MORNING BRIEFING
May 4, 2017

Where Credit Is Due

See the collection of the individual charts linked below.

(1) Coffee, tea, or plastic? (2) A flight with no fights. (3) Auto and student loans leading consumer credit to new highs. Revolving credit lagging. (4) Consumer delinquencies rising back to old normal. (5) No signs of trouble in debt servicing ratio. (6) Dearth of deadbeats. (7) Payments processing is a great business. (8) But beware of the Great Disruptor. (9) Some cracks in commercial real estate's foundation. (10) Want to buy the Brooklyn Bridge and get a free taxi medallion?

Consumer Credit: Hard-Charging. When flying, you expect a flight attendant to offer coffee and tea. But Jackie was surprised last month when flight attendants on an American Airlines flight she was on between LaGuardia and Charlotte pitched an American Airlines credit card. How's that for low-cost advertising to a captive audience?! Jackie was happy to report that there was no violent outbursts on her flight.

The sales pitch did prompt us to have a closer look at the credit card business. Recent earnings out of Synchrony Financial (spun out of GE Capital) and Capital One Financial gave investors the jitters, as both sharply increased their reserves. However, economic data show that monthly payments remain manageable. Let's take a look:

(1) *Growing quickly*. As you'd expect, most consumer loan balances, except for student loans, shrank during the previous recession. Total consumer credit fell $147 billion (or 5.5%) from July 2008 through August 2010 (*Fig. 1*). Since then, consumer credit has increased rapidly, by $1.27 trillion to a record high of $3.79 trillion, up $1.13 trillion (or 42%) from 2008's peak. Leading the advance have been auto loans and student loans, which are included in the Fed's "nonrevolving credit" category (*Fig. 2*). Lagging has been "revolving credit," which consists mostly of credit card balances. It's up 20% through February since bottoming during April 2011, and remains slightly below its 2008 record high. The data suggest that consumers remain more cautious about using their credit cards but have been loading up on auto and student debt.

(2) *Back to normal*. In Q1 results, Synchrony and Capital One both reported increases in reserves and in charge-offs that caught investors by surprise. Synchrony increased its provision for loan losses by 45% to $1.31 billion, and its net charge-offs in Q1 came in at 5.33%, up from 4.74% a year earlier. For the full year, management expects net charge-offs to be in the low 5%s, edging up to the low-to-mid-5% range in 2018.

The company did not lower its lending standards. Instead, it attributed the need to boost provisions to lower recoveries on defaulted loans, to growth in the overall loan portfolio, and to "normalization trends"—which implies that defaults were abnormally low in the early years of the recovery and now are returning to more normal levels. At Synchrony, loan receivables grew 8.0% in 2015 y/y and 11.3% in 2016. That's much faster than consumers' incomes grew, 4.0% in 2015 and 3.6% in 2016.

Capital One's Q1 charge-off rate in its domestic credit card business was 5.14%, up 0.48ppts from Q4. The company now sees the 2017 charge-off rate on US credit cards in the high-4% to 5% range, up from earlier expectations for the rate to be around mid-4%. "Over the past year and a half, we have seen increasing competitive intensity, a growing supply of credit, and rising consumer indebtedness," observed CEO Richard Fairbank in the company's Q1 earnings call transcript. Later on the call, he said, "We continue to be concerned about the supply of credit in the marketplace. Revolving credit grew at about 6.5% year-over-year, the seventh consecutive quarter it has grown much faster than household income. Against this background, we have been tightening our underwriting."

(3) *Not too many deadbeats.* There is some good news. Data from the FRB-NY backs up these CEOs' assertions. The percentage of credit card balances that are delinquent by 90 days or more has fallen to levels well below where it stood in the years leading up to the 2008 recession (*Fig. 3*). So it's certainly possible that delinquencies will return to more normal levels and then stop deteriorating.

Another optimistic nugget is that household debt service payments as a percentage of disposable personal income was only 10.0% in Q4 , below the 13.2% peak just before the 2008 recession and lower than the 10.4% level seen back in Q2-1993 (*Fig. 4*). This is largely thanks to the low interest rates we've enjoyed for the past eight years. Credit quality in credit card portfolios may not be improving anymore. But as long as rates stay low and jobs remain plentiful, default-rate "normalization" shouldn't turn into a spike in the credit card default rate. Just what will happen to the student loan market, where delinquencies now are far higher than during the recession, is a story for another day.

