



## MORNING BRIEFING

June 30, 2020

### Stress Tests

Check out the accompanying [chart collection](#).

(1) A bank stress test with additional sensitivity to the virus. (2) A group of 34 lenders get tested for V/U/W scenarios. (3) A freeze on buybacks and a cap on dividends. (4) Awash in deposits and making lots of loans. (5) Provisioning for more losses. (6) GFC was much worse for Financials than GVC so far. (7) Large corporations in better position to survive GVC than small businesses. (8) Financials led dividend cuts during GFC. This time, Energy more likely to lead the way. (9) Tech firms and Financials are the big repurchasers of their own shares. (10) Buybacks data confirm that most are to offset dilution from employee stock compensation plans rather than to boost EPS.

**Strategy I: Banks Maintain Their Own.** Last Friday, the S&P 500 dropped 2.4% led by a 4.3% drop in the S&P 500 Financials sector after the Federal Reserve capped buybacks and dividend payments for the country's biggest lenders following its latest round of stress tests ([Fig. 1](#) and [Fig. 2](#)).

This year, the Fed's stress test of the biggest US banks added a so-called "sensitivity" test to its annual check-up, allowing it to measure the ability of 34 domestic lenders to weather an extreme double-dip recession triggered by the coronavirus pandemic. Under that W-shaped scenario, the Fed said, banks could be on the hook for a collective \$700 billion in bad loan losses and a 2.5% fall in aggregate capital ratios.

"In light of these results, the Board took several actions following its stress tests to ensure large banks remain resilient despite the economic uncertainty from the coronavirus event," the Fed said in a [statement](#). "For the third quarter of this year, the Board is requiring large banks to preserve capital by suspending share repurchases, capping dividend payments, and allowing dividends according to a formula based on recent income. The Board is also requiring banks to re-evaluate their longer-term capital plans." Here's more:

(1) *Three stressful scenarios.* The Fed's sensitivity analysis assessed the resiliency of large banks under three hypothetical recession scenarios that theoretically could result from the Great Virus Crisis (GVC): i) a V-shaped recession and recovery; ii) a slower, U-shaped

recession and recovery; and iii) a W-shaped, double-dip recession. In each of these scenarios, the unemployment rate peaked between 15.6% and 19.5%; that's a good deal higher than any of the Fed's pre-GVC stress tests assumed, making these significantly more stringent tests.

(2) *Projected losses.* In aggregate, loan losses for the 34 banks ranged from \$560 billion to \$700 billion in the sensitivity analysis, and aggregate capital ratios declined from 12.0% in Q4-2019 to between 9.5% and 7.7% under the hypothetical downside scenarios. Under the U- and W-shaped scenarios, most firms would remain well capitalized, but several would approach minimum capital levels. (Notably, the sensitivity analysis does not incorporate the potential effects of government stimulus payments and expanded unemployment insurance.)

(3) *Stopping buybacks and limiting dividends.* For Q3 this year, the Fed is requiring large banks to preserve capital by suspending share repurchases, capping dividend payments, and allowing dividends according to a formula based on recent income. All large banks will be required to re-evaluate their longer-term capital plans and to resubmit and update their plans later this year to reflect current stresses.

During Q3, no share repurchases will be permitted. The Fed's release noted that recent years' share repurchases have represented approximately 70% of shareholder payouts from large banks. By the way, on March 15, eight giant US banks—including JPMorgan Chase & Co. and Bank of America Corp.—agreed to stop buying back their own shares through Q2, saying that they will focus instead on supporting clients and the nation during the coronavirus pandemic.

The Fed is also capping dividend payments to the amount paid in Q2 and is further limiting them to an amount based on recent earnings. As a result, a bank cannot increase its dividend and can pay dividends if it has earned sufficient income.

(4) *Monitoring happy data.* Now for some good news: The banking sector is flooded with cheap deposits and has lots of liquid assets. Total deposits of all commercial banks in the US rose \$2.1 trillion since the last week of February to a record \$15.6 trillion during the June 17 week ([Fig. 3](#)). Over this same period, deposits are up \$1.5 trillion to a record \$9.5 trillion at the large domestically chartered banks and \$0.6 trillion to a record \$4.9 trillion at small domestically chartered banks ([Fig. 4](#)).

