

*Delta Investment Management is a registered investment advisory firm headquartered in San Francisco.
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Delta manages portfolios at TD Ameritrade and Schwab.
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November 9, 2018

Midterm Elections – The Next 12 Months

Since 1946, there have been 18 midterm elections. Stocks were higher 12 months after every single one over this 72 year period. The average appreciation over the next twelve months has been 17%. Additionally, we are entering the third year of the presidential term which is historically the strongest year for stocks.

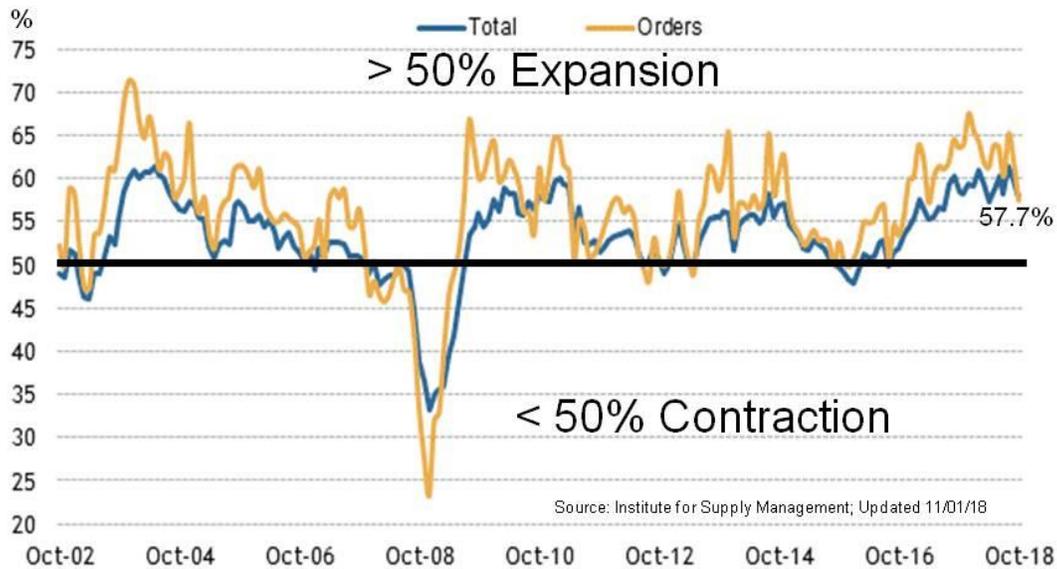
For stocks to keep rising over the next year, they must climb a “wall of worry.” Rising interest rates, rising labor costs and a tight labor market are expected to slow growth and reduce corporate margins in 2019. Real GDP growth is running at about 3.5% but the Federal Reserve expects it to slow to about 1.8% by 2021. If the trade war with China worsens, this could exacerbate the expected slowing of growth globally.

The current consensus expectation is for earnings growth to slow from the 25%+ pace year-over-year in 2018 to roughly 9% in 2019.

The wall of worry is built on the idea of slowing profit and economic growth momentum eventually followed by a recession. This investment outlook explains much of the reason the S&P 500 P/E multiple contracted from about 18.2x earlier this year to about 15.5x at the end of October. Credit Suisse’s chief U.S. equity strategist says this is the third-worst P/E decline in forty years.

What is unusual about the P/E contraction is it has occurred during a time when the ISM Manufacturing Index has been indicating expansion. Historically, the stock market has experienced double digit gains over the next twelve months with this type of P/E contraction combined with an ISM reading well into expansion territory.

ISM Manufacturing Index U.S., 2002-2018



The wall of worry offers the stock market a mechanism by which to climb higher. Through election day, 87% of the S&P 500 reported earnings. Operating earnings are now tracking a gain of 30%+ according the JP Morgan which is an acceleration from the 27% earnings growth rates of the first and second quarters. This is an unexpected positive.

The Federal Reserve is indicating it will raise rates in December. It is quite possible, because of a steady inflation rate near 2%, that they raise rates only two more times in 2019 before pausing to allow the economy to digest higher rates. This represents upside from current Federal Reserve rate projections.

