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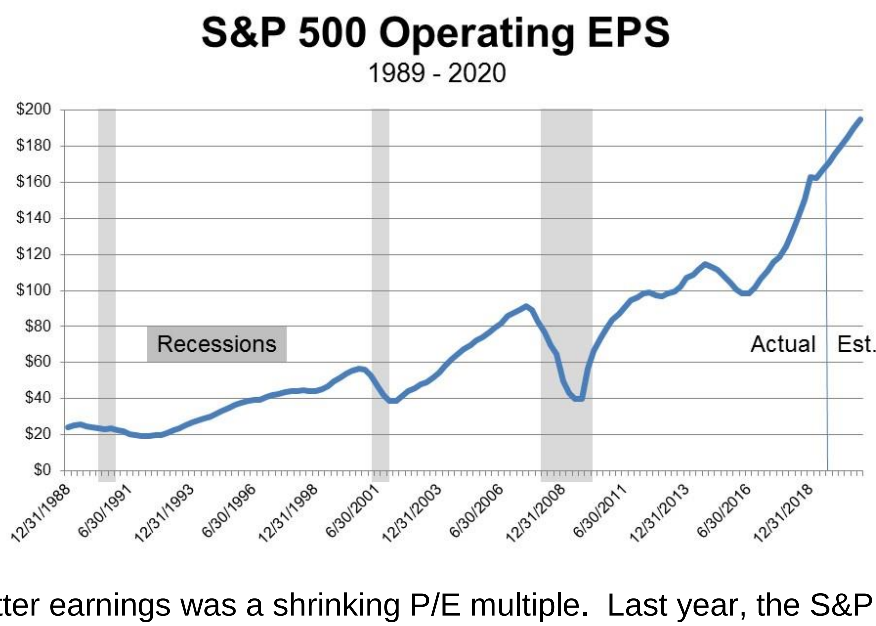
Delta Insights
a weekly commentary on investing

November 16, 2018

Delta's 2019 Stock Market Outlook

A year ago, our 2018 outlook was positive. If the P/E remained constant as it had in 2016 and 2017, we projected the S&P 500 would climb by 11% along with earnings. Through the market close yesterday, the S&P 500 index is up 8% over the prior twelve months.

Instead of 11% earnings growth, earnings are set to rise 24% this year. The extra growth was stimulated in large part from the Tax Cuts and Jobs Act of 2017, which among other things lowered corporate federal tax rates from 35% to 21% - a significant tailwind. This will mark the second consecutive year earnings grew greater than 20%. Looking forward, S&P consensus earnings expectations for 2019 are $177.25, +9% and $194.88, +10% in 2020.



Offsetting better earnings was a shrinking P/E multiple. Last year, the S&P 500 P/E had climbed above 18. Today, the P/E is 15.3 – below its 25-year average P/E of 16.1. There are a variety of reasons for the P/E contraction including rising interest rates and doubts about future earnings growth which we discuss in greater detail below. The P/E reduction was the surprise of 2018 but may be the opportunity for 2019.

There has been upside to GDP growth as well as earnings. The tax cuts bumped real GDP well above trend (2.2% 10-year average) to 4.2 % in the 2nd quarter and 3.5% in 3rd quarter (the “advance” estimate) and GDP on pace to exceed 3% for the year.

The Fed

After the Fed’s unconventional ZIRP (zero interest-rate policy) from 2008-2015, the U.S. economy is past the accommodative phase and rates are rising/normalizing. The Federal Reserve’s dual mandate is to foster economic conditions that achieve both stable prices and maximum sustainable employment. This year, unemployment fell from 4.1% to 3.7% - the lowest since 1969. For inflation, the Fed tracks the personal consumption expenditures (PCE) price index excluding food and energy. The core PCE price index has increased 2% for five straight months, which is at the Fed’s 2% target.

