DELTA
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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.
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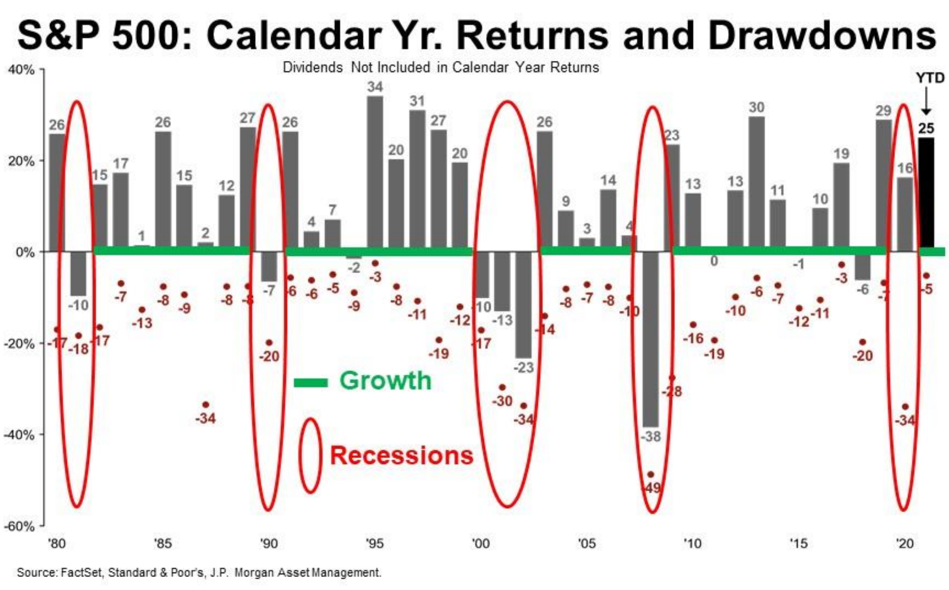
December 3, 2021

Delta 2022 Outlook

When considering possible returns of the U.S. stock market next year, we start with the question is the risk of recession elevated? In recessionary periods, stock market drawdowns can be much more severe (e.g., down by 50% and in drawdown for years) than they are during non-recessionary periods. In non-recessionary periods, market drawdowns typically last for a few months and calendar year returns are almost always positive.

The chart below shows S&P 500 calendar year returns (without dividends) since 1980. The red dots and numbers show intra-year market drawdowns. In recessionary years (red circles) the intra-year drawdowns are significant and the calendar year returns are often negative. In growth years (highlighted with green lines), calendar year returns are normally positive and intra-year declines tend to be in the single digits. In all years, the market experiences drawdowns. But only in recessionary years does the market deliver large, negative calendar year returns.

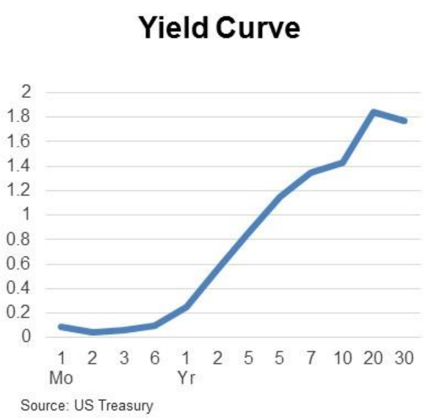


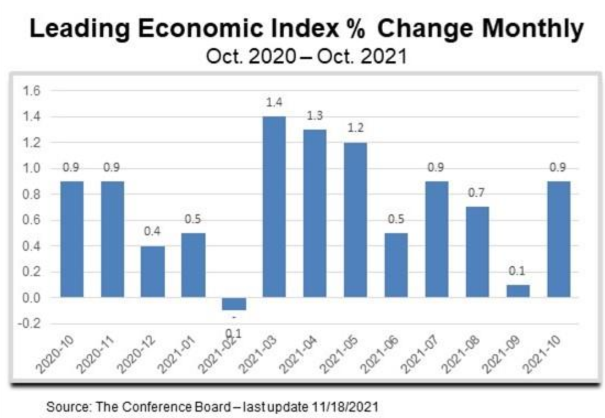
It is unlikely that we will experience a recession in 2022, even with the Omicron Covid variant. If there is no recession in 2022, it is very likely the S&P 500 will experience another positive calendar year.

Recession Risk Minimal

Recession risk in 2022 is minimal because:

1. The U.S. treasury yield curve is far from inverted. Today, the 10-year treasury rate of 1.45% is significantly higher than the 2-year rate of about 0.56%. For an inversion to occur, the 2-year rate would have to be higher than the 10-year.
2. The sequential monthly percent change in the Leading Economic Index (LEI) has been positive for the past eight months and positive for eleven months over the past year. Until the six-month moving average of the LEI turns negative, recession is unlikely.





