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Delta Insights
a weekly commentary on investing

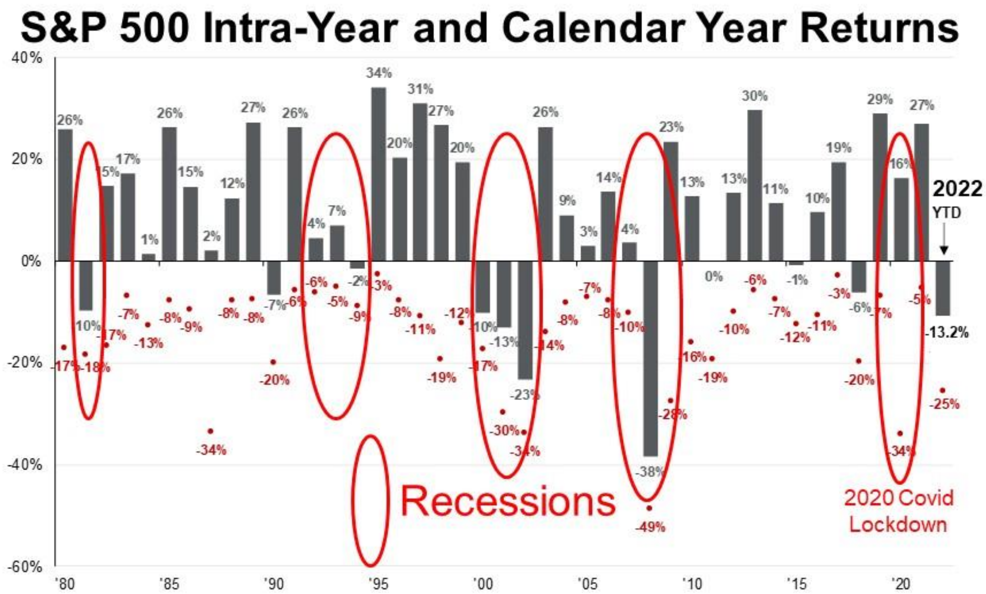
December 2, 2022

Now We Know; Delta's 2023 U.S. Stock Market Outlook

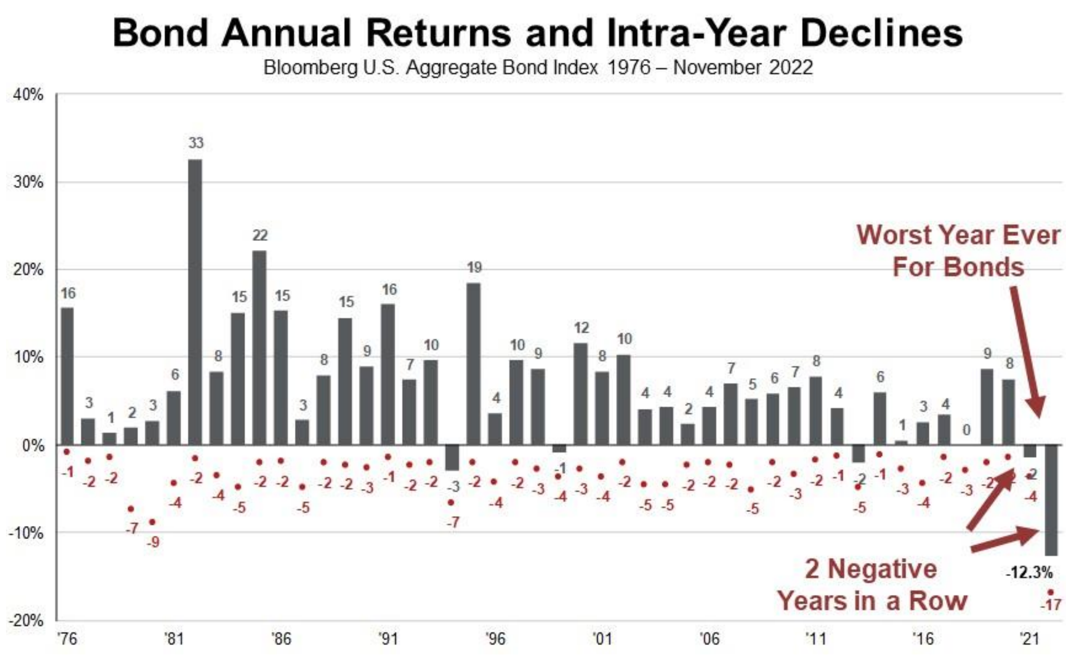
Since the Great Financial Crisis (GFC, 2008-09), the stock market trended higher on low interest rates, double digit GDP growth in China (the economic engine of the world), and robust non-cyclical growth from the major technology companies. What would happen if the Fed Funds rate jumped from zero to 4% in a single year? What would happen if China's GDP growth became hobbled by non-stop Covid lockdowns? What would happen if big-cap technology stocks stopped offering consistent earnings growth and became the worst performing major segment of the U.S. stock market?