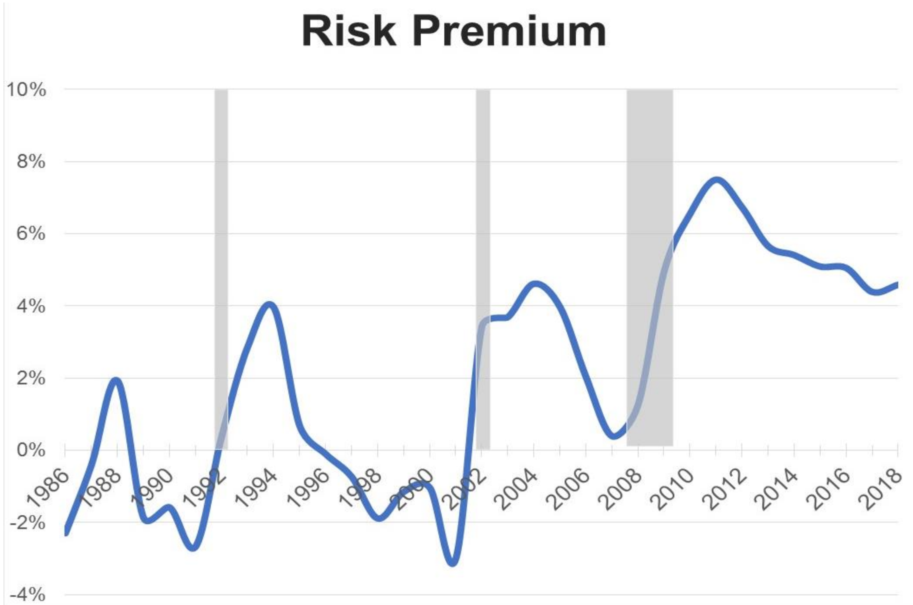
The Fed has raised rates three times (a quarter point each time) so far in 2018. Another 25 bps is expected in December. This will take the Fed Funds rate to a target range of 2.25% - 2.50%. Market expectations are for two more hikes next year in March and June…and then a pause is likely. With inflation on target and unemployment low, it begs the question why the Fed doesn't pause now.

Investors should remember that the Fed is following through with rate hikes and reducing their balance sheet because the economy is healthy. Rate hikes are not a reason to abandon equities. A strong economy and rate hikes in the U.S. have propped up the dollar, putting pressure on international markets which have given back most of their 2017 gains.

Valuing Stocks: Present Value Formula

The Fed Funds Rate drives the risk free rate (1-3 month treasury bills) which is used in the Present Value Formula (PV = future earnings/(risk-free rate + risk premium)). A higher risk-free rate pushes the denominator higher and the present value lower, presuming no change to earnings and risk premium. As mentioned above, however, earnings are rising as well as rates. The unknown is the level and direction of the risk premium or in the case of stocks, the equity premium.