The deposit inflows, which were mostly attributable to the mad dash for cash by individuals, financed the mad dash for cash by businesses that cashed in their lines of credit. Commercial

and industrial (C&I) loans at all banks in the US jumped \$573 billion to \$2.9 trillion from the last week of February through the June 17 week ([Fig. 5](#)). Over this same period, C&I loans rose \$206 billion at the large domestically chartered banks and \$263 billion at the small domestically chartered ones ([Fig. 6](#)).

During the June 17 week, all US banks had a record \$3.3 trillion in US Treasuries and agency securities, up \$248 billion since the end of February for banks overall, up \$234 billion at the large domestically chartered banks, and up \$19 billion at the small domestically chartered banks ([Fig. 7](#) and [Fig. 8](#)).

(5) *Monitoring stressful data.* Now for the bad news: Banks are provisioning more for loan losses. The Fed's weekly compilation of the balance sheet of the commercial banking sector includes an item for "allowance for loan and lease losses." For all banks in the US, it rose to \$151 billion during the June 17 week, up from \$111 billion at the start of the year ([Fig. 9](#)).

The Federal Deposit Insurance Corporation (FDIC) collects similar quarterly data for all FDIC-insured financial institutions. During Q1, its provisions for loan and lease losses totaled \$52.7 billion, up from \$14.9 billion during Q4-2019 ([Fig. 10](#)). However, its net charge-offs were only \$14.6 billion during Q1. This number undoubtedly will jump higher over the remainder of this year as GVC-related bankruptcies mount. On the other hand, the Fed remains committed to providing up to \$4 trillion in loans to Main Street borrowers. That could reduce bankruptcies and losses for the banks.

(6) *GFC vs GVC.* In my 2018 book [Predicting the Markets](#), I reviewed what happened to the S&P 500 Financials in early 2009 when banks were warned not to pay dividends by Larry Summers, the director-elect of the National Economic Council of the incoming Obama administration. In a Monday, January 12 letter to the congressional leadership, he wrote: "Those receiving exceptional assistance will be subject to tough but sensible conditions that limit compensation until taxpayer money is paid back, ban dividend payments beyond *de minimis* amounts, and put limits on stock buybacks and the acquisition of already financially strong companies."

That heightened fears that the banks might be nationalized under the new administration. Indeed, on January 22, *The New York Times* hosted a discussion by experts on nationalizing US banks. (See the *NYT* [article](#) "Should the Government Nationalize U.S. Banks?")

During the Great Financial Crisis (GFC), the S&P 500 Financials stock price index dropped 67.7% from its peak on October 5, 2007 through Friday, January 9, 2009, the trading day before the Summers letter. It plunged another 47.5% from then through the March 6, 2009 record-low bottom for the Financials sector. It was down a whopping 83.0% over the entire period. It certainly was a GFC for the Financials sector!

So far during the GVC, the S&P 500 Financials stock price index is down 27.1% from February 19 (when the S&P 500 rose to a record high) through Friday's close.

(7) *After the close.* After the stock market's close yesterday, CNBC [reported](#): "Nearly all of the largest U.S. banks said Monday that they performed well enough on the Federal Reserve's most-recent stress test to maintain their current quarterly dividend. Goldman Sachs, Bank of America, Morgan Stanley, and Citigroup all said they will maintain their current dividend. Wells Fargo, however, said the Fed's assessment of its business will warrant a reduction to its quarterly payout. While the nation's largest banks were quick to drop stock buybacks at the onset of the coronavirus pandemic, the group is often loathe to cut its dividend payments, which are viewed as a steady source of income for investors."

Apparently, the big banks believe that they passed their virus-sensitive stress tests with flying colors, or well enough not to cut their dividends.

**Strategy II: Putting Dividends & Buybacks in Perspective.** Now is a good time to update our thoughts on dividends and buybacks. Both tend to fall during recessions. The current recession could be the shortest on record. If so, then it isn't likely to do much damage to the underlying earnings- and cash-generating power of large corporations. It will certainly do so on a cyclical basis, but not in a structural fashion.

On the other hand, many smaller businesses might very well be seriously impaired by the immediate collapse of their cash flow during the GVC's lockdowns and the slow pace of re-opening their businesses. Many may have to do business with half as many customers as before the GVC. If they can't cut their costs commensurately, then they will continue to hemorrhage cash and go out of business. Arguably, large companies might be in a position to gain from having a bunch of smaller competitors go out of business or by acquiring some of them.

