MORNING BRIEFING
October 29, 2020

Trick or Treat?

Check out the accompanying chart collection.

(1) Markets get spooked. (2) Panic Attack #67 started on September 3 and should end on November 3. (3) Election uncertainty and spiking Covid-19 cases haunt the markets. (4) Markets rotate to risk off and Tech stocks stumble. (5) Next year should bring new fiscal stimulus and easier earnings comparisons. (6) Scientists trying to use Crispr to cure cancer. (7) Bayer is the latest big pharma company to buy into Crispr. (8) PPP loans affect some banks' financials, but only temporarily.

Strategy: Panic Attack #67 Isn't Over. Halloween, which falls on Saturday this year, dates back to the Celtic festival of Samhain, according to History.com. The night before their new year began on November 1, the Celts believed the ghosts of the dead returned to earth. They would build huge bonfires, where people wearing costumes burned crops and animals as sacrifices to the gods.

Investors have been easily spooked since the S&P 500 peaked at a record high of 3580.84 on September 2 (*Fig. 1*). It dropped 9.6% through September 23, finding support at the level at the start of this year. It then rebounded but failed to make a new high. After yesterday's rout, it is down 8.7% from the September 2 peak and ready to test the September 23 low. We characterized September's selloff as Panic Attack #67, mostly attributable to the market's overvaluation and triggered by jitters about the coming election (*Fig. 2*). It has continued into October. (See our *Table of S&P 500 Panic Attacks Since 2009*.)

The question is will it end once we know who will be in the White House? We should know that by the end of November 3. The market's recent selloff may reflect jitters about a contested election. In recent weeks, investment strategists, including yours truly, have argued that the market should move higher no matter who wins. The common notion was that another round of fiscal stimulus will be delivered under either Trump or Biden. There might be even more government spending under Biden, which should offset some of the negative consequences of more taxes under him.

However, the latest wave of the pandemic may be raising concerns that Biden would be more likely to reimpose severe lockdown restrictions if so advised by his health experts than would Trump. The resurgence of Covid cases is leading to renewed business restrictions in Europe. France is returning to full lockdown mode, with residents allowed to leave their homes only for school, to buy essentials, seek medical attention, or exercise. Italy is closing restaurants and

bars at 6 pm for a month. Germany is closing bars, restaurants, gyms, discos, theatres, and concert venues for four weeks. And Sweden, which eschewed restrictions during the first Covid wave, is expected to invoke restrictions similar to its neighbors next week.

Here's a look at the market's recent price action and what analysts are expecting for earnings growth in the first half of 2021.

(1) *Utilities beat out Tech.* You know the market gods want human sacrifices when the widely owned Technology sector gets hit, while the Utilities sector shines. Here's the performance derby for the S&P 500 sectors from September 2 through yesterday's close: Utilities (4.5%), Industrials (-6.1), Consumer Staples (-6.3), Health Care (-6.3), Materials (-6.5), Consumer Discretionary (-6.7), Financials (-7.2), Real Estate (-8.3), S&P 500 (-8.7), Communications Services (-10.6), Information Technology (-12.2), and Energy (-20.3) (*Fig.3*).

That's vastly different than the action that has propelled the S&P 500 by 60% from March 23 through September 2: Information Technology (80.2%), Consumer Discretionary (79.8), Materials (72.1), Industrials (63.4), S&P 500 (60.0), Communication Services (56.7), Health Care (46.2), Energy (45.3), Real Estate (44.5), Financials (44.0), Consumer Staples (36.7), and Utilities (34.1).

(2) *2021 comparisons: So much easier.* The only good thing about a recession is that a year later earnings comparisons so are much easier. The virus-induced recession of this spring torpedoed earnings, but it means that 2021 is setting up for a year of earnings growth, thanks in part to much easier comparisons.

While S&P 500 earnings started to tumble in Q1-2020, the biggest earnings decline occurred in Q2. Here's a look this year's miserable quarterly earnings declines for the S&P 500, with Q3 and Q4 representing estimates from Refintiv: Q1: -12.8%, Q2: -30.6%, Q3: -16.7% and Q4: -12.4%.

Starting in the first quarter next year analysts are optimistic that earnings growth for the S&P 500 will resume. Here are the 2021 quarterly forecasts: Q1: 14.2%, Q2: 44.4%, Q3: 23.3%, Q4: 23.6%.

Estimates going out more than six months are notoriously suspect, but the forecasts in the first half of the year should be right directionally if nothing else. Add the quarters together and 2020 earnings appear on a path to fall 18.1%, only to rebound by 24.5% next year (*Fig.4*).

(3) *Most sectors' earnings improve too.* By Q1-2021, earnings growth for all of the S&P 500 sectors—except Energy and Real Estate—turn positive. And by Q2-2021 even those laggard sectors post positive earnings growth, according to analysts' estimates.