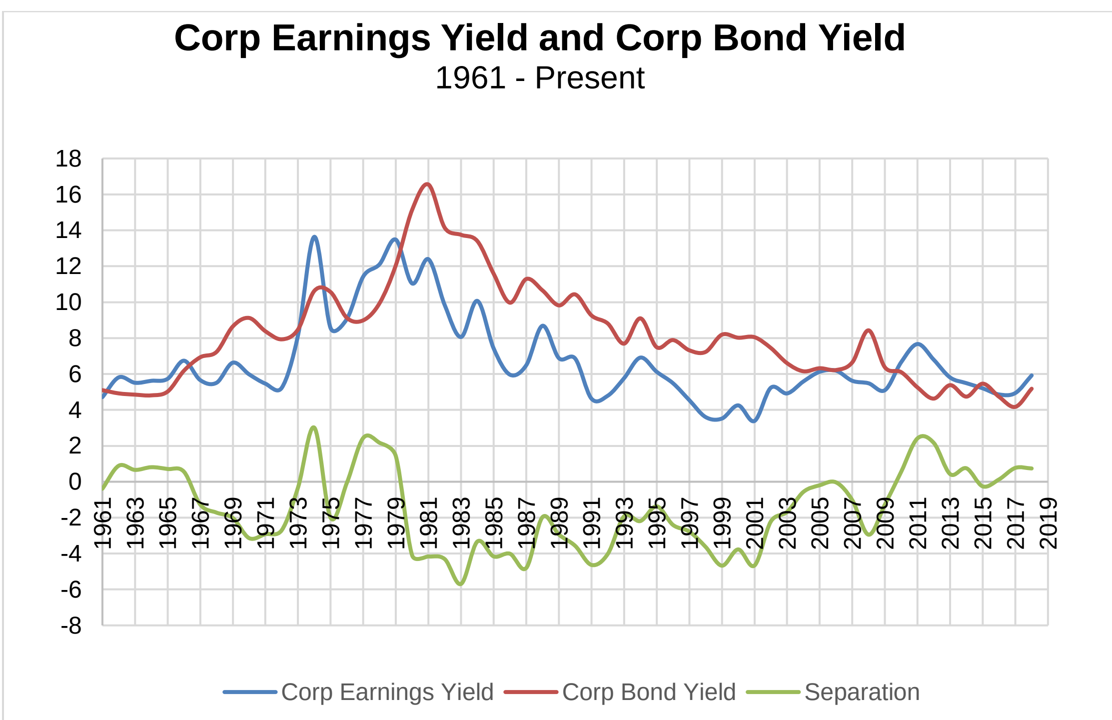
The risk premium is the expected return minus the risk-free rate. The higher the risk premium, the more risk averse investors are towards risk assets. The higher the risk premium, the more investors are being paid for owning stocks. At the end of the bull market in the 90’s, the risk premium was negative. By contrast, today the risk premium is 4.6%, a relatively high level on a historical basis. Bottom line: the risk premium is bullish. Below is the risk premium over the past 30 years with the grey bars marking recessions.



More on Valuation: Earnings Yield vs. Corp Bond Yields

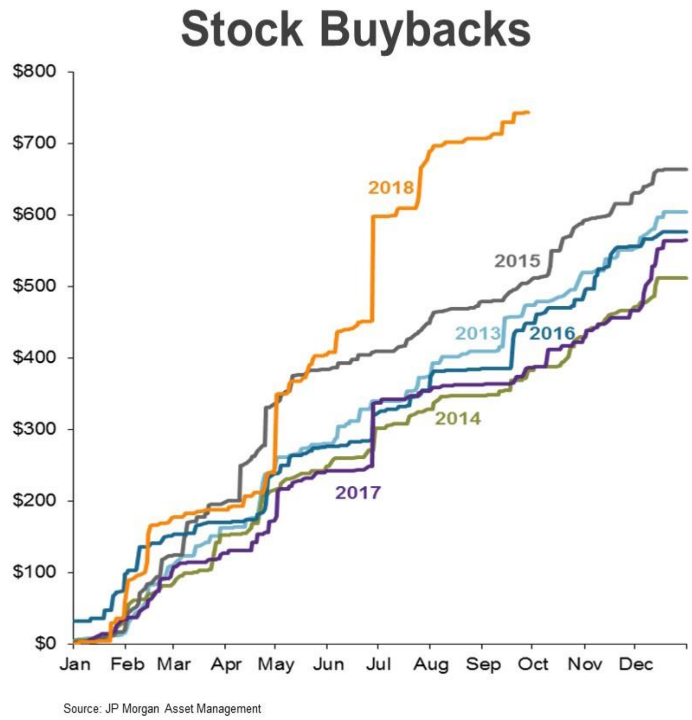
Another way to look at stock valuation is on earnings yield which is calculated by inverting the Price/Earnings (P/E) ratio -- dividing earnings by price. The earnings yield on stocks is 6.5%. The 25-year average earnings yield is 5.4% which, if applied to the market today, the S&P 500 index would be at 3,275 or 20% higher.

Corporate bond yields have historically been higher than equity yields. With the exception of 2015, equity yields have been greater than bond yields since 2009. Investors are being paid to take the risk of owning equities relative to bonds.