We know of no major economist, federal government agency including the Federal Reserve or investment bank analyst who is predicting recession in 2022.

If 2022 Is an Up Year, How Much Up?

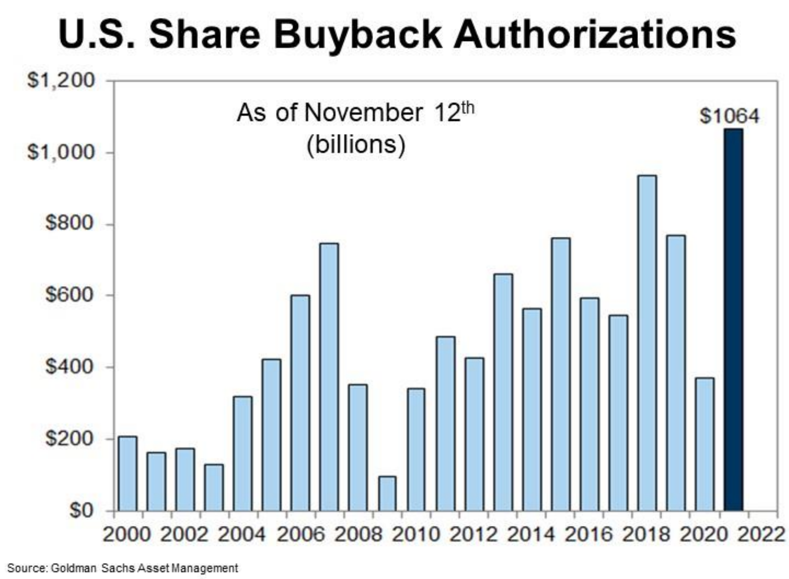
If there is no recession in 2022 and we expect to see further advances in the stock market, how large an advance might we see? We would not be surprised to see another year of double-digit appreciation in the S&P 500. Capital is plentiful, earnings growth is strong and interest rates are low.

1. **Easy Money**

Broad measures show that financial conditions in the United States have never been "easier." When money is plentiful (banks lending, Federal Reserve accommodative, heavy fiscal spending, open capital markets), assets like stocks tend to do well.

Easy money is flowing into equities. Nearly $220 billion has flowed into US equity mutual funds and ETFs through October, a pace that will set a new annual record. Household cash assets are up $3 trillion since the start of the pandemic. Some of this excess cash will be spent on buying equities in a bull market

On the corporate side, cash/asset ratios stand at record highs, and 2021 witnessed record buyback authorizations exceeding $1 trillion.



A concern with the easy money bull argument is that the Fed has begun to taper, it is projected there will be rate hikes next year and the federal government is no longer handing out Covid cash. The fear of decreasing cash stimulus is somewhat offset with the signing of the infrastructure bill, the potential signing of a reconciliation package and the pent-up trillions of dollars of transfer payments to households that are likely to be spent as Covid further diminishes.

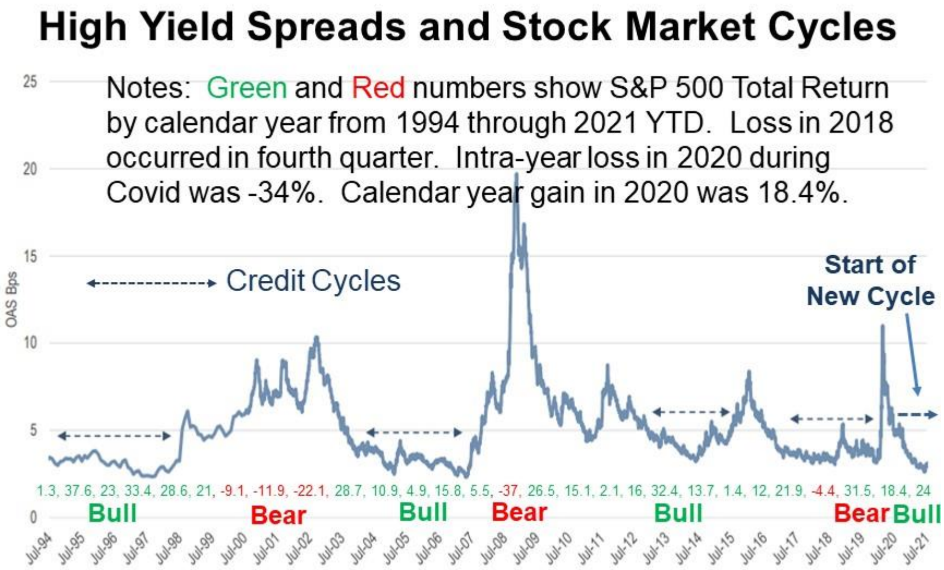
2. **Earnings Growth**

Earnings forecasts show growth and analysts have been revising estimates higher over the past several months. Part of the increase in estimates is that the potential for a corporate tax rate increase is being pushed out to 2023.