On November 29, President Trump and China President Xi will meet to talk about trade. It is possible the conversation leads to the beginning of the end of the trade war with China. This year, the U.S. has resolved its trade wars with Mexico, Canada and the European Union. China is the outlier.

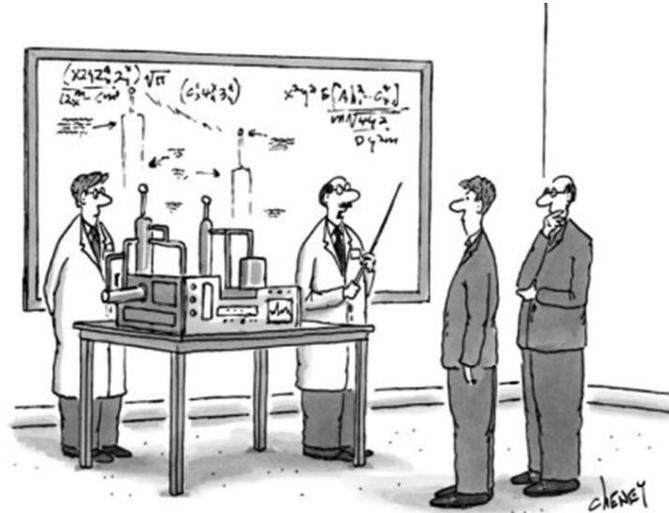
Before the midterm election and before the October sell-off, Warren Buffet was bullish and buying stock. In the first six months of the year Buffett bought \$11.8 billion worth of equities. In the next three months (third quarter ending September 2018), Berkshire Hathaway accelerated its stock buying taking in a net \$12.5 billion worth of equities.

R&D: A Long-Term Positive for U.S. Stocks

Innovation drives profits. In the United States, free flowing capital markets fuel innovation. For the year ending June 30, 2018, American firms spent \$329 billion on research and development. This is more than 5x the amount spent by China and represents 40% of the world's total R&D expenditure. Eventually, R&D expenditures create innovation which drives profits and wealth creation.

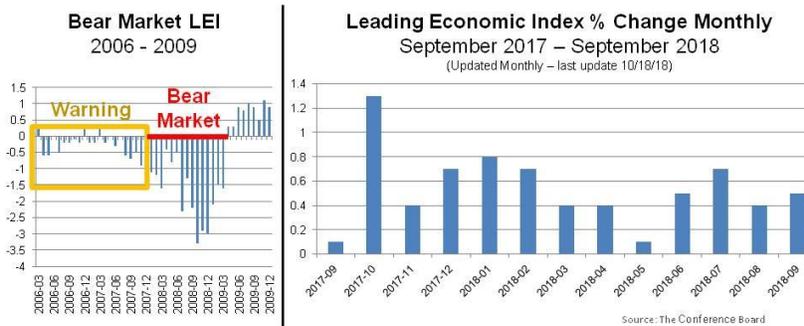
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"It's designed to generate electricity by moving with fluctuations in the Dow."

Delta Stock Market Dashboard



MARKET SENTIMENT IS

BEARISH

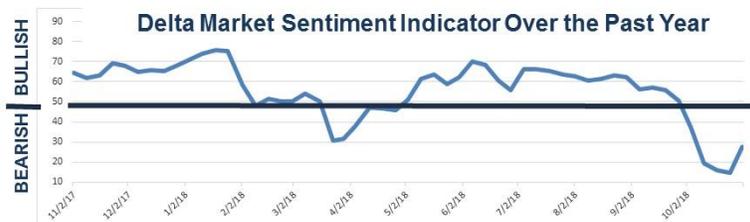
THIS WEEK'S NUMBER IS
27.6

Our technical indicator increased this week from 14.8 to 27.6

INDICATOR STATISTICS

Consecutive Bearish Weeks:	5
Cycle Inception Date:	10/11/2018
Range:	14.8 - 37.4
Mean:	23.0
Bullish Weeks YTD:	34
Bearish Weeks YTD:	11
*S&P 500	0.8%
*DJIA	2.4%
*NASDAQ	1.6%

* Percentage change during current cycle



(Delta MSI is published in *Barron's*)

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