Now we know. The NASDAQ 100 is down by 25.9%, the S&P 500 is down by 13.2% and the Dow Jones Industrial Average is down by 3.1% through November. Considering that the above questions are only a subset of questions that could be expanded to include what happens if Russian invades Ukraine, inflation spikes from below 2% to 12% and the U.S. economy has to work through the distortions of a 42% increase in the money supply and massive lockdown fiscal stimulus, the above results seem almost mild.

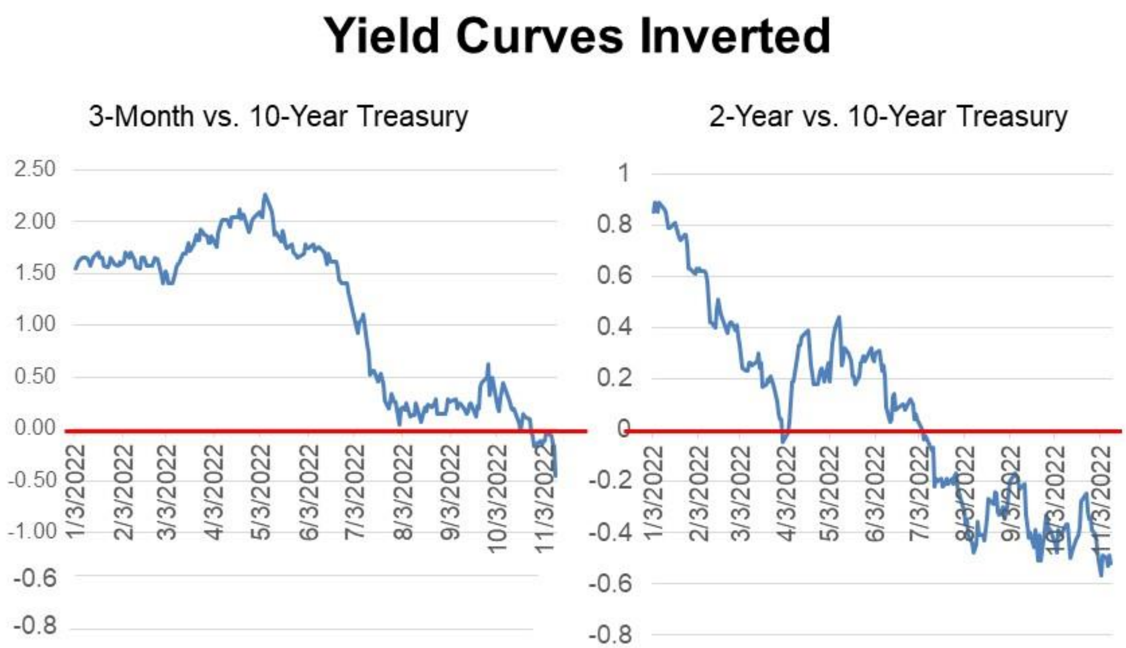
Below is a chart of the intra-year and calendar year returns of the S&P 500. Although it has not been declared an official recession year, it certainly looks and acts like one. The intra-year maximum drawdown of the S&P 500 is 25% and the market will likely experience a double-digit negative calendar year return. 2022 also experienced two sequential quarters of negative GDP growth, an inverted yield curve and well over six months of negative readings on the Leading Economic Index (LEI).



