Yardeni Research

MORNING BRIEFING
January 14, 2021

Financials on the Move

The next *Morning Briefing* will be on Tuesday, January 19.

Check out the accompanying chart collection.

(1) Optimism rising about Financials earnings. (2) Steeper yield curve and booming markets kick 2021 off right. (3) Bank buybacks look ready to resume. (4) Loan loss reserves low with government help. (5) Beware fintech competition and higher taxes and regulations from Democrats. (6) Technology lets us do just about everything from the couch. (7) Keeping an eye on software as a service, artificial intelligence, and quantum computers. (8) Elon is our hero. (9) Robots on the rise and medical miracles.

Financials: Looking Ahead. The S&P 500 Financials sector is starting 2021 on an optimistic note. After just seven trading sessions in this new year, the sector is up 6.2% through Tuesday, and the shares of both JP Morgan and Goldman Sachs hit new all-time highs that day. Concerns about loan losses have been replaced by enthusiasm about a steeper yield curve and a roaring stock market. Were that not enough, the Federal Reserve will allow the banks to start buying back stock and increase dividends, activities the Fed halted last year.

Here's the performance derby for the S&P 500 sectors ytd through Tuesday's close: Energy (15.0%), Materials (7.1), Financials (6.2), Consumer Discretionary (3.2), Health Care (2.8), Industrials (2.1), S&P 500 (1.2), Information Technology (-0.9), Utilities (-2.1), Consumer Staples (-2.2), Communication Services (-3.5), and Real Estate (-4.1) (*Fig. 1*). That's quite a turnabout from 2020, when Financials was the third worst-performing sector, falling 4.1% for the year.

The Financial sector's Q4 earnings season kicks off tomorrow with BlackRock and First Republic Bank reporting, followed by JP Morgan, Citigroup, Wells Fargo, and PNC Financial Services divulging their results on Friday. Let's take a gander at what investors will be watching:

(1) *Yield curve should help.* With the Democrats in control of the White House and Congress, expectations are high that spending to boost the economy will rise even beyond the hearty

levels spent by President Donald Trump and the Republican-led Senate. The 10-year US Treasury bond yield backed up to 1.15% as of Tuesday's close, up 63 bps from its August 4 record low. Meanwhile, the federal funds rate has remained near zero. As a result, the spread between the two instruments has widened to 94 bps during the January 8 week. That's up 149 bps since the week of March 6, 2020, during a period when the yield curve was inverted (*Fig. 2* and *Fig. 3*).

Investors undoubtedly hope that a steepening yield curve will help improve banks' net interest margin (NIM) and net interest income (NII). Banks' NIM declined in Q3 to 2.68%, down 68 bps y/y (*Fig. 4*). It is the lowest NIM and the largest y/y basis-point decline reported in the FDIC's Quarterly Banking Profile since the start of the data. NII also declined in Q3, but not as sharply as NIM. NII fell 7.2% in Q3 y/y to $128.7 billion (*Fig. 5*). The backup in the bond yield may have come too late to help Q4 results, but if it holds it should help results going forward.

(2) *Booming markets should boost bottom lines.* With the stock market near all-time highs, the IPO (initial public offerings) market is on fire, and mergers and acquisitions finished the second half of 2020 at a pace that exceeded year-earlier levels. All of that should help the large money center banks and brokers, which profit from trading and capital market business.

US equity issuance was at an all-time high as some companies sold stock in 2020 to raise liquidity to survive the Covid-19 economy. Meanwhile, other companies pounced on an opportune time to go public given the strong IPO market. The 12-month sum of US corporate equity issuance was $314.6 billion in November, up 92% y/y (*Fig. 6*).

In Q4 alone, $57.5 billion was raised in US IPOs, up nearly tenfold from $5.9 billion in Q4-2019, according to Dealogic data in the *WSJ*. Many of the offerings were from SPACs, or special purpose acquisition corporations, raising money in hopes of buying a company that offers investors good returns. Expect the deals to keep coming, as IPO performance has been stellar. The Renaissance Capital IPO index is up 108.3% y/y through Tuesday's close.