Smaller corporations don't tend to pay dividends or to buy back their shares as larger ones do. If larger ones come out of the GVC bigger and stronger than ever, so should their dividends. What about buybacks? They might be suppressed if left-leaning politicians gain power in Washington come the next election. However, as Joe and I have argued in the past, buybacks have had more to do with offsetting dilution resulting from employee stock compensation plans than with boosting earnings per share. If large companies maintain these plans, they will continue to buy back their shares to reduce dilution. (See our May 20, 2019 [Stock Buybacks: The True Story](#).) Consider the following:

(1) *Dividends*. Dividends paid by S&P 500 companies totaled a record \$493.9 billion over the four quarters through Q1-2020 ([Fig. 11](#)). Over the same period, dividends paid by companies in the S&P 500 Financials sector rose to a record \$71.8 billion and accounted for just 14.5% of total S&P 500 dividends.

Here are the comparable dividends and percentages of total S&P 500 dividends for the 11 sectors of the S&P 500: Communication Services (\$35.7bn, 7.2%), Consumer Discretionary (\$33.8bn, 6.8%), Consumer Staples (\$52.2bn, 10.6%), Energy (\$45.3bn, 9.2%), Financials (\$71.8bn, 14.5%), Health Care (\$62.9bn, 12.7%), Industrials (\$45.8bn, 9.3%), Information Technology (\$79.7bn, 16.1%), Materials (\$14.7bn, 3.0%), Real Estate (\$24.5bn, 5.0%), and Utilities (\$27.4bn, 5.5%).

During the GFC, the actual quarterly dividends of the S&P 500 fell from \$66.8 billion during Q4-2007 to \$47.3 billion during Q3-2009 ([Fig. 12](#)). Over that same period, the dividends paid by the Financials dropped from \$20.3 billion to \$4.1 billion, accounting for 83% of the drop in total S&P 500 dividends. This time, there may be more downside in the dividends paid by S&P 500 Energy sector companies than by Financials sector ones.

(2) *Buybacks*. S&P 500 buybacks totaled \$721.7 billion during the four quarters through Q1-2020 ([Fig. 13](#)). Financials repurchased \$182.2 billion of their shares over the same period, accounting for 25.2% of the total.

Here are the comparable buybacks and percentages for the 11 sectors of the S&P 500: Communication Services (\$51.8 bn, 7.2%), Consumer Discretionary (\$66.8bn, 9.3%), Consumer Staples (\$29.3bn, 4.1%), Energy (\$18.3bn, 2.5%), Financials (\$182.2bn, 25.2%), Health Care (\$73.9bn, 10.2%), Industrials (\$62.1bn, 8.6%), Information Technology (\$216.0bn, 29.9%), Materials (\$15.5bn, 2.1%), Real Estate (\$3.1bn, 0.4%), and Utilities (\$2.2bn, 0.3%).

Joe compiled data for the basic shares outstanding for current S&P 500 companies with data for all periods, adjusted for stock splits and stock dividends, from Q1-2007 through Q4-2019 ([Fig. 14](#)). From Q4-2010 through Q4-2019, the count for the S&P 500 fell 8.2%, or 0.9% per year on average. That's not much considering that buybacks totaled \$5.1 trillion over that same period. That confirms our view that the majority of buybacks is aimed at avoiding dilution rather than boosting earnings per share, as we explained in our 2019 study cited above!

Here are the comparable total and average percentage changes in the share counts of the S&P 500's 11 sectors: Communication Services (11.6%, 1.3%), Consumer Discretionary (-14.3, -1.6), Consumer Staples (-11.7, -1.3), Energy (1.0, 0.1), Financials (-12.4, -1.4), Health Care (-10.0, -1.1), Industrials (-14.7, -1.6), Information Technology (-19.2, -2.1), Materials (15.6, 1.7), Real Estate (42.8, 4.8), and Utilities (24.7, 2.7).

Here are the comparable average percentage changes in the share counts and in S&P 500 operating earnings per share (using I/B/E/S data) of the 11 sectors of the S&P 500 from Q4-2010 through Q4-2019: Communication Services (1.3%, 5.6%), Consumer Discretionary (-1.6, 11.0), Consumer Staples (-1.3, 3.3), Energy (0.1, -5.7), Financials (-1.4, 15.1), Health Care (-1.1, 12.8), Industrials (-1.6, 7.3), Information Technology (-2.1, 14.2), Materials (1.7, 1.5), and Utilities (2.7, 3.6) ([Fig. 15](#)).

