DELTA
INVESTMENT
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Delta Insights
a weekly commentary on investing

Delta Investment Management is a registered investment advisory firm. Delta welcomes discussions with individuals seeking investment advice and advisors seeking a new turnkey asset management solution.
Delta manages portfolios at TD Ameritrade and Schwab.
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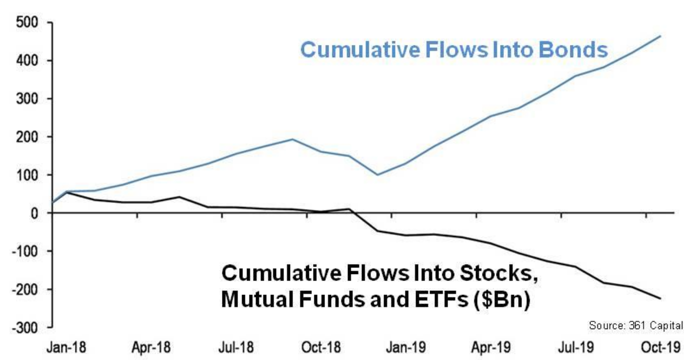
November 22, 2019

Delta's 2020 Stock Market Outlook

Let's start with a quick look in the rear view mirror. 2019 will go into the books as a strong year for the S&P 500, up roughly 26% year-to-date. But much of the gains of 2019 were simply a recovery of the losses from the fourth quarter of 2018. As of this writing, the S&P 500 is up roughly 5.4% from the September 2018 high.

Investors did not like the stock market in 2019. Since January 2018, US equities saw $225bn of outflows, which fully unwound the inflows seen in 2016-2017. During the same time period, fixed income had $465 billion net inflows.

Cumulative Fund Flow: Stocks and Bonds



Earnings growth evaporated in 2019. Calendar year 2019 consensus S&P 500 earnings estimates were roughly $178 a year ago. We end the year with the estimate at about $163 showing almost no growth on a year-over-year basis.

One important reason for positive stock performance in 2019 was the Federal Reserve reversing its policy of raising rates and instituting three Fed Fund rate cuts during the year. The 2-10yr treasury yield curve went from inverted in August to having a material positive upward slope by mid November.

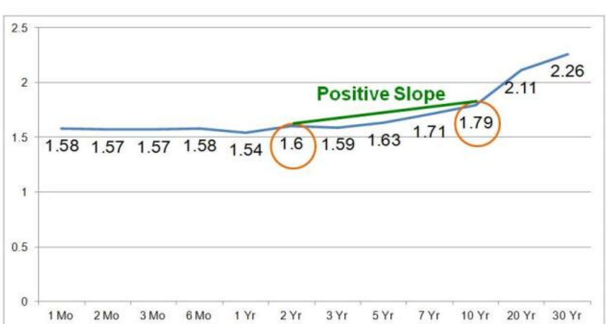
We published the Delta 2019 Stock Market Outlook on November 16, 2018. We were bullish and ventured a one-year S&P 500 price target of 3,200. As of this writing, we were off target by about 3%.

As we approach 2020, there are several positive developments:

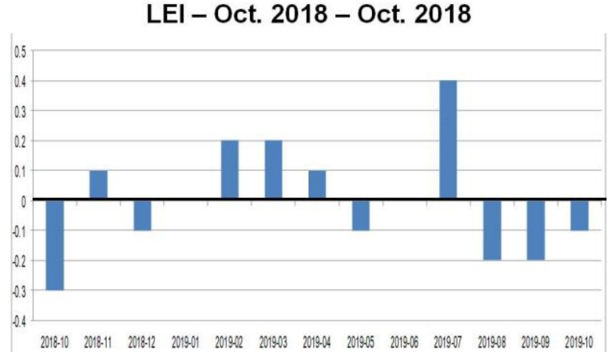
1) The Federal Reserve has signaled that they will leave the Fed Funds rate at its current level unless there is very compelling data to cause them to do otherwise. With the Fed Funds rate "corrected" lower and yield curve having an upward slope, this is a positive development.
2) Consensus earnings estimates show roughly 10% growth year-over-year in 2020 and 9% growth in 2021.
3) We may be progressing towards a trade deal with China. Strength in U.S. and European stocks and a 10-year U.S. treasury up over 30% from the lows are market signals that growth may accelerate in the future.

We are bullish with a lower case "b". What is restraining our enthusiasm is weakness in the Leading Economic Index (LEI) and the 2-10yr treasury yield curve recently inverting for several days. We see the very brief yield curve inversion as an aberration caused by an excessively high Fed Funds rate. The longer dated yields maintained an upward slope. The LEI is backwardly revised for three months. Recent weakness in the LEI may be revised upward. We are in a wait-and-see mode for the next couple of months on the LEI to see if it strengthens.

U.S. Treasury Yield Curve 11/19/2019



LEI – Oct. 2018 – Oct. 2018



Without recession and with earnings growth, our math says the S&P 500 may reach roughly 3,500 this time next year. If our macroeconomic long-term recession indicators give us a definite recession signal, our market expectations will become more pessimistic. At this point, we are bullish and expect some acceleration to the positive in both earnings and economic measures.

There is always the risk of exogenous events having a negative impact on the market. A primary known risk is the trade war and the possibility it becomes worse rather than better. Presidential impeachment proceedings are underway. There is a presidential election scheduled for Tuesday, November 3, 2020. The stock market does not like uncertainty. Unfortunately, the events that typically impact the market the most are events we do not know about today. It is often the case that the known risks at the start of the year are not the reason one-year forecasts fall apart.