The poor stock market performance was accompanied by the worst year on record in bonds. Investment grade U.S. corporate bonds are down by about 12% with an intra-year drawdown of 17%. This is by far the worst single year loss on record and the first time the bond market has experienced back-to-back losses. 1994 was the second worst year on record with the loss being less than 3%.



It is likely that the unwinding of the pandemic distortions (high inflation, interest rates and flood of money being reversed) has not reached its end. Delta's two primary recession indicators are the inversion of the U.S. treasury yield curve and the six-month moving average the Leading Economic Index (LEI) turning negative. Both indicators signal impending recession.



Source: The Conference Board – last update 11/18/2022

Earnings

Corporate earnings for the S&P 500 for 2022 are expected to be $221. This is a 5.2% increase from 2021. This is not too far off from where analysts thought they would be a year ago. However, earnings estimates are below peak expectations of $231 we saw during the April – June period. The 2023 consensus earnings expectation for the S&P 500 has been revised down from roughly $252 to about $232 today. In a recession, corporate earnings are likely to be revised lower with some investment banks predicting $200 in a recession scenario.

If the Federal Reserve had to sum up its interest rate policy going into 2023, it would be "the beatings will continue until morale improves." The Fed's "dot plot" shows the Fed Funds rate reaches at least 4.6% and the debt markets are currently projecting a peak Fed Funds rate of 5.0-5.25% in the first half of next year. Higher rates will continue to place downward pressure on earnings (slower economic growth) and Price/Earnings (P/E) multiples.

Because of the declining earnings estimates, rising interest rates and a higher probability of recession, the outlook for 2023 is mixed. Many market strategists see the stock market depreciating meaningfully in the first half of next year. If negative forecasts are realized, it is possible that the U.S. stock market retests its 2022 lows and potentially goes lower.

But at some point in 2023, Fed rate hikes will end and inflation will be discernably trending lower. As we look further forward, beyond 2023, the probability is high that the S&P 500 will eventually reach earnings of $250 and higher. For the record, the S&P 500 consensus earnings estimate for 2023 when we began 2022 was roughly $245.

The Federal Reserve is saying that their long-term (years out) Fed Funds target rate is roughly 2.5%. The combination of lower rates and higher earnings should cause the S&P 500 to return to its old highs, up roughly 20%. Other potential positives to look out for in 2023 could be a declining dollar (especially beneficial to technology stocks with a disproportionate international sales) and a reopening of the China economy. To be clear, the path to new highs may be through some conviction-testing lows.

For longer-term investors, attempting to trade through a potential first half decline and second half recovery may prove to be difficult – think of the volatility of 2020. The largest risk associated with removing market exposure from a portfolio is to have the stock market migrate higher without a low retest or new low. If one does remove market exposure in expectation of a first half stock market pullback, it will be very important to have disciplined rules as to when to re-enter the market in either an up or down outcome.

Three Reasons for Optimism

Recession, higher interest rates and declining earnings fundamentally make it difficult to imagine a strong bull case for 2023. But there are technical indicators that give us reason to be optimistic. Three key technical reasons for optimism are 1) historic stock market performance after a negative mid-term election year, 2) very low consumer sentiment and 3) market performance in advance of a Fed pivot.

