MORNING BRIEFING
October 8, 2020

Banks, Sweden & Digital Currencies

Check out the accompanying chart collection.

(1) A year financials want to forget. (2) Watching loan losses in commercial real estate, credit cards, and autos. (3) Next week's earnings reports will reveal whether banks have to set aside more reserves than the market already expects. (4) Banks' forward earnings have risen, but questions about 2021 linger. (5) How Sweden managed through the first Covid wave with restaurants open and no masks. (6) Recently, Sweden has become more restrictive in the wake of a second wave, while the rest of Europe has become less so, avoiding the blanket shutdowns it had before. (7) Central banks develop digital currencies, with Chinese in the lead.

Financials: Reality Check Coming. Financials has been one of the S&P 500's worst-performing sectors this year, battered by a flat yield curve, surging loan losses, and a regulator that's prohibiting the payment of dividends and stock buybacks. Next week, as banks' Q3 earnings start rolling in, we'll get a better feel for how well banks are reserved for loan losses. Many set aside billions of dollars for losses in Q2 as Covid-19 descended. Given the poor performance of bank stocks, investors may already have priced in banks' need to continue building reserves in Q3.

The S&P 500 Financials sector's stock price index has barely rebounded from the market's March selloff, while the S&P 500 Technology and Consumer Discretionary sectors have hit new highs. Here's the performance derby for the S&P 500 and its sectors ytd through Tuesday's close: Information Technology (26.3%), Consumer Discretionary (22.3), Communication Services (6.5), S&P 500 (4.0), Materials (3.7), Health Care (3.0), Consumer Staples (1.9), Utilities (-4.1), Industrials (-4.2), Real Estate (-6.2), Financials (-20.6), and Energy (-50.6) (*Fig. 1*).

Let's take a look at bank reserves and loan losses over the past few months:

(1) *Bad news: Losses in many loan categories rising.* While home-related loans continued their strong performance through Q2, delinquencies in other loan categories were increasing, in

some cases sharply. The percentage of balances that are 90 days or more delinquent remains at an extremely low 0.8% for home mortgages and only 1.3% for home equity loans (*Fig. 2*).

Conversely, there has been a sharp spike in credit-card loan delinquencies to 9.8% in Q2 compared to 8.4% in Q4. The figure looks like it's ready to climb further. The peak of delinquencies during the Great Financial Crisis (GFC) was 13.7% during the first half of 2010.

Auto loan delinquencies have been slowly grinding higher over the past five years and now stand at 5.0% of total balances. That's just below the record high of 5.3% during Q4-2010. Student loan delinquencies have dropped sharply to 7.0% from north of 10% last year; borrowers have been allowed to pause those payments without interest accruing since March and can continue to do so through year-end.

One area of concern is commercial mortgages: Loans outstanding for commercial mortgages have climbed far more sharply since the GFC than loans outstanding for residential mortgages (*Fig. 3*). In addition, vacancies in certain real estate sectors are creeping up and rents are falling. The apartment vacancy rate rose to 5.0% in Q3, the highest since Q1 2012, the office vacancy rate edged higher to 17.4%, the highest since Q3 2011, and the retail vacancy rate increased to 10.4%, the highest since Q4 2013, according to data from Reis in an October 6 Calculated Risk report. So far, however, commercial real estate loan delinquencies have ticked up only to 0.9% in Q2, from a low of 0.7% during Q2-2019 (*Fig. 4*).

(2) *Good news: Reserves are up.* Banks have been setting aside funds to deal with the loan losses that are sure to mount. The allowance for loan and lease losses at all commercial banks has surged higher, to $219.7 billion during the September 23 week, a level last seen during the GFC (*Fig. 5*). Large banks have been more aggressive, with their allowance rising to $142.3 billion, up from $68.8 billion at the start of the year. Small banks have increased their allowance only to $75.3 billion, up from $42.9 billion on January 1.

(3) *Hope in the squiggles.* Earnings for banks and brokerages are going to be ugly this year; but after falling like a knife into negative territory, 2020 earnings forecasts have stopped sinking. Estimates for next year are expected to bounce for the S&P 500 Diversified Banks and Investment Banking & Brokerage industries but continue to fall for the S&P 500 Regional Banks industry. Here's a closer look.