Buybacks & Corporate Cash Repatriation

In the low interest rate environment of the past nine years, corporations raised inexpensive debt. Besides retiring more expensive debt and shoring up their balance sheets, corporations used some of these funds to buy back stock. Critics cited financial engineering by corporations lowering share counts to boost earnings per share.



Tax reform also brought the Repatriation Provision. The repatriation of overseas corporate cash was a key objective of the tax reform. U.S. companies operating overseas have amassed roughly $3 trillion of undistributed foreign earnings. Only a fraction of the dollars has been repatriated. A large amount of the dollars repatriated have gone to stock buybacks. This extra boost to buybacks in 2018 (orange line) is largely behind us.

Volatility Returned and is Likely to Stay

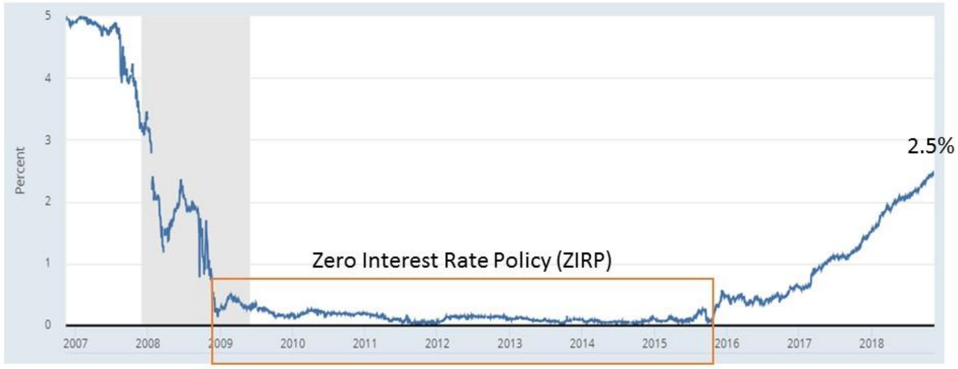
From November 2016 through January 2018, the greatest drawdown on the S&P 500 was -2.8%. The volatility index (VIX) historical average is 19.2. In 2017, the VIX averaged 11.1. This year, the average VIX is 15.7. Since January, there have been two pullbacks in excess of 10%. This volatility is normal for equity markets, especially in a rising-rate environment.

Bonds – Fixed Income

In a rising-rate environment, fixed income investing is challenging. There is an inverse relationship between bond prices and yields. Bond investors are likely to suffer capital losses from bonds as interest rates rise with longer duration bonds being the most sensitive to rising rates.

6-Month Treasury Bill

2007 - Present



Source: Federal Reserve Bank of St. Louis

The Barclays Aggregate Bond Index is -2.2% YTD. A positive side of rising rates are increased cash flow for floating rate, shorter duration and cash-like funds. From December 2008 through 2015 during the Fed's ZIRP, cash flow on savings was essentially zero. Today, 6-month CDs are paying 2.5%. Although still half of the income earned in 2007, this bump up is positive for savers and their spending. As we move from mid cycle to late cycle when returns are typically lower, there are different segments of fixed income that have historically outperformed like floating rate debt and commercial mortgage-backed securities (CMBS).

High Yield Spread Positive

In October, the high yield spread climbed off lows from 3.16% to 3.89%, the highest level in the past year. The spread between investment grade rated corporate debt and Treasuries remains well contained and is not displaying any real warning sign as it did in early 2016. We worry when the high yield spread rises above 5%, indicating bond investors are concerned about credit risk.

