Investors have been exposed to stock market risk for a year but have precious little to show for it, other than a tremendous amount of volatility.

SOUND AND FURY

Investors continue to face a good news/bad news situation in the stock market. Yes, the S&P 500 returned 20.55% for the first nine months of 2019, a stellar result by any measure. The problem is that the S&P is up just 1% from where it was *last* September. So, investors have been exposed to stock market risk for a year but have precious little to show for it, other than a tremendous amount of volatility.

There's no question some of the blame for this must be laid at the White House door. Trump's trade war is taking a toll on the global economy. Together, China and the US represent 40% of total world trade. When the world's two largest economies start going tit-for-tat with tariffs on each other's exports, the entire world is affected. And, indeed, the World Trade Association cut its forecast for global trade growth to the lowest level in a decade.

To be fair, Trump's trade war is an aggravating factor—a huge one—but it's not the underlying cause of the global slowdown, which began before Trump's tariff tantrums. Leading indicators of the Chinese economy peaked in early 2017 while those in the US peaked later that year. Trump's first tariffs—on solar panels and washing machines—were miniscule and not levied until January of 2018.

RATES AND THE BUSINESS CYCLE

The underlying cause of the global slowdown and stalled-out market is rising interest rates. Historically, the Federal Reserve's interest-rate manipulations are the best leading indicator of where the US economy is heading—but with a lag of roughly 24 months. The same is true in China, where interest-rate moves by the People's Bank of China (their Fed) lead the Chinese economy by roughly two years.

Raising interest rates is just increasing the cost of money—borrowed money. And this eventually has a dampening effect on economic growth. As the stock market anticipates the economic future by about six months, the Fed's moves are also a great leading indicator of where the stock market is going with a lag of about 18 months—six months ahead of their impact on the actual economy.

As the Fed stopped raising rates only in December of 2018, their dampening effect on the US economy will continue to be felt for another year or so and, consequently, keep pressure on the US stock market for another six months or so.

LEADING AND LAGGING

Many investors look to the headline news on economic data like unemployment, gross domestic product (GDP) or inflation to shape their market outlook. But that's like peering into your rearview mirror to see where you're going, because those are *lagging* economic indicators. They tell you where you've been, not where you're going.

While interest-rate policy is a very good *leading* indicator of the economy, it takes a very long time to register in the stock market or economy. As most market strategists operate with a 12-month time horizon, an 18- or 24-month indicator is useful but not immediately actionable. It's like a map that shows you what your route will be a couple hours down the road.

Regular readers know we pay close attention to a set of leading indicators that are more actionable as they look out about six months (much like the stock market, which is itself a leading indicator). These are called Purchasing Managers Indexes and you can find them for countries, regions, even the global economy. These "PMIs" are surveys of purchasing managers throughout the relevant area, which asks for their outlook over the coming six

months. Those views are then aggregated after each month has ended, and a PMI score is reported.

One of the most useful PMIs is the Institute for Supply Management's US monthly manufacturing survey, which aggregates the six-month outlooks of purchasing managers throughout the US manufacturing sector. The ISM, as it's known, creates an index of these reports, which registers above 50 when purchasing managers on the whole see expansion ahead and below 50 when they see contraction coming. For this past August, the ISM registered 49.1. The September ISM came out with a reading of 47.8—the lowest in a decade.

DÉJÀ VU

Since 1950, every time the Federal Reserve implemented a policy of interest-rate increases, a series of events has unfolded with uncanny regularity. Market volatility increased. Corporate-earnings growth slowed. Market returns flattened out. And the ISM fell below 50. Sound familiar? If so, you won't be cheered to hear that in each case either a recession or, at the least, a corporate-earnings recession followed.

Last December Wall Street expected corporate earnings to grow nearly 20% over the coming 12 months. Today, earnings are estimated to grow 2.1% over the coming year. We think they easily could turn negative. That would not be welcome news to the stock market.

The good news is that the path of interest rates over the past two years suggests that the economic headwind from higher rates should fade toward the end of 2020 and be replaced in early 2021 by a tailwind from the lagged effects of falling interest rates. And that means the headwind on the stock market should ease up in the first half of 2020—around six months ahead of the economy—and be replaced by a tailwind in the back half.

Given this projected timeline, we don't see a recession on the horizon or a protracted bear market in stocks, as the cavalry of lower interest rates should be coming to the rescue fairly soon. We do, however, suspect we'll get a corporate-earnings recession and a correction in the stock market—meaning a decline of between 10% and 20%. Which is why in early July we moved client portfolios from a neutral to a defensive posture, reducing (where we have discretion) exposure to the stock market.

ON POLITICS

To state the obvious, we're living through one of the craziest periods of American political history, with uninformed, inconsistent, counterproductive and dangerous policy initiatives firing on almost every front—from trade wars with China to real wars in Syria. Handicapping what Trump will do next has proven utterly futile, which adds an element of risk and volatility to the markets quite apart from the underlying economic trends.

With today's headlines trumpeting impeachment and claims of criminal malfeasance at the highest levels of government, the unpredictability arising from the political arena will only increase. While those political factors are not the primary force driving the economy and the markets, they may compound the already-negative underlying trends in coming months.

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-19-20*