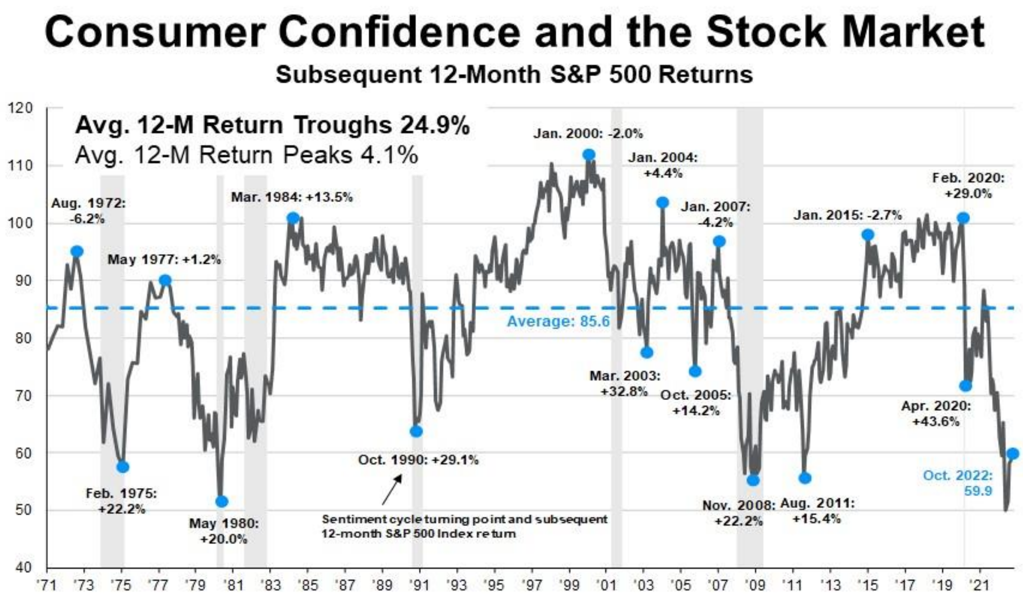
1. **Performance after a negative mid-term election year**

S&P 500 Performance Year After Negative Midterm Year (1950 – Present)

DATE	MIDTERM YR. RETURN		YEAR AFTER RETURN
1962	-11.8%		18.9%
1966	-13.1%		20.1%
1970	-0.1%		10.8%
1974	-29.7%		31.5%
1990	-6.6%		26.3%
1994	-1.5%		34.1%
2002	-23.4%		26.4%
2018	-6.2%		28.9%
2022*	-15.5%		?
		Average	24.6%
		Median	26.3%

Source: Carson Investment Research, Factset
* Return as of 11/25/2022

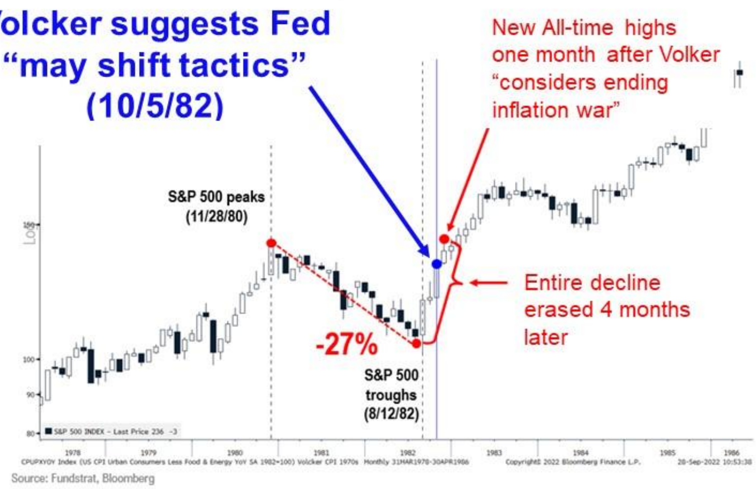
2. **Performance after a consumer sentiment low**



3. **Performance around the time the Fed pivots**

The last time inflation was running at a double-digit annual pace in the late 1970s and early 1980s, Paul Volcker was the Chairman of the Federal Reserve. To combat persistently high inflation, Volcker made clear that he would raise rates as far as necessary even if it drove the economy into recession. From December 1980 to the trough in August,1982, the S&P 500 declined by 27%. The S&P 500 had recovered all of its losses in four months ending one month after Volcker said he was considering ending his "war on inflation." This helps explain why the S&P 500 is so quick to respond to the idea of a Fed Pivot.