The "FAAMG" companies (FB, AAPL, AMZN, MSFT, GOOGL) account for 23% of S&P 500 market cap and 17% of earnings. In aggregate, FAAMG stocks have compounded their sales at a CAGR of 19% since 2010, 14 percent faster than the rest of the S&P 500. The group has also consistently outperformed fundamental expectations, typically reporting annual sales 6% greater than analyst consensus expectations at the start of the previous year. In 2022, these stocks are forecast to grow revenues by 17% versus S&P 500 sales growth of 7%. In 2023, the sales forecast growth numbers are 15% and 5%, respectively.

3. **Low Rate, New Credit Cycle**

Interest rates are low and a new credit cycle has begun. The start of the new credit cycle is marked by the compression in bond yield spreads post Covid. Credit cycles last for years. During the bullish portions of a credit cycle, the S&P 500 normally enjoys double-digit returns. (Please see *Delta Insights, The New Credit Cycle*, November 5, 2021 for a full discussion).



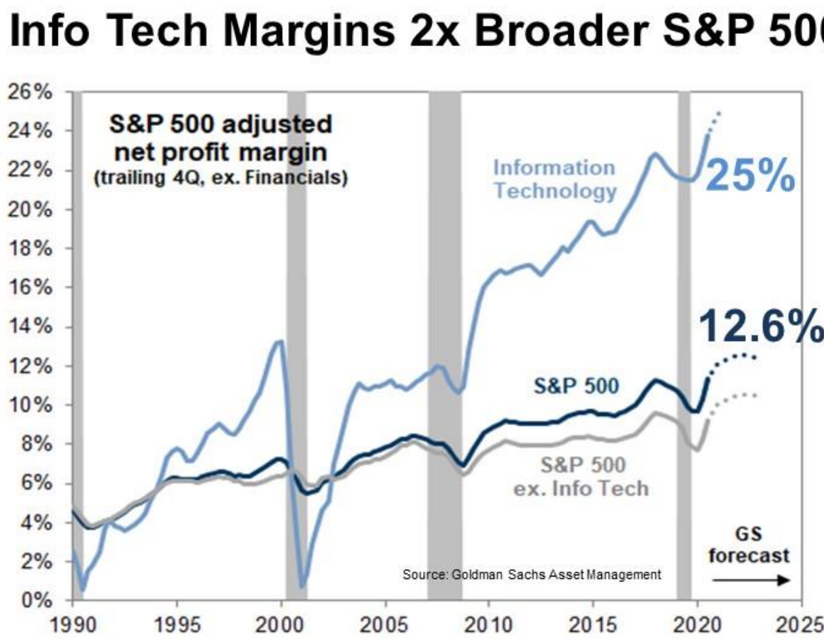
Even with the expected two rate hikes by the Federal Reserve beginning in July, 2022, relatively low interest rates are supportive of currently historically high P/E multiples on stocks. (Please see *Delta Insights, The Inflation Game*, November 12, 2021 for a full discussion of inflation interest rates).

And the Number Is…

Delta projects that the S&P 500 Index will achieve 5200 by the end of 2022. This represents a nearly 14% advance from the current level of 4560. We assume the forward 12-month P/E remains roughly constant, even if interest rates rise to a 2% yield on the 10-year U.S. treasury.

A 24% advance in the S&P 500 in 2021 is not a reason in itself to expect a weak return in 2022. Since 1900, the S&P 500 has generated an average 12-month return of 11%. following 12-month gains exceeding 20%.

Part of the reason we do not forecast a declining P/E multiple even in a moderate rising rate environment is because of continued margin expansion. Bigger, faster growing, more profitable companies representing an increasing share of the S&P 500 are worthy of a higher P/E multiple.



Risk

The significant risks are the risks that are currently unknown. Because they are unknown, it is difficult to make a comment other than to say in non-recessionary periods, there are always market pull-backs, but rarely do they prevent the market from achieving a positive return during the calendar year.

Of the known risks, much higher than expected inflation and interest rates lead the pack. If higher inflation expectations become entrenched, it is possible the Fed has to raise rates faster and farther than expected. Rapidly rising interest rates in a slowing growth environment may deflate the expansion that is currently underway.

The 10-year treasury rate has remained remarkably low at about 1.4% as the highest inflation readings in thirty years have been reported and GDP growth has been running twice as fast as the long-term average. This is an indication that the markets are looking through the post-covid growth spurt and see longer-term, normalized conditions of about a 2% annual inflation rate.

Have an enjoyable holiday season and we look forward to helping you handle whatever investment challenges the market throws our way next year.

Let Us Help You Position Your Portfolio – Give Us a Call Today

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"An 'ability to smell fear' is a quality I've never seen listed on a resume before."