(4) *Taking stock.* The S&P 500 Consumer Finance stock index is down 11.0% from its cyclical high on May 2, 2016 (*Fig. 5*). The index has been depressed by the 20.3% decline in Synchrony, the 12.5% drop in Capital One, and the 13.0% drop in Discover Financial since March 1. Analysts still forecast that the Consumer Finance industry will grow revenue by 5.0% over the next 12 months and grow earnings by 7.7% (*Fig. 6*). The industry's forward P/E has come down a touch to 11.5, which is high relative to where the multiple has been over the past 16 years but low compared to the highest multiples that the industry has commanded during the best of times over the past 20 years (*Fig. 7*).

(5) *What's in your wallet?* Higher credit card volumes are good news for Mastercard and Visa, which process credit card transactions but don't hold the outstanding credit card debt. On Tuesday, Mastercard reported that Q1 net revenue rose 12% y/y and adjusted net income increased 13%. Earnings per share rose more than net income, by 16%, due to a reduced share count. Last month, Visa reported that earnings excluding restructuring charges for fiscal Q2 were 86 cents a share, up 27% y/y.

Both companies benefitted as more traffic traveled over their payment systems. At Mastercard, the gross dollar volume on the company's worldwide network rose 4.7% y/y to $1.2 trillion, including a 2.0% increase in the US. The US volume includes a 5.4% increase in Mastercard's credit and charge programs and an 0.8% decline in its debit program. The shares of both companies have had a great start to the year.

Visa's traffic jumped even more dramatically, as it won some large new clients, including Costco Wholesale. The company's payments volume grew 37.2% y/y to $1.7 trillion, assuming a constant dollar. Visa shares are up 18.6% ytd through Tuesday's close, and Mastercard's shares have added 14.4%.

The two companies are members of the S&P 500 Data Processing & Outsourced Services stock index, which has had an amazing run since 2009, climbing 423.0% (*Fig. 8*). The industry includes Automatic Data Processing, Fiserv, PayPal Holdings, and Paychex along with others. It's expected to grow revenues by 11.7% over the next 12 months and earnings by 14.2% (*Fig. 9*). Investors will need to pay up for the above-market earnings growth, as the industry trades at 23.1 times forward earnings (*Fig.*

10).

(6) *The Great Disruptor.* Amazon has been around since 1994 and creating headaches for other retailers for many years. But in recent months, it seems that the number of store closures has accelerated as a number of retailers have given up the fight. Even Synchrony CEO Margaret Keane said on the Q1 conference call: "The retailers are going through a transformation. But I would say, as per our reading, it's definitely accelerated coming out of the holiday season."

And that presumably means that Synchrony cannot depend on consumers going into a retailer and opening up a credit card to gain customers. So Synchrony is undergoing its own transformation. The company is "making sure we can really attract those customers through the online channels, whether it's through their iPad or on their mobile phone." In Q1, 26% of retail-card penetration was online.

The company purchased GPShopper, a mobile app developer, in Q1 for an undisclosed amount. Synchrony made an initial investment in the company in 2015, and subsequently they developed a plugin that allows retailers' credit cardholders to shop, redeem rewards, and manage and make payments to their accounts with their smartphones, according to a 3/22 article in the *Stamford Advocate*. More than retailers need to learn how to find customers online.

Commercial Real Estate: Soft Spots. The rash of store closures this year is also affecting landlords and investors in retail real estate investment trusts (REITs). Lower-end malls have been struggling for years to replace tenants, but even the hottest spots to shop are showing some signs of weakness, and investors have headed for the hills. Things have gotten so bad that the CEO of GGP recently suggested he'd consider selling the REIT that specializes in malls. Let's take a look at some of the soft spots in commercial real estate:

(1) *NYC rents falling*. Average commercial rental prices have decreased and availability increased in many of NYC's toniest shopping areas. "Average asking rents for direct ground-floor leases in Manhattan rose 95% from the first quarter of 2011 to the first quarter of 2014, according to real-estate services firm CBRE Group Inc. Average prices during that period rose to a peak of $1,073 a square foot. Since that high point, average asking rents across the 16 areas tracked by CBRE have decreased 21% to $850 a square foot," a 4/30 *WSJ* article reported.

(2) *Shorts circling*. Short sellers have pounced on the debt and the equity of retail REITs, betting that cash flows could decline as more stores close and as landlords need to spend more to keep their malls looking attractive in order to retain current tenants and replace those that have closed. "The amount of so-called short interest, a measure of short-selling activity, on retail-focused REITs increased to $7.6 billion as of March 6 from $5.6 billion as of the end of December," the 3/7 *WSJ* reported, citing data from S3 Partners, a financial analytics firm.

