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STAGFLATION REDUX?

For the first nine months of 2021, the S&P 500 returned 16%, and this despite a sudden swoon in September that drove the index 5% below its recent all-time high. We're pleased to report that our Arjuna 350 US equity strategy also returned 16% for the period, and this despite the fact that the fossil-fuel energy sector—which we don't invest in—gained 39% over the span. Our Arjuna Global Impact stock strategy also did quite well, returning 15% for the period while its benchmark MSCI World Index returned 13%.

While we're pleased with these returns, they're in the rearview mirror now. Investors today are worried that the US economy is entering a period of "stagflation" like it suffered in the 1970s, where rising inflation combines with a stagnant economy to form a worst-of-both-worlds stock market scenario. These worries were prompted by the US economy's sudden slowdown in the third quarter combined with sharply rising inflation numbers.

On this reading, the stock market's sudden swoon in September along with a sharp rise in interest rates confirmed the stagflation scenario: stocks fell because the economy was slowing, and interest rates rose because inflation was rising. It's a plausible reading, but one we're fairly sure is wrong. It is, we believe, because it leaves out another very important development that happened in September: the peaking and sudden plunge in US Covid data.

A DIFFERENT TAKE

On our view, during the summer the US economy experienced a temporary "growth scare" as a surging Delta variant caused a third wave of US infections, sharply slowing the US economy and leading investors to question the economy's continued expansion. As part of this growth scare, bond investors rushed to buy US Treasury Notes, seeking a safe haven against the prospect of a slowing economy. Bond yields accordingly fell.

Then, during September when the Covid data fell sharply, investors sold their safe-haven Treasury Notes, causing yields to rise back to pre-scare levels, as investors grew comfortable with a renewed growth outlook. On our reading, the sharp rise in interest rates wasn't driven by inflation fears but by a renewed faith in economic growth. (Indeed, the long-term inflation expectations reflected in the overall bond market are unremarkable as the bond market, like the Fed and like us, sees the recent inflation spike as largely Covid-related and temporary.)

In the equity markets, stock investors followed a similar pattern: When faced with the growth scare, they sold more cyclical companies, whose earnings are more vulnerable to an economic slowdown, and bought growth companies whose earnings aren't as sensitive to the economic cycle—think Facebook, Apple, Amazon, Netflix, Google (the so-called FAANG stocks).

Then, in September when Covid data fell sharply, stock investors sold the growth-oriented FAANG stocks, which they had bought as a safe-haven from a slowing economy, and went back to buying more cyclical shares as they grew comfortable with a renewed growth outlook.

A close reader may be wondering: Why did the stock market fall on the improving economic outlook? The answer to that question is rather technical, but it's key to properly reading the message the market was sending.

CAP-WEIGHTING

The technical part here is that the five FAANG stocks account for about 15% of the S&P 500. That's because the S&P 500 is capitalization-weighted, that is, each stock's share of the index is weighted by its market capitalization. So, for example, Apple's common stock has a market "cap" of $2.5 trillion while steel maker Nucor's market cap is just $30 billion. As a result, Apple stock's weight in the S&P 500 is 83 times that of Nucor.

So, while the FAANG stocks are just five of the S&P 500 stocks, their massive market capitalization makes them account for 15% of the overall index. If they go up or down a lot in tandem, it moves the entire index.

And, indeed, in September each of the FAANG stocks got whacked: Facebook fell 15%, Apple 12%, Amazon 10%, Netflix 6% and Google 8%. The sharp sell-off in these behemoths contributed mightily to the 5% decline in the S&P 500. And yet, the message investors were sending by selling these names was one of renewed confidence in the growth of the US economy.

Which is how the S&P 500 fell despite the bond market and Covid data signaling a more sanguine outlook for the economy. The stock market, paradoxically, was signaling the same.

SO, WHAT NOW?

We're confident the pundits are wrong about stagflation on the horizon. We simply had a growth scare, which is now passing as Covid eases its grip on the US economy and the supply chains that feed it. That said, the torrid pace of economic growth coming out of the pandemic recession is bound to ease.

In the decade prior to the pandemic recession of 2020, US annual GDP growth averaged 2.3% per year. In the second quarter of 2021, US GDP grew 6.7% as part of a snapback in the economy following recession. Most estimates we see for US GDP growth in 2022 cluster around 4%. So, yes, the US economy will slow over the coming year while still doing substantially better than the long-term average.

Similarly, we expect stock returns to moderate from their blistering pace next year, while remaining positive.

ALL EYES ON THE FED

As we've emphasized, perhaps *ad nauseum*, the primary risk to the stock market is always Fed policy, that is, a tightening of the Fed's monetary policy to fight inflation (= raising interest rates). As we've reported, the current debate over Fed policy is whether Chairman Powell's avowed emphasis on full employment overrides the Fed's traditional priority of fighting inflation. If full employment takes priority, the Fed will not raise rates next year, letting the economy run hot in order to maximize employment. Letting the economy run hot also means letting the stock market do the same. On this scenario, the Fed likely won't raise interest rates until 2023.

The jury is still out on this question. Much will depend on how the data unfolds. If inflation pressures ease sufficiently, Powell's position will gain favor and the stock market should benefit, not to mention the US workforce. If, however, inflation proves "stickier"—if, for example, rising rents and oil prices replace the easing Covid-driven inflationary pressures—the Fed may revert to its traditional inflation-focused priorities and begin raising rates in 2022.

We should emphasize, however, that on neither scenario would history suggest that stock returns turn negative in 2022. Historically, the stock market continues to rise through several interest rate increases by the Fed. So, while we hope Powell's view carries the day, for both financial and full-employment reasons, in either case we remain positive on stocks in 2022.

Farnum Brown, Chief Strategist

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