Delta Stock Market Dashboard

MARKET SENTIMENT IS

BULLISH

THIS WEEK'S NUMBER IS

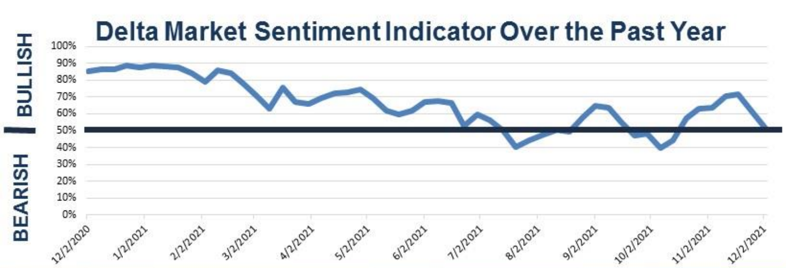
51.0

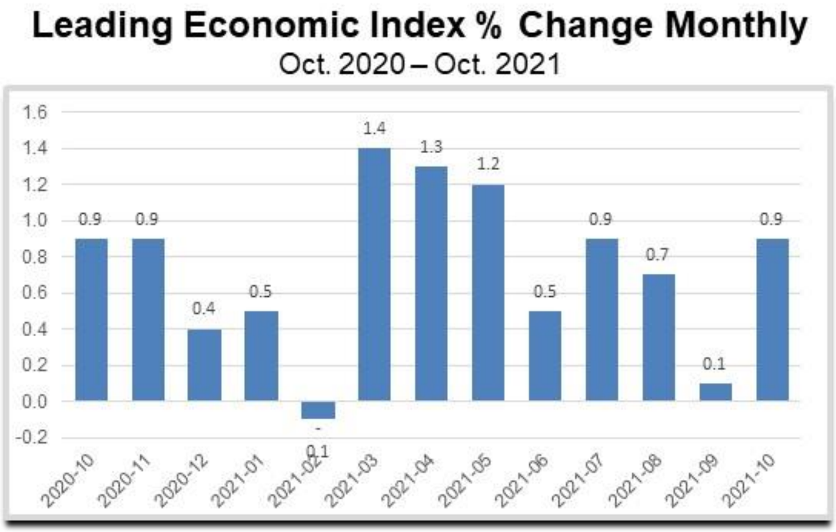
Our technical indicator decreased from 63.0 to 51.0 this week

INDICATOR STATISTICS

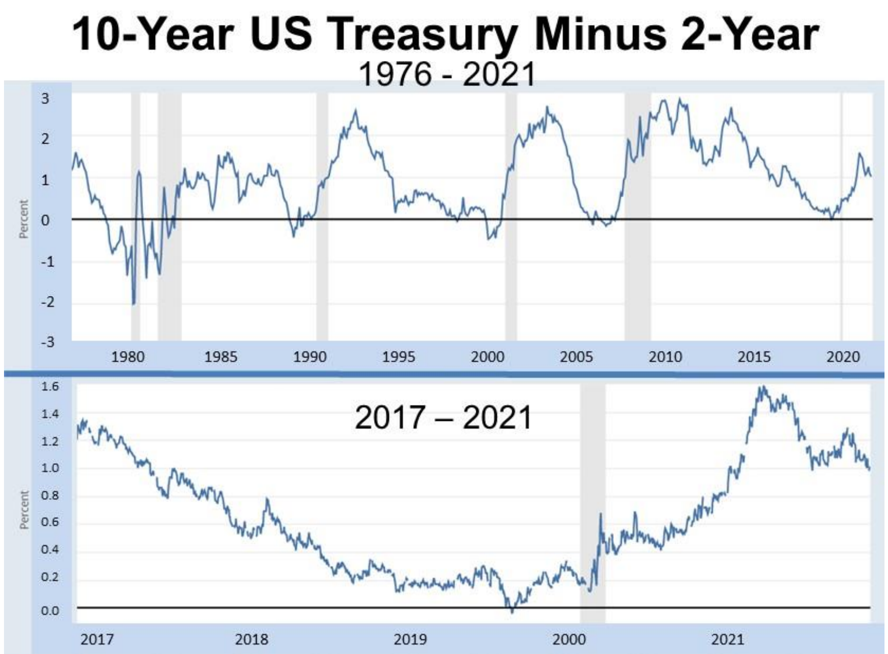
Consecutive Bullish Weeks:	7
Cycle Inception Date:	10/21/2021
Range:	51.0 – 71.4
Mean:	66.2
Bullish Weeks YTD:	43
Bearish Weeks YTD:	5
*S&P 500	0.4%
*DJIA	-2.8%
*NASDAQ	1.0%

** Percentage change during current cycle*





Source: The Conference Board – last update 11/18/2021



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