Volcker Fed Pivot and S&P 500



Bottom line: Uncertainty is elevated which drives high volatility. The current market environment is offering attractive buying opportunities in both high-quality equities and fixed income. We remain somewhat defensive heading into 2023 with an eye on being opportunistic in both fixed income and equities on potential further valuation deterioration, earnings stabilization and/or Fed pivot.

Let Us Help You Position Your Portfolio – 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.

"A dash of hope, a dollop of optimism, a hint of courage—and gin—on the rocks."

Delta Stock Market Dashboard

MARKET SENTIMENT IS

BULLISH

THIS WEEK'S NUMBER IS

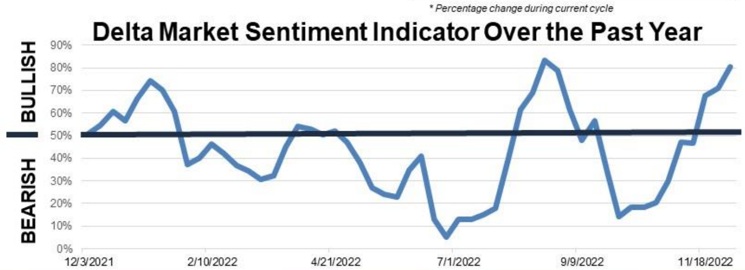
80.6

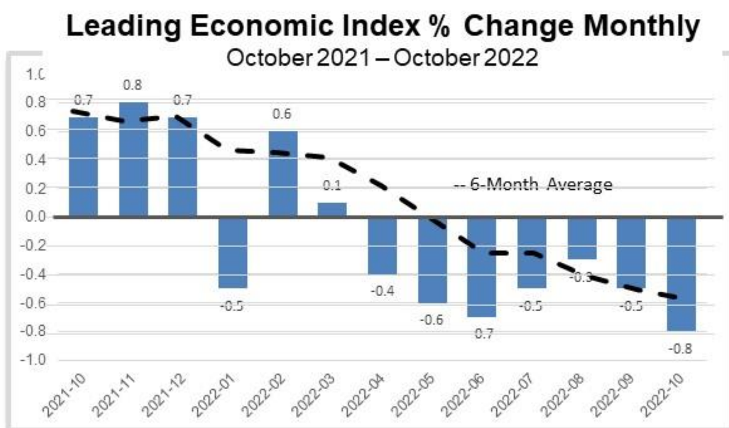
Our technical indicator increased from 80.6 to 71.2 this week

INDICATOR STATISTICS

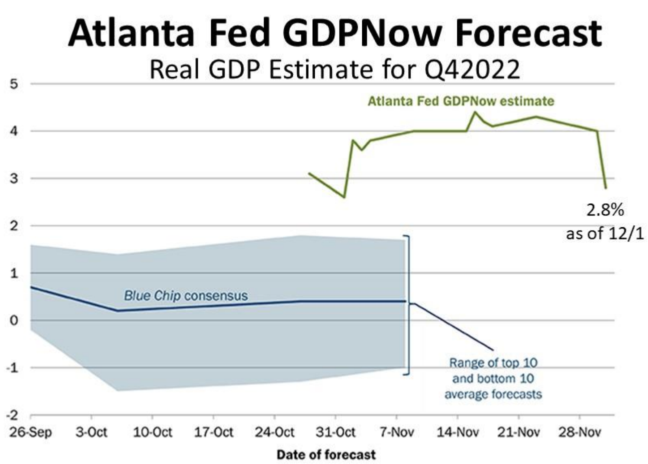
Consecutive Bullish Weeks:	3
Cycle Inception Date:	11/17/2022
Range:	67.8 – 80.6
Mean:	73.2
Bullish Weeks YTD:	16
Bearish Weeks YTD:	30
*S&P 500	4.3%
*DJIA	2.5%
*NASDAQ	4.3%

** Percentage change during current cycle*





Source: The Conference Board – last update 11/18/2022



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*