall with investor confidence. That is, the more confident I am in the continuation of a given earnings stream, the more I'm willing to pay for it.

In the case of the overall stock market, the primary risk investors focus on is the odds of a coming recession, as this is typically what sends stocks into a steep decline, a.k.a., a bear market.

As we've recounted in recent *Market Outlooks*, almost all bear markets in stocks since WW II have been brought on by the Federal Reserve raising interest rates (the recent pandemic-induced bear market is the notable exception). The Fed does so to cool an overheating economy and so ward off rising future inflation. An unfortunate, secondary effect of such Fed policy can be to drive the economy into recession, corporate profits into decline, and stocks into a bear market.

So, it's only logical that investors' primary perception of risk to the overall market is, in effect—whether directly or indirectly—an assessment of future Fed interest rate policy.

DUAL MANDATE

By law, the Federal Reserve has two mandates: to contain inflation and promote full employment. Ever since the raging inflationary spiral of the 1970s and early '80s in the US, the Fed has been almost exclusively focused on containing inflation. The result has been a Fed averse to a booming US economy as that has been taken, almost as an article of faith, to be the precursor of unwelcome inflation. And, so, the Fed has tended to put the brakes on the US economy before it reached full speed, if you will, and full employment.

Over the past decade, however, globalization and technology have introduced powerful disinflationary forces into the global economy, fundamentally altering inflationary dynamics. As a result, the Fed's single-minded focus on fighting inflation has come to look like a strategy designed to fight the last war: indeed, inflation has tended to run *below* the Fed's desired target rate of 2% per year, which is also unwelcome.

SEA CHANGE

Under the chairmanship of Jerome Powell, a Trump appointee, the Fed has declared a dramatic, even historic, shift in the Fed's emphasis going forward. Powell has repeatedly asserted that the Fed will prioritize full employment in its interest-rate policy, with concerns over *actual*—rather than anticipated—inflation a secondary priority.

What this means in practice is that the Fed wants the US economy to reach full speed, and so to reach full employment, which we, as progressives, applaud. For corporations, this means that the Fed intends to let their profits grow for longer than it would have over the past 40 years. And for investors, it means the Fed will let the bull market in stocks run longer than previously would have been expected, which we also applaud.

The potential here is for the US economy to engage a positive feedback loop: an economy with higher levels of employment will drive higher levels of consumer spending, which in turn will drive higher levels of corporate profits, which then drive further increases in employment, etc. One byproduct of this higher level of employment would be greater bargaining power—and thus higher wages—for workers as the supply of labor shrinks.

We take this proposed shift in the Fed's emphasis to be but one aspect of what we hope is a sea change in the federal government's approach to economic policy. For over 40 years, since the election of Ronald Reagan as president, the federal government's economic policies, both Republican and Democrat, have dramatically tilted the playing field in favor of the wealthy and against the working class.

Indeed, the Fed's focus on inflation rather than employment has been interpreted by some as a way to maintain a large pool of unemployed workers competing for available jobs, thus keeping wages down and corporate profit margins up.

OLD HABITS DIE HARD

If you read the financial press and particularly if you follow the bond markets, you know that there is quite a lively debate as to whether the Fed actually means what Chairman Powell has been saying. That is, many investors, particularly in the bond markets, are skeptical that the Fed will actually follow through on its promised shift in priorities.

This debate has grown most salient recently as inflation readings have spiked well above the Fed's 2% target, a spike Powell believes is the result of temporary, Covid-related factors that soon will fade (we agree).

So, the question troubling investors now is whether the Fed will wait to start raising rates until at least 2023, as Chairman Powell has indicated, or raise rates sooner, in 2022, as the Fed would traditionally do. This, of course, has great import for the stock market, as the Fed's raising rates—while not marking the end of a bull market--does mark the *beginning* of the end.

Given this debate, it's no surprise that the overall market's P/E ratio has stopped rising this year and flattened out, albeit at a fairly high level. While there are a host of factors at play in the market's P/E, one factor driving the P/E higher last year was confidence in the Fed's new priorities and what they would mean for the economy, profits, and stock prices. Given that cracks are appearing in that confidence, the price investors are willing to pay for future earnings has naturally stalled.

We believe there's a lot more at stake in this debate than just stock prices. We hope the Fed follows through on Powell's avowed priorities and that this is but one piece of a wholesale reorientation of federal economic policy.

Farnum Brown, Chief Strategist

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