Here is the performance derby for the S&P 500 sectors' Q1-2021 estimated earnings growth: Consumer Discretionary (73.4%), Financials (43.0), Materials (25.6), S&P 500 (14.2), Health

Care (12.6), Information Technology (10.8), Communication Services (6.7), Utilities (3.4), Industrials (0.9), Consumer Staples (0.6), Real Estate (-2.0), and Energy (-59.1). It's a welcome change to see some of the more cyclical sectors earnings doing well, with Materials, Industrials, and Financials posting stronger earnings growth than Technology and Communication Services.

Financials Q1-2021 earnings estimates have improved sharply since October 1 when the industry began reporting Q3 results. Q1-2021 estimates for the Financials sector have improved from 26.5% on October 1 to 43.0% now. The earnings growth estimate for the Materials sector also improved nicely, by 4.8ppts since October 1.

With the easiest comparisons, Q2-2021 earnings growth is the strongest of any quarter next year. Here's the performance derby for the S&P 500 sectors' earnings forecasts for Q2-2021: Industrials (419.1%), Consumer Discretionary (186.7), Energy (152.1), Financials (55.7), Materials (52.7), S&P 500 (44.4), Communication Services (29.5), Real Estate (13.4), Information Technology (13.0), Consumer Staples (9.7), Health Care (6.7), and Utilities (2.8).

Estimates for the Financials sector also improved nicely for Q2-2021, as they only stood at 47.4% on October 1 and they're now 55.7%. Estimates for Q3 and Q4 of 2020 have also improved since the start of the month. On October 1, Financials was supposed to see earnings growth fall by 21.6% in Q3-2020 and fall 22.1% in Q4-2020. The sector is still expected to see earnings fall, but by much less: -3.7% in Q3-2020 and -10.3% in Q4-2020. With nearly two-thirds of the Financials sector's results in for Q3, 86% of companies have exceeded analysts' expectations and only 14% have disappointed.

Other sectors haven't had as many members report as Financials. But primarily thanks to the improvement in the Financials sector's earnings estimates, the entire S&P 500's earnings estimate has improved. It now stands at a 16.7% decline in earnings for Q3, up from the 21.4% decline expected back on October 1.

Disruptive Technologies: Gene Therapy Evolution Continues. Among the most exciting advancements in science are occurring in the development of gene therapies. Two recent developments caught our eye. First, Crispr technology is now being tested in the treatment of cancer and second Bayer announced this week its acquisition of gene therapy pioneer Asklepios BioPharmaceuticals. Here are some of the details.

(1) *Crispr targets cancer.* Researchers at Madrid's National Center for Cancer Research used Crispr technology to correct mutations in cancer cells in mice to slow or stop the growth of those cancer cells, the folks at ARK Investment Management reported in this week's newsletter.

Spontaneous gene mutations in cancer cells drive tumor growth. The scientists in Madrid focused on gene fusions, "when two genes, often from different chromosomes, collide inside a

cancer cell. Fusions create highly dangerous proteins, called chimeras, that drive tumor growth," the ARK explained.

Scientists used RNAs to bind to the mutated cancer genes in mice and delete the fusion. Fusions only occur in cancer cells, so this therapy would not affect healthy cells. And it allows cancer cells essentially to repair themselves.

Tumors in the mice that were treated with the Crispr technology were smaller than the tumors in the untreated mice. In addition, the treated mice lived longer, according to the study, which appeared in Nature Communications on October 8. Results were even more positive when Crispr technology was combined with chemotherapy.

(2) *Big pharma buys in.* Bayer became the latest large pharmaceutical company to purchase a gene therapy company. It will pay $2 billion to purchase Asklepios BioPharmaceuticals and up to an additional $2 billion if milestones are met.

Known as AskBio, the company is conducting trials of gene therapies to treat Pompe disease, Parkinson's, and congestive heart failure. And, according to its website, the company is also in preclinical trials for treatments of Angelman Syndrome, Huntington's disease, and Methylmalonic acidemia.

AskBio has sold two gene therapy subsidiaries in the past. Bamboo Therapeutics, which focused on Duchenne muscular dystrophy, was sold to Pfizer in 2016 for $645 million and Chatham Therapeutics, focused on genetic solutions for hemophilia, was sold to Baxter International for an initial $70 million in 2014.

Financials: The ABCs of PPP Loans. US banks provided $525.0 billion of loans under the Paycheck Protection Program (PPP) overseen by the Small Business Administration. The impact on the financials of large money center banks, like JPMorgan, was modest and few details were given. Asset management, capital markets, and huge loan books made the impact of even large volumes of PPP loans barely material.