The S&P 500 Diversified Banks stock price index has fallen 37.0% ytd through Tuesday's close, making it the worst-performing industry in the Financials sector (*Fig. 6*). Yet the industry's forward earnings bottomed in late April and have resumed an upward trajectory (*Fig. 7*). The industry's 2020 earnings are now expected to fall 56.6% in 2020, an estimate that has remained relatively steady over the past five months, and earnings are expected to jump 64.0% in 2021, an estimate that has come down from its peak of 85.3% in late April (*Fig. 8*).

The picture isn't quite as rosy for the S&P 500 Regional Banks industry, though it too has enjoyed an upward hook in forward earnings (*Fig. 9*). Regional Banks' 2020 earnings forecasts now stand at a 26.3% drop, which is an improvement over the 48.5% decline that was expected back on June 18. However, the 2021 earnings growth estimate has fallen from 52.0% on April 30 to the current 1.4% drop (*Fig. 10*). The S&P 500 Regional Banks stock price index remains down 28.3% ytd.

The S&P 500 Investment Banking and Brokerage industry's forward operating earnings also have improved since late April (*Fig. 11*). Earnings growth expectations for 2020 in this industry have been trimmed in recent months to a 21.0% decline, while 2021 forecasts have seesawed from 27.9% in late April down to 6.4% in early September before rebounding to 18.3% since then (*Fig. 12*). The S&P 500 Investment Banking and Brokerage stock price index is down only 12.5% ytd.

Epidemiology: A Closer Look at Sweden's Experiment. Last spring, Sweden went rogue. It kept its economy open even as most countries shut down their economies as Covid-19 turned into a pandemic. The country aimed to balance the risk of the virus with the damage of closing schools and businesses.

Swedish schools have remained open for children 16 and under. Restaurants and businesses have continued to operate. The country did ban gatherings of more than 50 people; it also closed museums and canceled sporting events. Citizens were urged to keep socially distant, work from home when possible, and wash their hands frequently. In March, visits to nursing homes were prohibited. But mask-wearing was not—and still is not—required. Here's a look at how the country has fared in the months since choosing this course of action:

(1) *Death rate spikes, then plateaus.* When the number of total deaths in the country quickly spiked past 4,000 in May and 5,000 in June, derision from many quarters quickly followed. But

in the subsequent weeks, the new deaths slowed and the curve flattened. As October begins, the total number of deaths remains below 6,000, according to statistics from Worldometer.

Sweden's Covid-19 death rate, once among the worst compared to other developing nations, now looks much better than many. Sweden has experienced 582 deaths per 1 million citizens. That's below the levels of Italy (596), the UK (624), the US (649), Spain (685), and Belgium (869). But it is still north of levels in Norway (51), Finland (62), Denmark (114), and the Netherlands (378).

After Sweden's death rate peaked in April and May—when the number of daily new deaths bounced between 80 and 115—it fell sharply over the summer. Now daily new deaths in Sweden can be counted on one hand. That's vastly better than the levels experienced in the US on October 5: (697), Spain (261), UK (76), France (66), Italy (28), Netherlands (21), Germany (19). But it's on par with Denmark (4), Finland (0), and Norway (0).

(2) *A new wave of cases arrives.* But as Yogi Berra famously said: "It ain't over 'til it's over." And the Covid-19 pandemic is not over. There's a new surge of cases in Europe from which Sweden hasn't escaped. New Covid cases in Sweden regularly topped 1,000 a day in June before falling to 200-300 for the remainder of the summer. The recent uptick has pushed new cases up to 600-700 a day in September and October. The most recent datapoints, for October 5, included 343 new cases, and the seven-day moving average of new cases dipped to 515, from 522 on October 3.

Here are some daily new case counts in other countries: US (31,223), UK (14,542) Spain (12,793), France (10,489), Netherlands (4,528), Germany (2,462), Switzerland (700), Denmark (322), Finland (227), and Norway (65).

With the wisdom of hindsight, Sweden has enacted a few more restrictions, and its European neighbors have not completely shut down their economies in the face of this new wave of Covid-19 cases. Sweden now recommends that "anyone experiencing cold-like symptoms such as a sore throat is encouraged to stay at home and get tested," an October 6 *WSJ* article reported. In addition, "all members of a household should isolate for a week if one of them becomes infected." As we said, so far Sweden's death rate hasn't spiked, and hopefully it won't.

(3) *Covid invades nursing homes.* There are a number of theories about why Sweden's death rate spiked last spring. About 42% of Sweden's deaths occurred in Stockholm, which has a large subway system that may have made the transmission of the disease easier, speculates an August 29 article on The American Institute for Economic Research website. Also, the city's citizens take a winter break from February 24 to March 1 and often go skiing in the Alps, where they may have caught Covid-19 from Italians, whose nation was starting to feel the brunt of the pandemic. Also, Sweden had a very mild flu season the previous year with an abnormally low death rate, perhaps sparing more vulnerable folks than usual, who then fell prey to Covid-19 this year.