Mall debt is also being shorted. "Losses on securitized mortgages tied to retail property rose to $1.7 billion last year from $1.3 billion in 2015, the only property segment that showed an increase in losses, according to Moody's Investors Service," the *WSJ* article continued. "Spreads on the BBB-rated CMBS deals that have more retail real-estate exposure are widening, according to Trepp LLC, a real-estate data service. Widening spreads indicate the perceived risk of default is rising."

(3) *Seeking alternatives.* GGP CEO Sandeep Mathrani said on Monday that the mall owner, formerly known as General Growth Properties, was exploring strategic alternatives, and didn't rule out a sale of the company. "Mathrani told analysts in a conference call that the combined value of GGP's properties is much higher than its stock market value, one reason it's weighing its options. After hitting a post-recession high of $31.97 last July, the firm's shares have fallen 32 percent, closing April 28 at $21.61,

their lowest price in more than three years," according to a 5/1 article in *Crain's Chicago Business*.

GGP reported Q1 funds from operations (FFO) of 36 cents a share, down from 40 cents a year earlier. "The break-up value is more than the current market capitalization. Business is strong. We will pick a path soon," said Mathrani, according to the Crain's report.

Great Disruption: Medallion for Losers. The surge in rides available through Uber and Lyft has been a boon for consumers, but it has been a nightmare for traditional taxi drivers. A NYC taxi medallion recently sold for $241,000, down sharply from 2013 when some medallions sold for more than $1.3 million, reported a 4/5 *New York Post* article.

The pain was also felt by lenders to those buying medallions at top prices. Capital One's Q1 report notes that the firm has $655 million of loans in its commercial taxi medallion lending portfolio, down from $873 million a year earlier. The nonperforming loan rate on that portfolio is 52.7%, up from 29.9% in Q1-2016, according to the company's Q1 earnings presentation. These loans are an extremely small portion of Capital One's total loan portfolio—0.27%—but they were cited as one of the reasons why charge-offs increased a number of times over the past year. And they do show how disruptive ripple effects can show up in surprising places.

CALENDARS

US. Thurs: Merchandise Trade Balance -$44.5b, Factory Orders 0.4%, Nonfarm Productivity 0.0%, Jobless Claims 246k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Total & Private Nonfarm Payroll Employment 185k/180k, Unemployment Rate 4.6%, Average Hourly Earnings 0.3%m/m/2.7%y/y, Average Workweek 34.4hrs, Consumer Credit $15.6b, Baker-Hughes Rig Count, Yellen, Fischer, Evans. (Bloomberg estimates)

Global. Thurs: Eurozone Retail Sales 0.0%m/m/2.1%y/y, Eurozone, Germany, France, and Italy Composite PMIs 56.7/56.3/57.4/54.6, Eurozone, Germany, France, and Italy NM-PMIs 56.2/54.7/57.7/53.6, UK Composite & NM-PMIs 54.5/54.5, Draghi, Poloz, Lowe. **Fri:** Canada Employment Change & Unemployment Rate 10k/6.7%, RBA Statement on Monetary Policy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) climbed for the second week this week from 2.84 to a 3.27 over the period, a six-week high. Bullish sentiment rebounded 6.6ppts over the two-week period to 58.5%, moving back toward its 63.1% reading nine weeks ago—which was the most bulls since 1987! Virtually all the moves over the past nine weeks have been between the bulls and the correction camp. Over the past two weeks, 6.2ppts of the 6.6-ppt move to bullish sentiment came from the correction camp, which fell to 23.6% from 29.8%. Bearish sentiment was unchanged at 17.9% this week; it has fluctuated in a very narrow band between 17.3% and 18.3% the past nine weeks. The AAII Bull Ratio climbed to 54.5% last week after falling from 43.7% to 39.9% the previous week. Bullish sentiment rose from 25.7% to 38.1% during the week, while bearish sentiment fell from 38.7% to 31.7%.

S&P 500 Earnings Season Monitor (*link*): With 72% of the S&P 500 companies finished reporting Q1-2017 results, their revenue and earnings surprise metrics are stronger than at the comparable point of the Q4 season, but Apple's results have impacted the y/y earnings growth results. Of the 359 companies in the S&P 500 that have reported, 76% exceeded industry analysts' earnings estimates by an average of 6.3%; they have averaged a y/y earnings gain of 6.0%, down from 10.8% a day earlier.