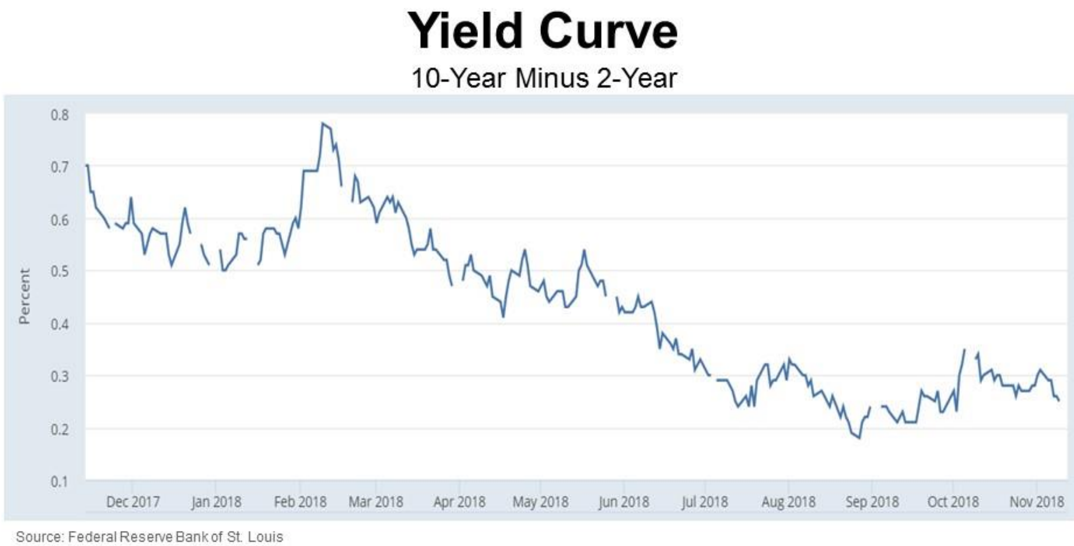
High Yield Spread

5 Year History

Source: Federal Reserve Bank of St. Louis

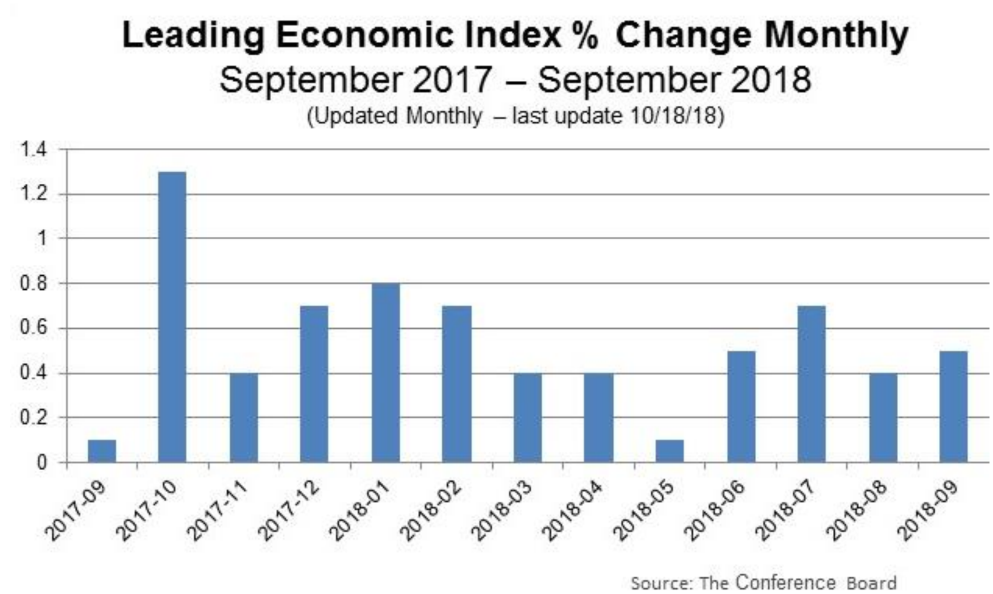
Treasury Yield Curve Positive

There is much talk about the yield curve. In a strong economy, the yield curve flattens and the spread narrows. With the Fed raising rates, investors are concerned about inversion whereby the short end (2-year) rate is higher than the long rate (10-year). Historically, the curve has inverted well in advance of recessions. At this time, the yield curve is not inverted. 10-year treasuries are 3.09% and 2-year treasuries are 2.93%.



Leading Economic Index Positive

In every month of 2018, the Leading Economic Index (LEI) has had a positive month-over-month gain. Prior to recessions, the LEI has turned negative on a six-month moving average basis.