The impact on smaller banks is more notable, however. Zion Bancorporation did an admirable job of disclosing just how PPP loans affect the bank's financials. Zion, like most large banks, is donating any profits from the loans to charity. The PPP loans do boost the bank's loan growth, a fact that the bank clearly points out. And the impact of the loans will be temporary. The loans will be forgiven by the government or they'll mature in five years. Here's a look at some of the details.

(1) *Big banks yawn.* JPM made $28 billion of PPP loans by the end of Q2. While seemingly large, the PPP loans represent just 2.9% of the banks $978.5 billion Q2 total loan book. Its Q2 quarterly filing states that the "impact on interest income was 'not material'" and because the loans are guaranteed by the government, the bank doesn't hold regulatory capital against them.

PPP loans have a 1% interest rate and the processing fees are deferred and accreted into interest income over the life of the loans, JPM reported. But expenses will offset much of that income.

“We don’t intend to profit from PPP,” said Jennifer Piepszak, chief financial officer in the company’s Q2 conference call. “[Y]ou’ll have some revenue and then you’ll have expenses, and the profit will be near zero. It is an immaterial amount this quarter, given these fees are recognized over the lives of the loans. …[W]e’ll see more of that probably in the third and fourth quarter. Again, they — it will still be zero on the bottom line.”

(2) *Zion offers up details.* Zion’s was the ninth largest PPP originator, an outsized market share given it’s the nation’s 37th largest financial institution. As of Q3 the bank made $6.8 billion of PPP loans.

PPP loans meant the bank’s loan book grew. Zion’s Q3 net loans and leases were $54.7 billion, up $5.9 billion, or 12%, including PPP loans. If the PPP loans are excluded, loans fell by $0.9 billion.

Like many other banks, Zion is contributing profits from the loans to charity. In Q3, the bank made a one-time $30 million contribution to the bank’s charitable foundation, related to the origination fees earned on the PPP loans. The donation was deemed a noninterest expense and it lifted the bank’s adjusted noninterest expense to $440 million in Q3, up from $415 million in Q3 2019. If the donation is backed out, noninterest expense was down 1% y/y.

The PPP loans brought down the yield on Zion’s loan portfolio. The yield on average interest earning assets was 3.2%, down 21bps q/q and down 95bps y/y. It was dragged down by the yield on PPP loans, 3.03%, compared to the non-PPP loan portfolio, 3.77%.

The yield on PPP loans will fall even further this quarter because the PPP loans’ maturity dates were extended to five years and in October the Small Business Administration began the PPP loan forgiveness process. In its Q3 conference call, Zion CFO Paul Burdiss noted that after extensions, the yield on the PPP loans falls to about 1.7% or less. As loans mature or are forgiven, fees attached to the PPP loans, which would have been amortized over the life of the loans, accelerate into net interest income. The bank has received an application for or granted forgiveness on about 25% of its PPP loans.

The bank incurred expenses related to the PPP program. It paid out $3 million of PPP-related bonuses and spent $3 million on advertising expenses in its effort to retain new PPP lending clients.

The PPP loans improve the bank’s credit statistics. The loans are guaranteed by the federal government and banks aren’t holding regulatory capital against them. With the PPP loans, the ratio of total allowance for credit losses to loans and leases outstanding was 1.68%, but

without the PPP loans that ratio deteriorates slightly to 1.91%. Conversely, it hurt the bank's efficiency ratio, which was 62.2% in Q3, up from 57.3% in Q3 2019. Without the PPP-related charitable contribution, the efficiency ratio would have been 58.0%.

CALENDARS

US: Thurs: Real GDP 31.0%, GDP Price Index & Core PCED 2.8%/4.0%, Initial & Continuing Claims 775k/7.7m, Pending Home Sales 3.5%, EIA Natural Gas Storage. **Fri:** Personal Income & Spending 0.4%/1.0%, Core PCED 0.2%m/m/1.7%y/y, Consumer Sentiment 81.2, Employment Cost Index 0.5%, Chicago PMI 58, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Economic Sentiment 89.6, Germany Unemployment Change & Unemployment Rate -5k/6.3%, Japan Unemployment Rate 3.1%, Japan Industrial Production 3.2%, ECB Rate Decision & Deposit Facility Rate 0.0%/-0.5%, European Council Video Conference. **Fri:** Eurozone GDP Flash 9.4%q/q/-7.0%y/y, Eurozone Headline & Core CPI -0.3%/0.2% y/y, Eurozone Unemployment Rate 8.3%, Germany GDP Flash 7.3%q/q/-5.3%y/y, Italy GDP Flash 11.2q/q/-8.7y/y, Italy Unemployment Rate 10.1%, Spain GDP Flash 13.5%q/q/-12.2%y/y, Canada GDP 0.9% m/m, China NBS M-PMI 51.3, Guindos, Mersch, Weidmann. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) this week rose for the third week, climbing to 3.00 after sliding from 3.75 (highest since January 2018) to 2.35 the prior five weeks. Bullish sentiment has increased 9.1ppts (to 60.6% from 51.5%) the past five weeks—its highest reading the final week of August (61.5%). Bearish sentiment fell for the third week to 20.2% this week, after climbing the prior four weeks from 16.2% to 23.2%—which was the highest percentage since the June 2 week. The correction count fell for the fourth time in five weeks by 9.9ppts (to 19.2% from 29.1%)—the lowest since September 2018. The AAII Ratio advanced for the fourth week last week from 35.1% to 52.0%over the period, as bullish sentiment rose from 24.9% to 35.8% and bearish sentiment fell from 46.0% to 33.0% over the four-week period.