## CALENDARS

**US: Tues:** Consumer Confidence 90.0, Chicago PMI 44.5, API Crude Oil Inventories, Powell Testimony, Williams, Brainard. **Wed:** ADP Employment Change 3.0m, ISM & IHS Markit M-PMIs 49.4/49.6, ISM Price Index 43.0, Construction Spending 1.0%, Motor Vehicle Sales, MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Minutes, Evans. (DailyFX estimates)

**Global: Tues:** Eurozone Headline & Core CPI Flash Estimates 0.1%/0.8% y/y, UK GDP -2.0%q/q/-1.6%y/y, Spain GDP -5.2%q/q/-4.1%y/y, Japan Housing Starts -15.9%, Japan Tankan Survey, Japan M-PMI 37.8, China Caixin M-PMI 50.5, Guindos, Schnabel, Haldane. **Wed:** Eurozone, Germany, France, and Italy M-PMIs 46.9/44.6/52.1/47.7, Germany Unemployment Change & Unemployment Rate 120k/6.6%, Germany Retail Sales 3.9%m/m/-3.5%y/y, UK M-PMI 50.1, Panetta, Wuermeling, Mauderer, Haskel. (DailyFX estimates)



## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): Forward earnings rose for two of these three indexes last week. LargeCap's forward earnings has risen for six straight weeks, MidCap's for four, and SmallCap's edged lower last week but is up in three of the past five weeks. LargeCap's forward earnings is now up 2.3% from its lowest level since August 2017; MidCap's surged 2.5% w/w for its biggest gain since May 2000 and has risen 6.3% from its lowest level since May 2015; and SmallCap's is up 1.9% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November until mid-February, before tumbling due to the COVID-19 economic shutdown. LargeCap's is now 19.4% below its record high at the end of January. MidCap's and SmallCap's are 29.4% and 44.2% below their October 2018 highs, with the former up from an 11-year low and the latter at a record low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings was steady at -18.1% y/y. That's up from mid-May's -21.2%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings improved w/w to -28.7% y/y from -30.6% y/y and is up from a record low of -32.7% four weeks earlier; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate dropped w/w to -40.9% y/y from -40.5% y/y and is up from a record low of -41.5% in early June. SmallCap's prior record low in its y/y percent change occurred during July 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially since early March, but have been relatively stable since late May as analysts await the Q2 earnings season. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-23.2%, 30.6%), MidCap (-34.5, 48.3), and SmallCap (-53.3, 83.6).

**S&P 500/400/600 Valuation** ([link](#)): Valuations were down across the board last week and have drifted lower since their cyclical and record highs in early June. LargeCap's forward P/E fell 0.6pt w/w to 20.9 from 21.5. Its early June reading of 22.4 was the highest since May 2001 and up from 13.3 in mid-March, which was the lowest since March 2013. MidCap was down 1.4pts w/w to 19.5 and has dropped 2.4pts from its record high of 22.9, which dates back to 1999 when the SMidCap series began. SmallCap was down 0.8pt w/w to 23.0 and has dropped 3.7pts from its record high of 26.7. That compares to MidCap's 10.7 and SmallCap's

11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E before COVID-19 decimated forward earnings had been at 18.9 during mid-February, which was the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E again last week, where it mostly has been since August 2018. It was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E is still above LargeCap's, though. It had been mostly below since May 2019 after being solidly above from 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): Analysts are focused on the pace of the reopening of the US economy, but have little to report amid a “withdrawn guidance” environment. The Q2 EPS forecast dropped 3 cents w/w to \$23.41, which is substantially less than usually seen at this point in the quarter. That represents a decline of 43.4% y/y on a frozen actual basis and -43.2% y/y on a pro forma basis. That compares to a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. Five of the 11 sectors recorded positive but low-single-digit y/y earnings growth in Q1, but none are expected to be positive in Q2. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Seven sectors beat the S&P 500's pro-forma 12.8% decline in Q1. That's similar to the six that beat the index in Q4-2019 and seven in Q3-2019, but up sharply from just three during Q2-2019. Looking ahead to Q2, all sectors are expected to post worse growth on a q/q basis due to the COVID-19 economic shutdown, and two are expected to report a loss: Consumer Discretionary and Energy. Here are the latest Q2-2020 earnings growth rates versus their final Q1-2020 growth rates: Utilities (-2.3% in Q2-2020 versus 4.3% in Q1-2020), Information Technology (-8.0, 7.2), Real Estate (-15.3, -3.8), Consumer Staples (-16.3, 6.9), Health Care (-15.2, 6.5), Materials (-37.1, -12.3), Financials (-47.8, -37.8), Industrials (-90.6, -32.8), Consumer Discretionary (-114.1, -52.8), and Energy (-153.7, -30.2).