Covid hit Sweden's nursing homes hardest. About half of the country's Covid-19 deaths were among nursing home residents, with some homes reporting that a quarter of its residents died from the disease. In Sweden, 22% of the deceased were in their 70s, 41% in their 80s, and 25% in their 90s, according to May 2020 data presented in a July 19 article that appeared on the Public Health Emergency COVID-19 Initiative website.

"I think the problem lies more with the structure of care homes," Leif Dotevall, a communicable disease control officer in Sweden said in a June 22 *FT* article. The article concluded: "Many Swedish care homes are too large and disconnected from the reset of the healthcare system while workers are often badly paid, poorly qualified and on hourly contracts." There are lingering questions about whether nursing home employees came to work sick and whether sick residents weren't sent to hospital when they should have been.

As cases surged and hospitals in Stockholm grew crowded, "[a] March directive to Stockholm area hospitals stated patients older than 80 or with a body mass index above 40 should not be admitted to intensive care, because they were less likely to recover. Most nursing homes were not equipped to administer oxygen, so many residents instead received morphine to alleviate their suffering," an October 6 *Science Magazine* article reported. The piece describes a group of scientists in Sweden that disagrees with the country's handling of the pandemic and favors more stringent separation of the sick and mask-wearing. Sweden has responded to the high nursing home mortality rate by boosting funding for elderly care by about $500 million in its 2021 budget, a September 15 Reuters article reported.

(4) *Sweden's less bad GDP drop.* Keeping Sweden's businesses open did not save the country from an economic downturn, but it did limit the damage. The country's Q2 GDP fell a record 7.7% y/y, less than most other developed countries' Q2 GDPs dropped: UK (-21.5%),

Spain (-21.5), France (-18.9), Italy (-18.0), Eurozone (-14.7), Germany (-11.3), Japan (-10.1), Netherlands (-9.4), US (-9.0), Denmark (-7.7), Finland (-6.4), and Norway (-4.7) (*Fig. 13* and *Fig. 14*).

Disruptive Technologies: Currencies Going Digital. The US, Europe, and China each is studying digitizing its national currency. They are not alone. Eighty percent of 66 central banks surveyed in May by the Bank of International Settlements (BIS) said they were working on a central bank digital currency (CBDC), a September 25 PYMNTS article reported.

The race to do so has only accelerated in the wake of Covid-19, which pushed consumers to make purchases online in an effort to remain out of stores and safe at home. A Fed survey taken in May found that consumers were keeping more cash on hand, but they were also buying more items online. "[A]bout 20 percent of respondents switched to paying online or over the phone for items from restaurants and big-box stores, and nearly two-thirds reported that they had made no in-person payments during the first several weeks of the pandemic," said Cleveland Fed President Loretta Mester in a September 23 speech.

Looks like the world's central bankers are playing a game of catchup. Here's a quick update on digital currency progress being made in the US, China, and EU:

(1) *Testing the digital yuan.* The People's Bank of China (PBOC) appears to be the furthest ahead in developing a digital currency. It has been experimenting with a digital yuan, which has been used in 3.13 million transactions valued at more than 1.1 billion yuan ($162 million), an October 5 *South China Morning Post* article reported. The digital yuan has been used in 6,700 situations, including paying bills, paying for transportation, and paying for government services.

"The PBOC regards digital renminbi as an important financial infrastructure for the future," said a PBOC official quoted in the article. China already has the largest market globally for mobile payments, with its citizens using the digital wallets provided by Alipay and WeChat Pay. A digital currency would give the country the "ability trace and track economic activity in real-time"—to say nothing of tracing and tracking what individuals are buying and selling.

(2) *Digital dollar being studied.* As part of its efforts to study the potential for a digital currency, the US central bank has been testing distributed ledger platforms to understand their benefits and trade-offs, said Cleveland Fed President Mester in her September speech. In addition, the

Boston Fed has been working with MIT to experiment with technologies that could be used for a CBDC. And finally, the Federal Reserve Bank of New York has an innovation center with the BIS to identify and understand trends in financial technology.

