MORNING BRIEFING
April 20, 2017

Financials: Out of Favor Again?

See the collection of the individual charts linked below.

(1) Bronx cheer. (2) C&I loans and flatter yield curve are turn-offs. (3) Net interest margins expanding. (4) Capital markets issuance boom may explain weakness in business loan demand. (5) No alarms about credit quality, even in auto loans, on bank conference calls. (6) Goldman was an outlier with a miss for a change. (7) S&P 500/400/600 forward revenues and earnings continue to rise in record territory.

Industry Focus: Financials Mostly Shine. Investors gave financial companies' Q1 earnings the Bronx cheer as the lack of growth in commercial and industrial (C&I) loans and poor performance in fixed-income trading at Goldman Sachs amplified concerns that the industry's outperformance over the past year could unwind. C&I loans rose just $58.1 billion y/y through the week of April 5, the weakest pace since July 2011 (*Fig. 1* and *Fig. 2*). Confidence in the sector was already faltering, as the yield curve has flattened in recent weeks (*Fig. 3*).

Despite the gloomy developments, there are a number of reasons for continued optimism. Banks were able to charge more for their loans in Q1, and they should be able to do so again in the current quarter thanks to the Federal Reserve's March interest-rate increase. Capital markets are alive and well, and loan credit quality appears to be stable despite analysts' worries about auto loans and retailers. In addition, the sector's valuation looks more reasonable in the wake of its recent selloff, and strong capitalization levels mean banks should be able to continue returning capital to shareholders via stock repurchases and dividends.

The S&P 500 Financials stock price index fell 1.4% over the week through Tuesday's close, and it has fallen 8.3% since peaking on March 1 (*Fig. 4*). However, it remains the top-performing S&P 500 sector on a y/y basis: Financials (23.2%), Tech (21.1), Industrials (13.6), S&P 500 (11.8), Materials (11.4), Consumer Discretionary (9.3), Utilities (5.9), Energy (4.8), Consumer Staples (4.7), Health Care (3.9), Real Estate (1.6), and Telecom Services (-1.3) (see *Tables*). Here's a look at what may drive the sector for the rest of this year:

(1) *Fatter NIMs*. The brightest part of banks' earnings was the increase in revenue from loan portfolios due to the quarter-point increase in the federal funds rate in December and again in March. The increase in revenue was even more impressive because it doesn't look like banks had to pass their windfalls on to depositors. So the overall difference between what banks earned on their loans and what they paid on deposits—their net interest margin (NIM)—widened nicely and should do so again in Q2 (*Fig. 5*).

At JPMorgan, the NIM improved to 2.33% in Q1, up 0.11ppt from Q4 and up 0.3ppt y/y. M&T Bank's NIM was 3.34% in Q1, up 0.26ppt from Q4, and PNC's NIM was 2.77%, up 0.08ppt from Q4. Bank of America's net interest income improved $730 million from Q4, primarily due to higher interest rates, according to CFO Paul Donofrio's comments in the Q1 conference call transcript. "The net interest yield increased 16 basis points to 2.39% from Q4 as loan yields improved 17%, while the rate we paid on deposits was flat at 9 basis points." The improvement is expected to continue, but to a lesser extent, in Q2—closer to $150 million.

PNC's CEO Bill Demchak noted that corporate CFOs looking to park their cash have limited options. Institutional prime money-market funds, which invest in commercial paper and other short-term debt, are required to market-to-market their assets because of new regulations that went into effect last year, explained a 9/14/16 *WSJ* article. Because of the rule change, institutional investors pulled their money out of prime funds and put it into government money market funds, which aren't subject to the new rules. Government money market funds offer extremely low yields, providing little competition to banks looking to raise deposits.

(2) *Deals cut into loans*. Banks' largest problem during Q1 was the lack of growth in C&I loans. At JPMorgan, C&I loans remained relatively flat versus the Q4 level, even though they were up 8% y/y. CEO Jamie Dimon remained sanguine about lending activity. He noted that companies have a choice between funding with bank loans or selling debt in the capital markets. And Q1 activity was brisk in the debt capital markets. Investment-grade bond issuance is up 5% ytd, and high-yield bond issuance is up 84%, according to Dealogic.

There's some concern that President Trump's inability to pass health care legislation and the related delay in tax reform and infrastructure spending have led to delayed decision-making in the C-suite. Dimon referred to the new President's first 100 days as a "sausage-making period," when there will be wins and losses. However, the President's pro-growth agenda—with proposed tax reduction, increased infrastructure spending, and regulatory reform—should be a good thing for Americans, he said in the Q1 conference call transcript. It has already led to clients hiring and spending more, and that should ultimately translate into loan growth, JPMorgan's CFO Marianne Lake said.

PNC's CFO Rob Reilly said the bank continues to expect mid-single-digit loan growth, helped by its expansion into new markets including Dallas, Kansas City, and Minneapolis. "Given the March rate hike, we now expect revenue to grow in the upper end of the mid-single digit range. And we continue to expect a low single-digit increase in expenses, which will allow us to post positive operating leverage for the year," he said according to the Q1 conference call transcript.

