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MORNING BRIEFING
December 14, 2017

Financials Are Catching Up

See the collection of the individual charts linked below.

(1) The first digital tulip bubble. (2) Cornering the market. (3) Bitcoin vs. the banks. (4) Financials getting inflows, deals, and less regulation. (5) Wall Street returning to the business of trading. (6) Flatter yield curve. (7) Earnings optimism. (8) The Dark Web is very dark.

Financials I: Digital Tulips? Last week, bitcoin hit an intraday high north of $19,000 per dollar (*Fig. 1*). This week, the S&P 500 Financials sector stock index hit a post-recession high (*Fig. 2*). This index is only 8.3% below its record high on February 20, 2007.

It's a bit odd that these two events occurred simultaneously. Investors buying bitcoin are presumably betting against the viability of the dollar and other currencies, as well as against the current financial system. Conversely, investors buying financial stocks are placing the opposite wager.

Our view is that bitcoin is the first digital tulip bubble. The tulip bubble in Holland during 1636-37 was limited to Holland. Today's tulip bubble is global thanks to the Internet. The creation of a digital currency that is limited in supply by its algorithm has attracted buyers who are basically "cornering" the market. In the old days, commodities that were deemed to be in short supply were cornered by speculators. They had no interest in ever taking delivery of the commodity or using it. They expected that at some point the buyers would need the commodity that they had cornered and would pay a significantly higher price (than their own purchase price) to buy it from them.

We don't have any experience with digital bubbles. So it is hard to say how high the price might go for bitcoin. It is also hard to say what will burst the bubble. In the past, high prices stimulated more supply, or a government crackdown on the speculators. A government crackdown on bitcoin and other cryptocurrencies is possible, though that might only send more speculators to the Dark Web, as discussed below. A proliferation of new IPOs of cryptocurrencies might be the supply response that causes the price of bitcoin to take a dive.

Financials II: Vote of Confidence. In theory, bitcoin and the software behind bitcoin have the potential to seriously disrupt the business models of most financial intermediaries. Who needs banks if all our financial transactions can be accomplished easily and quickly using a virtual ledger? This existential question hasn't slowed the remarkable rally in the stock prices of the Financials so far this year. Let's have a closer look:

(1) *Coming from behind*. The Financials sector had a slow start to the year, but it's finishing strong. As recently as September, the index had returned less than 5% ytd, but in recent weeks investors jumped on board, bringing the ytd return through Tuesday's close up to 20.8%, behind only Technology (37.0%) and Health Care (21.2) (*Fig. 3*).

Many of the industries within Financials had a strong 2017 so far. Leading the sector is Asset Management & Custody Banks, up 26.7% ytd through Tuesday's close, followed by Diversified Banks

(21.7%), Investment Banking & Brokerage (20.4), Regional Banks (15.6), and Consumer Finance (15.4) (*Fig. 4*).

(2) *Ac-cent-tchu-ate the positive*. Financials benefitted from busy capital markets, strong flows into equity and fixed-income funds, good credit quality, and less regulation under the Trump administration.

Global investment banking revenue was 6% higher ytd than during the same period in 2016, according to Dealogic data on *WSJ.com*. The total was boosted by a 44% jump in revenue from IPOs and a 50% increase in global high-yield bond underwriting revenue. That was partially offset by a 6% decline in global M&A revenue and a 3% decline in global investment-grade bond underwriting revenue.

Asset managers have been helped by rising markets and positive fund flows. As discussed in Monday's *Morning Briefing*, funds are flowing into both equities and fixed-income products. Equity mutual funds and exchange-traded funds (ETFs) had net inflows of $323.9 billion over the past 12 months through October—the best showing since September 2014. ETFs had record net inflows of $375.6 billion, while equity mutual funds had net outflows (*Fig. 5*). Meanwhile, bond mutual funds and ETFs together recorded net inflows of $415.8 billion, the best flows since March 2013 (*Fig. 6*).

Banks and brokers also benefitted from the Trump administration's regulatory rollback of rules put in place under the Obama administration to reduce risk-taking. According to a 12/3 article in the *FT*: "The likes of Goldman Sachs and Morgan Stanley spent the years since the crisis winnowing their inventories of stocks and bonds held for trading, as new constraints on capital, and new rules such as the Volcker ban on proprietary trades, bit hard. But over the past nine months the trading arsenals of the big six banks have grown by more than $170bn, bringing the total to $1.71tn, the highest level since the end of 2012, according to an FT analysis of public filings."