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 continue to 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. Forward revenues is at its highest level since early April and is now just 3.6% below its record high in mid-February. Forward earnings is also at its highest level since early April and is now 10.7% below its record high in early March. Forward revenues growth remained steady at a 21-month high of 6.2%. That's 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. Forward earnings growth of 16.7% was unchanged w/w, but is down from a 10-year high of 17.7% in early October. Forward earnings growth is up 22.3ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 3.9% y/y in 2020 and rise 8.0% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 18.1% y/y in 2020 and a 24.5% gain in 2021 compared to a 1.5% rise in 2019. The forward profit margin was unchanged at 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 1.7ppt y/y in 2020 to 9.8%—from 11.5% in 2019—and to improve 1.5ppt y/y to 11.3% in 2021. Valuations dropped for the first time in three weeks from six-week highs. The S&P 500's weekly forward P/E fell 0.4pt w/w to 21.7. 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 lost 0.04pt w/w to 2.41. 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 and earnings rise w/w for eight of the 11 S&P 500 sectors. Energy and Real Estate had both measures decline w/w. 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. Utilities is now the only sector expected to have an improved profit margin 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 three sectors and fell 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 (14.9, down from 19.2), Utilities (14.3, record high), Communication Services (13.8, down from 15.4), Real Estate (13.1, down from 17.0), S&P 500 (11.1, down from 12.4), Health Care (10.6, down from 11.2), Materials (10.2, down from 11.6), Industrials

(8.2, 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 (2.3, 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 4.8%, forward earnings has gained 13.4%, and the forward profit margin has risen 0.8pt to 11.1%. Eight of the 11 sectors posted new highs last week in either their forward revenues, earnings, or profit margin. Energy's forward revenues remains near a 15-year low, and its forward earnings and profit margin are recovering now from their record lows during April. Real Estate's forward earnings have worsened to a six-year low and its profit margin is at an eight-year low. Materials moved up in the rankings last week. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Consumer Discretionary (forward revenues up 7.0%, forward earnings up 41.9%), Information Technology (6.5, 8.1), Financials (5.9, 16.6), Materials (5.9, 21.9), Industrials (5.9, 18.2), Communication Services (5.7, 8.9), S&P 500 (4.8, 13.4), Health Care (3.9, 9.9), Consumer Staples (2.5, 5.9), Energy (0.9, 301.2), Real Estate (-0.1, -8.1), and Utilities (-1.8, 0.9).

S&P 500 Q3 Earnings Season Monitor (*link*): With over 38% of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a whopping 3.0%, and earnings have crushed estimates by 16.9%. The large surprises are primarily due to a lack of financial guidance from the companies that analysts follow. At the same point during the Q2 season, revenues were 3.0% above forecast and earnings beat by 13.5%. For the 191 companies that have reported through mid-day Wednesday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise have improved from their Q2 measures. The current sample of Q3 reporters so far has a y/y revenue decline of 2.7%, and earnings are down 9.9%; those results mark a huge recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. Over 84% of companies are reporting a positive earnings surprise, and 82% have beaten their revenues forecast. Slightly fewer companies are reporting positive y/y earnings growth in Q3 (51%) than are reporting positive y/y revenue growth (52%). Taking a look at the shares outstanding tallied so far, companies have put the brakes on share buybacks. Basic shares outstanding are up 0.2% q/q and down just 0.2% y/y. At the same point during the Q2 season, the share count was up 0.2% q/q and down 1.6% y/y. The Q3-2020 figures are subject to change markedly as more results are reported in the coming weeks, but we expect y/y revenue

and earnings growth results to remain negative. Now more than ever, what companies say about the state of their business and their plans to ride out the Covid-19 crisis will be investors' main focus. With more companies providing guidance about their future financial periods, the revenue and earnings surprises should become smaller in future reporting periods.

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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