“Legislation has proposed that each American have an account at the Fed in which digital dollars could be deposited, as liabilities of the Federal Reserve Banks, which could be used for emergency payments,” Mester said. “Other proposals would create a new payments instrument, digital cash, which would be just like the physical currency issued by central banks today, but in a digital form and, potentially, without the anonymity of physical currency.”

A digital currency might allow the Federal Reserve to make emergency payments to individuals’ digital wallets directly without the help of banks. Before deciding on a digital currency, the Fed needs to better understand how digital currency would affect financial stability, market structure, security, privacy, and monetary policy, Mester said.

(3) *The digital euro being studied too.* The European Central Bank (ECB) is considering launching a digital euro development program by mid-2021, according to an October ECB report. A digital euro would provide “citizens with access to a safe form of money in the fast-changing digital world” and provide fast and efficient cross-border payments.

The digital currency should be like cash: easy for all to use, free of charge, and a protector of privacy. The ECB doesn’t want the digital euro to become an instrument of speculation, like cryptocurrencies, and it would be introduced in addition to cash, not instead of it. The digital euro must be accessible, robust, safe efficient, and private, the report states. The ECB will study the potential effects on central bank policies and the effect on bank deposit funding.

CALENDARS

US: **Thurs:** Initial & Continuous Jobless Claims 820k/11.4m, EIA Natural Gas Storage, Barkin, Kaplan. **Fri:** Wholesale Inventories 0.5%, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** Japan Household Spending -6.9% y/y, Caixin C-PMI & NM-PMI, ECB Monetary Policy Meeting Accounts, BOE FPC Statement, Mersch. **Fri:** UK GDP 4.6%m/m/8.2%3m/3m/-7.5%y/y, UK Headline & Manufacturing Industrial Production -5.9%/-4.6% y/y, UK Goods Trade Balance - £8.6b, France Industrial Production, Italy Industrial Production 1.3%, Canada Employment Change & Unemployment Rate 156.6k, 9.7%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) this week posted its fifth decline in as many weeks, slipping to 2.35, after climbing 20 of the previous 23 weeks from 0.72 (lowest since March 2018) during the March 24 week to 3.75 (highest since January 2018) five weeks ago. Bullish sentiment climbed for the second week, to 54.6% this week, following a three-week slide of 10.0ppts (to 51.5% from 61.5%). Bearish sentiment continued to climb, up 7.0ppts (to 23.2% from 16.2%) the past four weeks, to its highest percentage since the week of June 2. The correction count declined for the second week, to 22.2%, after climbing from 22.1% during the September 1 week to 29.1% during the September 22 week. The AAII Ratio continued its recent up-and-down pattern, rising to 37.9% last week after falling from 44.2% to 35.1% the previous week. Bullish sentiment rose to 26.2% after falling from 32.0% to 24.9% the prior week, while bearish sentiment fell to 43.1% after rising from 40.4% to 46.0% over the comparable periods.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The rapid pace of Covid-19 estimate cuts has turned into a V-shaped recovery as analysts play catch-up from their lowball estimates prior to the better-than-expected Q2 earnings season. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. They mostly edged lower during the latest week, though. Forward revenues surged 0.9% w/w for its biggest rise in 13 weeks to its highest level since early April and is now just 3.7% below its record high in mid-February. Forward earnings was up 1.7% w/w to its highest level since early April and is now 11.1% below its record high in early March. Forward revenues growth surged 1.0ppt w/w to a 21-month high of 6.2%. Forward revenues growth is just 0.1ppt below its seven-year high of 6.3% in February 2018, but is up from 0.2% in April, which was the lowest reading since June 2009. However, forward earnings growth roared 3.8ppts higher to a 10-year high of 17.7%. Forward earnings growth is up 23.3ppts from its record low of -5.6% at the end of April. Analysts still expect revenues to decline 4.1% y/y in 2020 and rise 8.1% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 19.3% y/y in 2020 and a 26.1% gain in 2021 compared to a 1.4% rise in 2019. The forward profit margin jumped 0.2ppt w/w to a six-month high of 11.1%. That’s up 0.8ppt from 10.3% during April and May, which was the lowest level since August 2013. It’s still down 1.3ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.8ppt y/y in 2020 to 9.7%—from 11.5% in 2019—and to improve 1.6ppt y/y to 11.3% in