The improved regulatory climate under President Trump has boosted their willingness to hold those securities on their balance sheets, the article concludes. And the loosening of regulations is expected to continue as Fed Chair nominee Jay Powell takes over.

(3) *Flatter curve.* Conversely, the Financials sector was held back by low volatility in the markets, which hurt trading revenues. In addition, the slim difference between the yields of short- and long-term Treasuries didn't help. The spread between 10-year and two-year Treasuries has fallen to 57bps, its lowest level since 2007 (*Fig. 7*). The spread has narrowed despite three rate hikes this year, including the Fed's decision to raise rates by 25bps Wednesday.

(4) *Optimism prevails*. With looser regulations just starting to have an impact, analysts are optimistic that earnings in the Financials sector will grow 15.6% over the next 12 months (*Fig. 8*). Those earnings projections are topped only by the 37.7% and 17.9% growth anticipated in the Energy and Materials sectors.

Part of the Financials sector's earnings strength comes from the Reinsurance and Property & Casualty Insurance industries, where losses from the catastrophes in 2017 are expected to be reversed next year. Forward earnings in those industries are anticipated to jump by 921.7% and 49.5% respectively.

Banks and brokers are forecasted to have respectable results over the next 12 months. Earnings are expected to grow 12.1% at Diversified Banks, 9.7% at Regional Banks, 12.8% at Consumer Finance, 9.4% at Asset Management & Custody Banks, and 10.9% at Investment Banking & Brokerage.

One should certainly keep an eye on the sector's forward P/E, at 14.9, since it has crept up from below 10.0 during 2009 and 2011 (*Fig. 9*). But given that Financials spent most of 2017 consolidating, the sector should have more room to run in 2018.

Tails from the Crypt. Pets.com sock puppet commercials from 1999 are always good for a chuckle. Something about the puppet perfectly captured the essence of doginess. Unfortunately, the company spent more on advertising than it generated in revenue and met its untimely demise before the delivery of pet food and products became commonplace.

This trip down memory lane was inspired by CryptoKitties, the latest wrinkle in the world of cryptocurrencies. Consumers can use the cryptocurrency Ethereum to buy cartoon cats, and the platform "has processed more than $12 million in sales," according to a 12/11 Cointelegraph article. Each cat has a name, biography, "cattributes" and lineage. Owners can breed their cats and sell the kittens.

Cryptocurrencies have come a long way from when they were first used to execute transactions on the Dark Web, the place on the Internet that Google does not go. The Dark Web, which was first established by the Navy, is accessed by the Tor browser and allows users to visit sites anonymously.

The Dark Web is prized by advocates who believe you have the right to privacy on the Internet. You have the right to read things without being monitored by web providers, advertisers, or the government. You have the right to control your own data and information. Newspapers have used the Dark Web to set up sites that whistle blowers can use to pass on information without exposing their identities.

However, the Dark Web is also a place where you can reportedly buy anything from drugs to guns to illegal documents. Here's a good Ted Talk with some of the basics.

To purchase things anonymously, buyers can't exactly whip out their AmEx; nor will $100 bills work online. Cryptocurrencies do the job, and bitcoin was among the first to gain traction. However, since bitcoin transactions are recorded on the distributed ledger, criminals reportedly have moved on to currencies like Ethereum and Monero, which hide the name of the sender, the amount, and the receiver.

"Although hard numbers on criminal activity in digital currencies are difficult to pin down, Shone Anstey, co-founder and president of Blockchain Intelligence Group, estimates that illegal transactions in bitcoin have fallen from about half of total volume to about 20 percent last year," reported an 8/29 CNBC article. The price of Monero has risen to $310, up from almost $13 at the start of the year, and Ethereum trades north of $700 today, up from roughly $8 at the start of the year, according to Coinmarketcap.com.

The authorities are well aware of the nefarious things occurring on the Dark Web. This summer they shut down AlphaBay—a market for drugs, counterfeit credit cards, and other illegal goods. It rang up sales of $600,000 to $800,000 a day, according to a 7/13 *WSJ* article. But there still seem to be many vendors selling all manner of things on the Dark Web according to a listing of web sites on darkwebnews.com. We'd expect a game of Whac-A-Mole between authorities and criminals to ensue for many years.