Building Blocks of Our Forecast

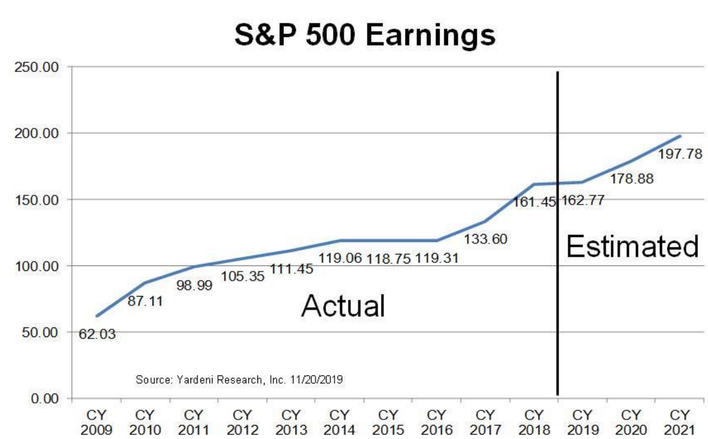
We use the Delta Stock Valuation model to establish our price target. Using a disciplined, mathematical model helps keep personal bias and emotion out of our forward perspective. Our task is to input values that have a reasonable probability of holding up over the next twelve months. We then do the algebra to arrive at our S&P 500 price target.

Delta Stock Valuation Model

$$\text{Stock Prices} = \frac{\text{Future Earnings (est.)}}{\text{Risk-Free Rate} + \text{Risk Premium (anxiety, uncertainty)}}$$

Future S&P 500 Earnings

Consensus analyst estimates are for earning to rise to $178.88 for calendar year 2020 and then to $197.78 for calendar year 2021.



Analyst estimates have been revised down over the past year. But recent breakout price action in the cyclical sectors (Industrials (XLI), Basic Materials (XLB), Financials (XLF) and Technology (XLK)) suggests earnings revisions may be up rather than down going forward.

Cyclical Sector Upside Breakout

European stocks also are on the verge of breaking out to new highs. Germany, the largest economy in the euro zone, avoided recession by positing positive GDP growth in the third quarter after posting negative growth in the second. The European Central Bank (ECB) is engaged in Quantitative Easing (QE) with €20 billion worth of monthly bond buying and zero/negative interest rates.

Risk Free Rate

We use the one-month U.S. treasury rate as the risk-free rate. This rate is currently 1.58%. At the end of October, the Fed cut the Fed Funds rate for the third time this year reversing the 2018 rate increases. They signaled that they are likely to be patient and not move rates again unless the data is highly compelling. Taking the Fed at face value, we predict no change in the risk-free rate by this time next year.

Risk Premium (Fear and Anxiety)

Since 2000, the average risk premium of the S&P 500 has been 3.7%. This represents the excess return an investor should expect to receive above the risk-free rate for taking on the risk of owning the S&P 500. In 2000 and 2007, the peak years before a significant bear market, the risk premium was -1% and 0.4%, respectively. There was little to no reward offered for taking on risk. Today, Delta's calculation of the risk premium is 3.7%, exactly at the 20-year average. Given we are going into and election year and election year risk premiums have tended to be higher than average, we assume the risk premium for owning stocks will rise to about 4%. A rising risk premium is a negative for stock values.

Delta Stock Market Valuation Model – 12 Month S&P 500 Index Forecast

When we insert the values described above into the Delta Stock Market Valuation Model, we arrive at a 12-month forward S&P 500 Index target price of about 3,544.

Delta Stock Valuation Model

$$\begin{array}{c}\text{S\&P 500}\\ \text{1-yr Forecast}\\ \mathbf{3{,}544}\end{array} = \frac{\begin{array}{c}\text{Future Earnings (est.)}\\ \mathbf{\$197.78}\end{array}}{\begin{array}{c}\text{Risk-Free}\\ \text{Rate}\\ \textbf{1-M Treasury}\\ \mathbf{1.58\%}\end{array} + \begin{array}{c}\text{Risk}\\ \text{Premium}\\ \mathbf{4\%}\end{array}}$$

The Delta Stock Market Valuation Model provides us with a framework to analyze world developments and translate them into stock valuation. As we progress into 2020, upside surprises could come from a further decline in the risk-free interest rate and a successful trade negotiation with China which is likely to reduce the risk premium. We will be watching closely to see if there are further reductions to consensus earnings estimates. As always, we will remain vigilant on our early recession indicator watch. If recession becomes more likely, we will report this in our weekly *Delta Insights* newsletter and become more cautious on equity investing. For now, we are bullish.

Give Us a Call Today

We have unique and sophisticated investment methods that seek to capture the stock market's gains while minimizing drawdowns in bear markets. If you would like to learn more about how we manage money, we invite you to give us a call at **(415) 249-6337**, visit www.deltaim.com or email us at info@deltaim.com.

"Explain to me again why enjoying life when I retire is more important than enjoying life now."

Delta Stock Market Dashboard

MARKET SENTIMENT IS

BULLISH

THIS WEEK'S NUMBER IS

69.9

Our technical indicator increased this week from 69.3 to 69.9

INDICATOR STATISTICS

Consecutive Bullish Weeks:	5
Cycle Inception Date:	10/25/2019
Range:	57.4 – 69.9
Mean:	65.0
Bullish Weeks YTD:	31
Bearish Weeks YTD:	18
*S&P 500	3.2%
*DJIA	3.7%
*NASDAQ	4.0%

** Percentage change during current cycle*

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