(3) *Watching autos and retailers*. Bank loan credit quality may have peaked last year but seems to have stabilized at high levels. That said, during the various bank conference calls, analysts asked a number of questions about the performance of auto loans and loans to retailers. The message they received: So far … so good.

Bank of America's CFO said auto loans were up 12% y/y and the bank is focused on prime and super-prime borrowers. As a result, its net charge-offs were 0.38ppt. The Fed's data show that auto loans rose 7.0% y/y during Q4 (*Fig. 6*).

(4) *Mostly friendly markets*. With the IPO market reviving and debt issuance surging, it's no wonder that capital markets provided a tailwind for most commercial and investment banks. At Bank of America, Q1 total investment banking fees were up 37% y/y, fixed-income trading revenue jumped 29% y/y, and equity sales and trading was up 7%. Morgan Stanley beat Wall Street Q1 earnings estimates, helped by a 30% y/y jump in sales and trading revenue and a 43% surge in investment banking revenue. Fixed-income trading nearly doubled to $1.7 billion y/y, while equity trading fell 1.9% to $2.0 billion. "Triple-digit gains in underwriting more than offset a 16% decline in M&A fees" noted a 4/19 *WSJ* article. It added that Morgan's CFO Jonathan Pruzan said the firm's merger pipeline is higher today than it was at this point in 2016.

Goldman Sachs was the outlier. The firm's fixed-income, currencies, and commodities trading revenue rose only 1% y/y. Also, revenue from the M&A business fell 2% y/y, and the firm said its backlog of

M&A and underwriting business decreased from the end of 2016. "This suggests that political uncertainty may be holding back activity to some degree," noted a 4/18 *WSJ* article. According to the Q1 conference call transcript, Goldman Deputy CFO Martin Chavez said: "However, during the first quarter, the market began to reconsider both the pace and strength of economic growth, particularly in light of uncertainty regarding upcoming European elections and legislative challenges in the United States. This confluence of events resulted in tempered expectations, a modest retreat in equity prices from intra-quarter highs, and a more benign market environment."

(5) *Analysts' outlook*. It's still too soon to tell whether Q1 results will send analysts scampering to slash their estimates. But it's very possible they may not, since most earnings—with the notable exception of Goldman Sachs'—came in above expectations.

Currently, analysts estimate that S&P 500 Diversified Banks will grow revenues over the next 12 months by 4.1% and earnings by 10.6% (*Fig. 7*). Likewise, S&P 500 Regional Banks is expected to grow forward revenues by 6.6% and earnings by 12.4% (*Fig. 8*). Net earnings revisions for both industries have been positive, yet their forward P/Es have come down slightly.

Diversified Banks has a 12.2 forward P/E, down from 13.6 in early March, and it trades at 1.08 times forward book value (*Fig. 9*). Regional Banks is growing faster and is slightly more expensive, with a forward P/E of 13.8 and a forward price-to-book ratio of 1.16 (*Fig. 10*).

The S&P 500 Investment Banking & Brokerage industry is more expensive than its banking counterparts, but it's expected to grow more quickly. Analysts see Investment Banks and Brokers growing revenues over the next 12 months by 7.2% and earnings by 16.7% (*Fig. 11*). The industry sports a 13.1 forward P/E and trades at 1.31 times its forward book value (*Fig. 12*).

(6) *Returning capital.* After years of bolstering their capital bases, many banks continued to share the wealth with shareholders via stock repurchases and dividends last quarter. With a little luck, the amount of capital returned should increase going forward.

For example, at Citigroup about $2.2 billion was returned to common shareholders in Q1 through dividends and the repurchase of roughly 30 million shares. The repurchases reduced the bank's average diluted shares outstanding by 6%. "Even still, our common Equity Tier 1 Capital ratio has increased to 12.8%, well above the 11.5% upper range of what we believe we need to operate the firm prudently. So, we clearly have excess capital and couldn't be more committed to returning that capital to our shareholders," said CFO John Gerspach, according to the Q1 earnings conference call transcript.

(7) *Most interesting factoid*. At Bank of America, mobile devices now account for one out of every five deposit transactions, approximating the deposit volume of nearly 1,000 financial centers.

Earnings: Looking Up. It's still a bit early in the Q1 earnings season, but it seems to be going about as expected, with the exception of a couple of outliers like Goldman Sachs and IBM. At the beginning of this month, the forward revenues estimates of industry analysts were still rising in record-high territory for the S&P 500/600 and moving closer to last year's record high for the S&P 400 (*Fig. 13*).

Forward earnings is on the up-and-up for the S&P 500/400/600 as well (*Fig. 14*). It has been rising at a nice steady pace since early last year for the S&P 500. It seems to be increasing at a faster pace for the S&P 400 over the same period. It has stalled in recent weeks for the S&P 600, though at a record-high level.