2021. Valuations rose for the first time in four weeks. The S&P 500's weekly forward P/E rose 0.4pt w/w to 21.3 from a 19-week low of 20.9. That compares to 23.1 in early September, which was the highest level since July 2000 and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio gained 0.07pt w/w to 2.36 from an 11-week low of 2.40. That's down from a record high of 2.53 at the beginning of September and up from the 49-month low of 1.65 in mid-March.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise w/w for all 11 S&P 500 sectors. Forward earnings also rose broadly w/w for all sectors except Real Estate. Due to the sharp decrease in forward earnings this year, forward P/E ratios for nearly all sectors now are back above their recent record or cyclical highs prior to the bear market. Tech and Utilities are the only sectors now expected to have improved profit margins in 2020, whereas back in early March eight sectors were expected to see margins improve y/y. During 2019, just two sectors' margins improved y/y: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since 2018, it has moved lower for nearly all the sectors. In the latest week, the forward profit margin moved higher for eight sectors, was unchanged for Tech and Utilities, and dropped again for Real Estate. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, down from 23.0%), Financials (14.5, down from 19.2), Utilities (14.2, record high), Communication Services (13.8, down from 15.4), Real Estate (13.3, down from 17.0), S&P 500 (11.1, down from 12.4), Health Care (10.6, down from 11.2), Materials (10.0, down from 11.6), Industrials (8.4, down from its record high of 10.5% in mid-December), Consumer Staples (7.4, down from 7.7), Consumer Discretionary (6.2, down from 8.3), and Energy (2.4, down from 8.0).

S&P 500 Sectors Forward Revenues and Earnings Recovery from Covid-19 Trough (*link*): The S&P 500's forward revenues and earnings, as well as its implied forward profit margin, bottomed at cyclical lows on May 28 after 14 weeks of Covid-19 declines. Since then, S&P 500 forward revenues has risen 4.7%, forward earnings has gained 12.9%, and the forward profit margin has risen 0.8pt to 10.9%. The latest week was a gangbuster as the S&P 500 and all 11 sectors mostly posted, across-the-board, new highs in their forward revenues, earnings, and profit margin. The exceptions: Consumer Discretionary and Energy's revenues, and Real Estate's forward earnings and profit margin. Real Estate's margin fell to an eight-year low in the latest week. Here's how the sectors rank by their changes in forward revenues and forward earnings since May 28: Consumer Discretionary (forward revenues up 6.5%, forward earnings up 40.0%), Information Technology (6.1, 8.0), Industrials (6.2, 20.8), Financials (5.7, 13.3), Communication Services (5.5, 8.6), Materials (5.1, 18.7), S&P 500 (4.7, 12.9), Health Care (3.7, 9.7), Energy (2.7, 333.7), Consumer Staples (2.2, 5.2), Real Estate (0.4, -6.1), and Utilities (-1.8, 0.8).

MSCI Countries & Regions Forward Revenues and Earnings Recovery from Covid-19 Trough (*link*): The forward revenues and earnings for the MSCI World ex-US index appears to have bottomed at cyclical lows on July 30 after 23 weeks of Covid-19 declines. Since then, the MSCI World ex-US forward revenues has risen 1.5%, forward earnings has gained 5.9%, and the forward profit margin has risen 0.2ppt to 7.1%. Looking at the revenue and earnings for the MSCI regions, all but EM Latin America's revenues has risen since then. Here's how the regions rank by their forward revenues changes and forward earnings changes since July 30: EM Asia (forward revenues up 4.3%, forward earnings up 6.3%), Emerging Markets (2.9, 6.5), United States (2.8, 3.4), All Country World (2.4, 6.7), World ex-US (1.5, 5.9), EMU (0.6, 7.3), EAFE (0.5, 4.9), Europe (0.1, 5.6), and EM Latin America (-2.8, 12.6).

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production (*link*): The rebound in industrial output stalled in August, after rebounding sharply during the three months through July, though the continued upswing in manufacturing orders during August is encouraging. Germany's headline production (which includes construction) slipped 0.2% after a 19.0% rebound the prior three months—boosted by record monthly gains of 9.3% in June and 7.4% in May. Manufacturing output dipped 0.7%, following a three-month surge of 26.0%, and is 12.1% below pre-pandemic levels; production had plunged a combined record 29.8% during March and April. Excluding construction, production also dipped 0.2% after a three-month 24.5% rebound. Here's a snapshot of movements in the main industrial groupings since April, and where they stand relative to their pre-pandemic levels: capital goods (49.0% & -16.4%), consumer durable goods (39.0 & -0.8), intermediate goods (12.1 & -10.3), and consumer nondurable goods (5.3 & -9.0). Both consumer durable and intermediate goods production continued their rebounds in August, while capital and consumer nondurable goods output dipped a bit.

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