CALENDARS

US. Thurs: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.7%/0.4%/0.4%, Business Inventories -0.1%, Jobless Claims 239k, Import & Export Prices 0.7%/0.3%, PMI Flash Estimates, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Headline & Manufacturing Industrial Production 0.3%/0.4%, Capacity Utilization 77.2%, Empire State Manufacturing Index 18.0, Atlanta Fed Business Inflation Expectations, Baker-Hughes Rig Count, Treasury International Capital. (*Wall Street Journal* estimates)

Global. Thurs: European Car Sales, Eurozone, Germany, and France Composite PMI Flash Estimates 57.2/57.2/59.5, Eurozone, Germany, and France M-PMI Flash Estimates 59.7/62.0/57.2, Eurozone, Germany, and France NM-PMI Flash Estimates 56.0/54.6/59.9, UK Retail Sales Including & Excluding Auto Fuel 0.3%/0.2% y/y, Japan Industrial Production, Japan Tankan Survey, China Retail Sales 10.3% y/y, China Industrial Production 6.2% y/y, China Fixed Assets Ex Rural 7.2% y/y, Australia Employment Change & Unemployment Rate 19k/5.4%, ECB Rate Decision, Marginal Lending Facility, and Deposit Facility Rates 0.00%/0.25%/-0.40%, BOE Bank Rate & Asset Purchase Target 0.5%/435b, Draghi, Poloz. **Fri:** Eurozone Trade Balance (euros) 24.3b. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): Our Bull/Bear Ratio (BBR) slipped to 4.07 this week—the eighth reading at 4.00 or higher in the past 10 weeks—after rising the prior two weeks from 3.99 to 4.25. It was at 4.47 five weeks ago, which was the highest reading since March 1987! Bullish sentiment has been at 60.0% or above for the past 10 weeks, though retreated to 61.9% this week from 64.2% last week, which was just shy of its record high of 64.9% posted in early 1987. It was as low as 47.1% 13 weeks ago. The correction count absorbed the 2.3ppts fall in bullish sentiment this week, climbing to 22.9% from 20.7%—which was near its low for the year of 20.4% during the final week of February. Bearish sentiment was little changed at 15.2% this week, fluctuating between 15.1% and 15.4% since mid-November; it began November at 14.4%, which was the fewest bulls since May 2015. The AAII Ratio fell for the second week last week to 51.9% after rising the prior week from 45.5% to 55.0%. Bullish sentiment rose for the third week from 29.4% to 36.9%, while bearish sentiment rose from 29.0% to 34.2% the past two weeks.

S&P 500 Earnings, Revenues & Valuation (*link*): Last week saw S&P 500 consensus forward revenues and earnings rise to new record highs. The forward profit margin forecast has been steady since October at a record high of 11.1%, which is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 fell to 5.4% from a 10-month high of 5.7%. That's down from 5.8% in late January, which was the highest since May 2012 and compares to a cyclical low of 2.7% in February 2016. Forward earnings growth was steady w/w at 11.1%, but is down from a nine-month high of 11.5% in mid-October. That compares to January's 11.7%, which was the highest since October 2011 and a cyclical 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 forward growth rate forecasts for revenues (STRG) and earnings (STEG) for Consumer Staples, Industrials, Materials, and Tech. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results, the S&P 500 ex-Energy's STRG (of 5.3%) and STEG (of 10.1%) each is only 1.0ppt lower. The S&P 500 ex-Energy forward profit margin was steady w/w at a record high of 11.7%, which is its first since August 2007. The forward P/E was steady at 18.2, which is the highest since January 2004 and up from a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio edged down to 2.03 from a record high of 2.04, and edged down to 2.10 on an ex-Energy basis from a record high of 2.11. On an ex-Energy basis, the forward P/E fell to 17.9 from last week's 14-year high of 18.1.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for all 11 sectors, and forward earnings rose for all but Real Estate. 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 ticking higher now, but remain near their lowest levels since the spring of 2017. Forward P/E ratios remain near cyclical highs for all sectors except Energy, Health Care, and Telecom. Energy's forward revenues and earnings are improving from cyclical lows in early 2016, but its valuations remain elevated; its P/S ratio of 1.31 compares to a record high of 1.56 in May 2016, and its P/E of 24.5 is down from a record high of 57.5 then. Higher y/y margins are expected in 2018 for all but Real Estate and Telecom. In the latest week, the forecasted forward profit margin edged up 0.2ppt for Financials and Materials, and rose 0.1ppt for Energy, Health Care, and Industrials. Real Estate was the sole decliner, falling 0.3ppt. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (21.1%), Real Estate (16.9), Financials (16.6), Utilities (11.4), Telecom (11.3), S&P 500 (11.1), Health Care (10.7), Materials (10.7), Industrials (9.2), Consumer Discretionary (7.5), Consumer Staples (6.8), and Energy (5.3).