## US ECONOMIC INDICATORS

**Pending Home Sales** ([link](#)): “This has been a spectacular recovery for contract signings, and goes to show the resiliency of American consumers and their evergreen desire for homeownership,” said Lawrence Yun, NAR's chief economist. “This bounce back also speaks



to how the housing sector could lead the way for a broader economic recovery.” The Pending Home Sales Index made a dramatic comeback in May, skyrocketing a record 44.3% to 99.6, with the decline in year-over-year comparisons narrowing to -5.1% from -33.8% in April! All regions posted massive gains in May, though only the South (+43.3% m/m & +1.9% y/y) showed sales increasing on both a monthly and yearly basis. Here’s how the remaining regions fared: West (+56.2 & -2.5), the Midwest (+37.2 & -1.4), and the Northeast (+44.4 & -33.2). According to Yun, “[a]ll figures light up in 2021 with positive GDP, employment, housing starts and home sales.” The National Association of Realtors forecasts that in 2021, sales will rise to 5.35mu (saar) for existing homes and 800,000 units (saar) for new homes, compared with their 2020 forecasts of 4.93mu and 690,000 units, respectively.

**Regional M-PMIs** ([link](#)): Analysts are focused on the pace of the reopening of the US economy, but have little to report amid a “withdrawn guidance” environment. The Q2 EPS forecast dropped 3 cents w/w to \$23.41, which is substantially less than usually seen at this point in the quarter. That represents a decline of 43.4% y/y on a frozen actual basis and -43.2% y/y on a pro forma basis. That compares to a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. Five of the 11 sectors recorded positive but low-single-digit y/y earnings growth in Q1, but none are expected to be positive in Q2. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Seven sectors beat the S&P 500’s pro-forma 12.8% decline in Q1. That’s similar to the six that beat the index in Q4-2019 and seven in Q3-2019, but up sharply from just three during Q2-2019. Looking ahead to Q2, all sectors are expected to post worse growth on a q/q basis due to the COVID-19 economic shutdown, and two are expected to report a loss: Consumer Discretionary and Energy. Here are the latest Q2-2020 earnings growth rates versus their final Q1-2020 growth rates: Utilities (-2.3% in Q2-2020 versus 4.3% in Q1-2020), Information Technology (-8.0, 7.2), Real Estate (-15.3, -3.8), Consumer Staples (-16.3, 6.9), Health Care (-15.2, 6.5), Materials (-37.1, -12.3), Financials (-47.8, -37.8), Industrials (-90.6, -32.8), Consumer Discretionary (-114.1, -52.8), and Energy (-153.7, -30.2).

## GLOBAL ECONOMIC INDICATORS

**Eurozone Economic Sentiment Indicators** ([link](#)): The recovery in the Economic Sentiment Indexes (ESI) for both the Eurozone (+8.2 points to 75.7) and the EU (+8.1 to 74.8) intensified

in June, posting their largest monthly gains on record, after hinting at the start of a recovery in May. ESIs for the former and the latter had plummeted by 38.6 points and 39.2, respectively, during the two months ending April, to new record lows. ESIs were up big in all the main Eurozone economies this month, France (+9.4 points to 77.1), the Netherlands (+8.3 to 77.4), Spain (+8.2 to 83.1), Italy (+8.2 to 71.2), and Germany (+6.6 to 81.9). At the sector level, both industry and consumer confidence posted sizeable gains for the second month, up 10.8 points and 7.3 points, respectively, during the two months through June, to -21.7 and -14.7. Meanwhile, retail trade confidence jumped 10.4 points in June to -19.4, following May's 0.3 point uptick. Service (+8.0 points to -35.6) and construction (+4.9 to -12.4) confidence jumped in June for the first time in four months and five months, respectively, to -35.6 and -12.4.

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Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683  
Debbie Johnson, Chief Economist, 480-664-1333  
Joe Abbott, Chief Quantitative Strategist, 732-497-5306  
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967  
Mali Quintana, Senior Economist, 480-664-1333  
Jackie Doherty, Contributing Editor, 917-328-6848  
Valerie de la Rue, Director of Institutional Sales, 516-277-2432  
Mary Fanslau, Manager of Client Services, 480-664-1333  
Sandy Cohan, Senior Editor, 570-775-6823

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