Ex-Apple, S&P 500 Q1 earnings growth improves 4.0ppts to 10.0%, and Tech's growth rate rises 16.5ppts to 9.0% from -7.5%. At the same point in Q4-2016, a lower percentage of companies (69%) in the S&P 500 had beaten consensus earnings estimates by a smaller 4.0% and ex-Apple earnings were up a similar 10.1% y/y. On the revenue side, 63% beat sales estimates so far, coming in 0.8% above forecast and 8.1% higher than a year earlier. During Q4, a lower 49% were above forecast, which exceeded estimates by a smaller 0.3% and rose a lower 4.3% y/y. Q1 earnings results are higher for 63% of companies versus a higher 70% at the same point in Q4, but revenues are higher for 78% versus 71%. The S&P 500's earnings beat is the highest in eight quarters and the revenue surprise is the best in nine quarters. These figures will change as more companies report, but the results to date are encouraging and bode well for future estimate revision activity. However, y/y growth is likely to slow in the coming quarters as comparisons become less easy.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings rose slightly last week to fresh record highs. The forward profit margin forecast was steady at a 16-month high of 10.8%, nearing the record high of 10.9% in September 2015 and up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 was steady w/w at 5.5%. 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 remained steady at a 13-week high of 11.0%, 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. S&P 500 forward revenues and forward earnings growth are enjoying a tailwind now due to easy y/y comparisons for Energy and improving prospects for Financials, but currency translation is likely to be a slight drag. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results for the S&P 500 ex-Energy, the forward growth rates for revenues (4.4%) and earnings (8.4%) are lower. The ex-Energy forward profit margin improves to 11.4%, which is close to its record high of 11.5% in August 2007. Valuation rose to a four-week high of 17.7 from 17.4, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. Ex-Energy valuation rose to a six-week high of 17.3 from 17.0, but is down from a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 7/11 sectors, and forward earnings rose for 6/11. These five had both measures rise w/w: Financials, Health Care, Industrials, Materials, and Tech. These three saw both measures decline w/w: Energy, Real Estate, 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 stalling recently near 15-month highs. Forward P/S and P/E ratios rose broadly w/w, but Real Estate had both measures decline. Financials' P/E is up from 12.0 before the election to 13.7, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.8 and P/S of 1.65 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 1.33 compares to a record high of 1.56 in May 2016, and its P/E of 27.4 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 19.8% in 2017 from 19.2% in 2016), Real Estate (16.2, 25.2), Financials (15.8, 14.4), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (10.1, 9.4), Industrials (9.1, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.8, 6.5), and Energy (4.3, 1.1).

US ECONOMIC INDICATORS

ADP Employment (*link*): "In April we saw a moderate slowdown from the strong pace of hiring during the first quarter," according to ADP. However, the company noted that "the growth is more than strong enough to accommodate the growing population as the labor market nears full employment." Private industries added 177,000 to payrolls in April, following a downward revision to March (to 255,000 from 263,000) and upward revisions to February (249,000 from 245,000) and January (268,000 from 249,000). In April, service-providing industries (165,000) once again accounted for most of the growth, while goods-producing industries (12,000) was in the plus column for the sixth straight month, though slowed from the heady pace during Q1. Within service-providing, the biggest gains came from administrative/support services (53,000), education & health services (41,000), and leisure & hospitality (35,000); brick-and-mortar retailers continued to cut jobs in response to competition from online merchants. Within goods-producing, manufacturing (11,000) and natural resources (3,000) companies continued to add jobs, while construction (-2,000) companies reduced payrolls slightly after a five-month surge of 188,000. Medium-sized companies topped the leader board last month, boosting payrolls by 78,000—with the mix 68,000 services and 10,000 goods-producing. Small businesses fell to the number two spot, adding 61,000 jobs—all services (69,000). Large companies remained in the bottom slot, adding 38,000 to payrolls—28,000 service-providing and 10,000 goods-producing.

US Non-Manufacturing PMI (*link*): The US service sector in April rebounded from March's five-month low according to the ISM survey and expanded at a subdued pace according to Markit's. ISM's NM-PMI recovered to 57.5 after retreating to 55.2 in March from 57.6 in February—which was the best reading since October 2015. Three of the four components accelerated last month: the business activity (to 62.4 from 58.9) and new orders (63.2 from 58.9) gauges rebounded back above 60.0, while supplier deliveries (53.0 from 51.5) climbed to a ten-month high; the employment measure fell to 51.4 from 51.6 in March and 55.2 in February. Markit's NM-PMI ticked up to 53.1 in April after falling the prior two months from 55.6 in January (which was the best performance since November 2015) to 52.8 in March. According to the report, growth in business activity was sustained at a relatively modest pace, in line with limited gains in new orders. April saw the lowest rise in jobs growth since July 2010.

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