S&P 500 Buybacks (*link*): S&P 500 quarterly buybacks rose 7.5% q/q to $129.2 billion during Q3-2017, and was up 15.1% y/y. While Q3-2017 marked the 15th highest quarterly buyback amount on record, dating back 79 quarters to Q1-1998, it was 24.9% below Q3-2007's record quarterly high of $172.0 billion, and lower q/q in four of the past six quarters since its Q1-2016 cyclical peak of $161.4 billion. However, the four-quarter buybacks sum improved for the first time in six quarters as it rose 3.4% q/q to a three-quarter high of $517.7 billion from $500.8 billion. It remains down 12.2% from Q1-2016's record high of $589.4 billion, which at the time was its first since Q4-2007. S&P 500 buybacks in Q3 accounted for 0.60% of the total market capitalization, up from 0.58% in Q2, which was the lowest since Q1-2010. That compares to a cyclical peak of 1.15% in Q3-2011 and a record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks (*link*): Buybacks rose q/q during Q3-2017 for six of the 11 sectors and fell for five. That matches the six rising and five falling during Q1-2017 and Q2-2017. The biggest q/q buyback gainers on a percentage basis in Q3-2017: Consumer Staples (up 51.3% q/q to a seven-quarter high of $15.6 billion from $10.3 billion), Materials (38.4%, to $1.4 billion from $1.0 billion), Financials (27.7%, to a record high of $34.3 billion from $26.8 billion), Utilities (12.7%, to $22.0 million from $19.5 million), Consumer Discretionary (8.4%, to a six-quarter higher of $24.2 billion from $22.4 billion), and Tech (1.1%, $27.9 billion from $27.6 billion). The biggest percentage q/q decliners: Telecom (-98.9%, to a 23-quarter low of $3 million from $282 million), Real Estate (-29.9%, to $806 million from $1.2 billion), Energy (-25.3%, to $2.3 billion from $3.1 billion), Health Care (-24.6%, to a 30-quarter low of $9.5 billion from $12.6 billion), and Industrials (-11.6%, to a 13-quarter low of $13.1 billion from $14.8 billion). Financials' buybacks was at a record high for the first time since Q1-2007. The sector also accounted for the biggest portion of total S&P 500 buybacks in Q3-2017, taking over Tech's spot as it improved to a 26.5% share from 22.3% in Q2. Tech had held the top spot for 16 straight quarters through Q3-2016, but has traded places since then with Financials and Health Care. Tech's share slipped to 21.6% in Q3 from 23.0% in Q2; Consumer Discretionary was third (up to 18.8% from 18.6%), and Consumer Staples was fourth (up to 12.1% from 8.6%).

S&P 500 Cash Return & Buyback Yield (*link*): During Q3-2017, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as buybacks of $129.2 billion outpaced the record-high quarterly dividend payment of $105.4 billion. Buybacks have exceeded dividends in 39 of the past 44 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. With the pace of buybacks rising in Q3, the four-quarter sum of buybacks and dividends, or cash returned to investors, improved for the first time in six quarters to a three-quarter high of $930.9 billion from a nine-quarter low of $906.7 billion during Q2. However, the cash return remains 4.5% below its record high of $974.6 billion in Q1-2016. On a positive note, companies earned more than they paid out to investors for a third straight quarter after paying out more than they earned for six straight quarters; more specifically, Q3-2017's four-quarter sum of operating earnings of $1017.5 billion was at a 12-quarter high and exceeded the $930.9 billion returned to investors. The cash return was 8.5% lower than trailing-four-quarter operating earnings during Q3, compared to 9.0% lower than operating earnings in Q2-2017, 5.3% lower during Q1-2017, and a 28-quarter high of 13.5% above operating earnings during Q1-2016. The improvement in operating earnings was helped in part by strong Tech earnings and by the Energy sector, which recorded positive trailing-four-quarter operating earnings for a third quarter**.** The S&P 500's figures are much better on an ex-Energy basis. Operating earnings exceeded the cash return for a fourth straight quarter, with the percentage rising to 89.5% from a 12-quarter low of 88.1% Q2-2017, and is down from a 28-quarter high of 102.2% in Q2-2016. Including Energy, the S&P 500's buyback yield was down to a 29-quarter low of 2.40% from 2.41% in Q2, and the dividend yield fell to a 13-quarter low of 1.91% from 1.96% in Q2. Adding both together, the buyback + dividend yield (or cash return) was down to a 30-quarter low of 4.31% in Q3 from 4.37% in Q2.