CALENDARS

US. Thurs: Jobless Claims 242k, Leading Indicators 0.2%, Philadelphia Fed Manufacturing Index 25.5, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell. **Fri:** M-PMI Flash Estimate 53.9, Existing Home Sales 5.605mu, Baker-Hughes Rig Count, Kashkari. (Bloomberg estimates)

Global. Thurs: Carney. **Fri:** Eurozone, Germany, and France Composite PMI Flash Estimates 56.4/56.9/56.3, Eurozone, Germany, and France M-PMI Flash Estimates 56.0/58.0/53.1, Eurozone, Germany, and France NM-PMI Flash Estimates 56.0/55.5/57.1, UK Retail Sales -0.5%m/m/3.8%y/y, Canada CPI 1.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) fell to 2.84 this week after climbing the prior two weeks from 2.73 to 3.22. This is only the second reading below 3.00 since the end of November. Bullish sentiment slipped to 51.9% after rebounding 6.8ppts the previous two weeks to 56.3%; seven weeks ago, the reading was 63.1%—which was the most bulls since 1987! Nearly all of the 4.4ppts move from the bulls this week went to the correction camp (up 3.6ppts to 29.8%), just as nearly all the prior two-week move to the bulls came from the correction camp (down 6.2ppts to 26.2). Bearish sentiment was little changed again this week, edging up from 17.5% to 18.3%. The AAII Bull Ratio increased to 43.7% last week after sliding the prior two weeks from 53.6% to 41.7%. Bullish sentiment rose from 28.3% to 29.0%, while bearish sentiment fell from 39.6% to 37.4%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings both rose to record highs last week. The forward profit margin forecast was steady at a 19-month high of 10.8% from 10.7%. That remains near the record high of 10.9% in September 2015 and compares to a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 improved w/w to 5.5% from 5.4%. That compares to 5.8% in late January, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth was steady at 10.8%, but is down from 11.7% in early January; that was the highest since October 2011 and compares to an 11-month low of 4.8% in February 2016. Valuation fell to a nine-week low of 17.5, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. S&P 500 forward revenues and forward earnings are enjoying a tailwind now from easier y/y comparisons for Energy and improving prospects for Financials, but currency translation looks likely to remain a challenge. Looking at last week's results ex-Energy, the forward revenue and earnings growth rates are lower at 4.3% and 8.3%, respectively. However, the ex-Energy forward profit margin improves to 11.4%, which is close to its record high of 11.5% in August 2007.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 6/11 sectors, and forward earnings rose for eight (all but Energy, Health Care, and Telecom). Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues and earnings are at or near 18-month highs. Forward P/S and P/E ratios both fell w/w for 6/11 sectors. Financials' P/E is up from 12.0 before the election to 13.4, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.6 and P/S of 1.64 are down from early March's 19-month highs of 16.1 and 1.70, respectively, and remain well below their early 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.35 compares to a record high of 1.56 in May 2016, and its P/E of 27.5 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, and margins are expected to improve in 2017 for all but Real Estate and Utilities. However, Real

Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.7% in 2017 from 19.2% in 2016), Real Estate (16.2, 25.2), Financials (15.7, 14.4), Telecom (11.2, 11.2), Utilities (10.8, 11.4), S&P 500 (10.5, 10.1), Health Care (10.4, 10.3), Materials (10.1, 9.4), Industrials (9.0, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.8, 6.5), and Energy (4.4, 1.1).

GLOBAL ECONOMIC INDICATORS

European Car Sales (*link*): EU passenger car registrations, a proxy for sales, accelerated 11.2% in March to 1,891,583 units—the highest March total on record, mainly due to Easter falling in March last year and April this year. The five largest markets all posted impressive gains, with Italy (18.2% y/y), Spain (12.6), and Germany (11.4) posting double-digit advances, and the UK (8.4) and Italy (7.0) recording high single-digit increases. Sales were up 8.4% during the three months ending March, with Italy (11.9) showing the best sales growth, followed by Spain (7.9), Germany (6.7), the UK (6.2), and France (4.8). EU passenger cars sales were at 13.8 million units in the 12 months through March, the best 12-month performance since September 2008.

Eurozone CPI (*link*): March's CPI rate matched the flash estimate of 1.5% y/y, slowing from 2.0% y/y in February, which had surpassed the ECB's inflation target of just under 2.0% for the first time in four years. Of the main components, energy (to 7.4% from 9.3% y/y), food, alcohol & tobacco (1.8 from 2.5), and services (1.0 from 1.3) costs all slowed, while non-energy industrial goods (0.3 from 0.2) prices accelerated slightly. Meanwhile, the core inflation rate—which excludes food, alcohol & tobacco—increased 0.7% y/y, down from 0.9% the prior three months and near its record low of 0.6% in spring 2015. Of the top four Eurozone economies, Spain's (2.1% y/y) inflation rate was above the Eurozone's 1.5%, while rates in Italy (1.4) and France (1.4) were just below, and Germany's matched the Eurozone's 1.5% rate.

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