Dollar and International

Much of the reason for the significant underperformance of international stocks in 2018 has been the strength of the dollar. The Federal Reserve has been raising rates versus other major developed country central banks which remain accommodative with low rates.

Currency fluctuations are difficult to predict. With the possibility the Federal Reserve will stop raising rates by mid 2019 or earlier, the U.S. dollar may be approaching peak valuation. Given international stock markets are forecast to show accelerating earnings growth in 2019, we would not be surprised to see the valuation gap between U.S. stocks and foreign stock close as a result of appreciating foreign markets.

In Closing

Recent volatility in the equity market reflects an increasing complexity of factors that are being discounted into stock prices. The surprise of 2018 is that the stock market did not have a stronger positive reaction to a very strong earnings year. The two biggest factors that may have held the stock market back in 2018 were rising interest rates and increasing skepticism regarding forward earnings estimates. Doubts about future earnings projections are tied to concerns stemming from trade wars and inflationary pressures (wage, raw material and transportation costs) which may negatively impact margins.

The sell-off that began in October has made U.S. stocks inexpensive. If the S&P 500 simply appreciates in line with the forecasted earnings growth for 2019, the market should be up by about 9% in the next twelve months. If the Fed signals to the market that it will pause rate hikes in 2019 and the trade war with China is resolved, the math tells us that the S&P 500 could reach roughly 3,200 by this time next year on a 25-year average P/E multiple. This would represent an 18% advance from current levels.

From a risk perspective, we do not see recession warning signs. Outside of recessions, market sell-offs typically last for short periods of time - three months or less in most cases.

From a long-term perspective, the secular bull move that began in March, 2009 is not over. We expect the market will see new highs in 2019, but with higher volatility. Given the accelerating rate of earnings growth abroad and a possibility the dollar is nearing peak valuation, international stocks may rebound nicely after a difficult 2018.

In fixed income (bond market), we remain generally cautious. Interest rates on an absolute level are low and are rising. Within fixed income, we are primarily positive on floating rate debt. Additionally, we are seeing high quality commercial real-estate ownership and lending opportunities that offer the stability of principal, attractive yields and some tax protection.

Give Us a Call Today

We invite you to give us a call at **(415) 249-6337**, visit www.deltaim.com or email us at info@deltaim.com if you have questions about how we can assist you in managing your investment accounts.

"I'd like the Thanksgiving Day Special, on the rocks."

Delta Stock Market Dashboard

MARKET SENTIMENT IS

BEARISH

THIS WEEK'S NUMBER IS

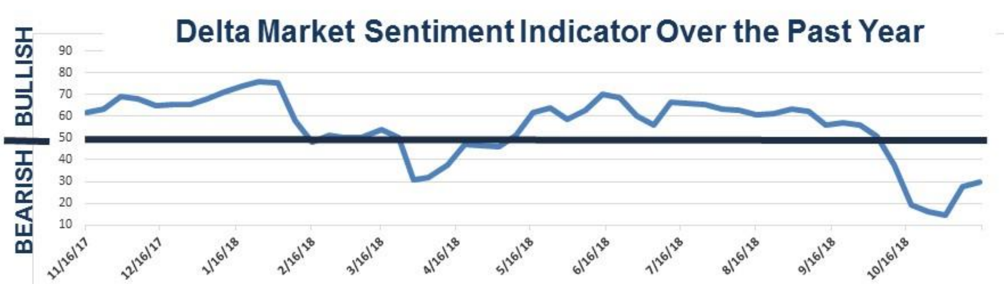
29.7

Our technical indicator increased this week from 27.6 to 29.7

INDICATOR STATISTICS

Consecutive Bearish Weeks:	6
Cycle Inception Date:	10/11/2018
Range:	14.8 - 37.4
Mean:	24.2
Bullish Weeks YTD:	34
Bearish Weeks YTD:	12
*S&P 500	-3.6%
*DJIA	-2.9%
*NASDAQ	-4.1%

** Percentage change during current cycle*



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