S&P 500 Sectors Cash Return & Buyback Yield (*link*): During Q3-2017, eight of the 11 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), unchanged from Q2 and up from 7/10 sectors during Q1-2017. Consumer Staples failed to cover its cash return for an 11th straight quarter, and the Energy sector missed for a tenth straight quarter. However, Energy was profitable on a GAAP operating earnings basis for a third quarter after five quarters of losses. Industrials covered its cash return for a second quarter after missing for seven straight quarters, Consumer Discretionary did so for a third quarter after missing for 12 quarters, Materials did so for just the fourth time since Q1-2014, and Tech did so for only the fifth time over that same time period. Here's how the sectors' four-quarter cash returns relative to four-quarter earnings ranked in Q3-2017: Energy (162.1%), Real Estate (126.0), Consumer Staples (116.6), Consumer Discretionary (98.7), Industrials (95.7), S&P 500 (91.5), Health Care (88.1), S&P 500 ex-Energy (89.5), Information Technology (78.1), Financials (89.2), Telecommunication Services (74.9), Utilities (66.9), and Materials (63.6). The four-quarter buyback + dividend yield rose q/q for Financials, Consumer Staples, Consumer Discretionary, Real Estate, and Utilities, and fell for the remaining six sectors. Here's how the 10 sectors ranked: Consumer Staples (5.74% [17-quarter high), Financials (5.38), Telecom (4.98), Consumer Discretionary (4.70), Industrials (4.60 [25-quarter low]), S&P 500 (4.31 [30-quarter low]), Health Care (4.08 [nine-quarter low]), Real Estate (3.62 [only the second quarter for which data is available]), Tech (3.52 [30-quarter low]), Energy (3.45), Utilities (3.43), and Materials (2.85 [27-quarter low]).

US ECONOMIC INDICATORS

CPI (*link*): The core CPI rate in November remained below the Fed's target rate of 2.0% y/y for the eighth month, after 15 months above—ranging from 2.1% to 2.3%—from December 2015 through February of this year. The yearly rate ticked back down to 1.7% after moving up to 1.8% in October, following four months at 1.7%. The three-month rate slowed to 1.9% (saar) after accelerating steadily from zero in May to 2.4% in October. On a monthly basis, core prices rose 0.1% for the sixth time in eight months—the exceptions were August and October, which both recorded 0.2% gains. Among the indexes posting gains last month were shelter, used cars & trucks, new vehicles, and motor vehicle insurance, partially offset by lower prices for apparel, air fares, and household furnishings & operations. The headline CPI accelerated 0.4% last month after ticking up only 0.1% during October; the yearly rate rose to 2.2% y/y from a recent low of 1.6% in June.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (*link*): Output in October recovered part of September's decline, climbing back to within 0.4% of August's cyclical high. Industrial production (excluding construction) expanded 0.2% after contracting 0.5% in September; it was the third increase in four months for a total advance of 1.4%. October production was a mixed picture, with consumer nondurable goods (0.5%) and energy (0.1) output moving higher—with the former at a new record high—and consumer durable (-

1.9) and capital (-0.3) goods production moving lower; intermediate goods production was unchanged. Over the past 12 months, headline production expanded 3.7% y/y, holding near May's 4.1%—which was the highest since August 2011. Among the top four Eurozone economies, France (1.8%), Spain (0.6), and Italy (0.5) posted production gains during the month; German output fell for the second month by 1.4%m/m and 2.6% over the period. Of the remaining countries for which data are available, the biggest monthly gains were delivered by Ireland (10.6) and Luxembourg (2.3); the biggest declines were recorded in Malta (-6.1), Portugal (-2.3), and the Netherlands (-1.8). The outlook remains bright: The Eurozone's November M-PMI (60.1) recorded its second-best reading in the history of the series, with Germany (62.5, 81-month high) remaining at the top of the leader board last month, followed by the Netherlands (62.4) and Austria (61.9), which both reached new record highs. Also posting impressive numbers were Italy (58.3, 81-month high), Ireland (58.1, 215-month high), France (57.7, 84-month high), and Spain (56.1, 129-month high); Greece (52.2) remained above 50.0 for the sixth month after contracting steadily for many years.

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