Investment-grade and high-yield debt underwriting was also active in 2020, and M&A activity was down for full-year 2020 but up in the final two quarters, with deals valued at $602 billion announced in Q4, up from $348 billion of deals in Q4-2019. Add that to a 16.3% climb in the S&P 500, and it's no wonder Goldman Sachs shares hit a record high on Tuesday and Morgan Stanley shares are back to levels last seen in 2007.

(3) *Let the buybacks resume.* The banks got an early holiday gift in December when the Federal Reserve loosened the restrictions it placed on bank dividends and share repurchases in June. The restrictions were meant to ensure that the banks had adequate capital while Covid-19 hurt the economy. After the last round of stress tests, the Fed decided that banks could do stock "buybacks as long as the aggregate amount of the repurchases and dividends don't exceed the average of the net income for the four [preceding] quarters," a December 18 MarketWatch article reported. Which banks will be allowed to make repurchases will be determined after Q4 earnings are reported.

While dividends paid by companies in the S&P 500 Financials sector remained steady at $69.7 billion in the trailing four quarters ending Q4, buybacks fell to $117.3 billion in the trailing four quarters ending Q3, down from $182.5 billion during the four quarters ending Q1 (*Fig. 7*). So presumably, most banks will be able to restart their stock repurchase programs this year.

(4) *Keeping an eye on loan losses, fintechs, and Dems.* During the week of May 6, 2020, commercial and industrial (C&I) loans spiked 32% y/y as the Covid-19 shutdown prompted companies to tap their bank lines and increase cash on hand. As the panic subsided, bank lending slowed but remains strong, with C&I loans jumping 11% y/y as of December 30 (*Fig. 8*).

Investors were pleasantly surprised by the sharp drop in loan loss reserves in Q3 compared to the major spike in reserves taken in Q2 as Covid-19 shut down the economy (*Fig. 9*). With the US government continuing to financially support both unemployed individuals and affected businesses, banks shouldn't see another spike in provisions in Q4. It's likely that the Democrat-controlled government will keep the financial support flowing and loan losses relatively low—or at least that seems to be what investors are counting on.

Investors should also keep an eye on the number of new fintech companies cropping up. They seem to be targeting almost every area of banking and finance, including consumer lending, payments, and trading. Large corporate commercial and investment banking may be safe, but startup tech companies have a habit of starting small and climbing up the value chain.

And lastly, Democrat control of the White House and Congress could lead to banks paying higher taxes and facing more regulatory headaches. President-elect Joe Biden has said he would seek to revive and strengthen the Consumer Financial Protection Bureau, an organization created by Senator Elizabeth Warren (D-MA). Biden has supported offering banking services through post offices to reach lower-income people and creating a public credit-reporting agency.

Warren, a member of the Senate Banking Committee, has long been a thorn in the side of banks, pushing for increased banking regulation and more disclosure. She has pushed for companies to suspend stock repurchases if they received federal aid and in July urged the Federal Reserve to suspend bank dividends and disclose more information on how the Fed measures the ability of banks to weather a crisis. In 2019, Warren proposed a bill that asked the Securities and Exchange Commission to require public companies to annually disclose risks posed by climate change and information about their greenhouse gas emissions and fossil-fuel assets.

Senator Sherrod Brown (D-OH) will be the ranking member of the Senate Banking Committee after January 20, and his priorities for the committee differ markedly from those of his Republican predecessor: “This committee in the past has been about Wall Street. As chair, I’m going to make it about workers and their families and what matters to their lives,” Brown said in a January 12 CNBC article. “Under Senate Republicans, we’ve had government intervention to put its thumb on the scale for corporations at every turn.” He said he thought many banks don’t hold enough capital, despite the fact that they passed the Fed’s stress tests during an economy tried by Covid-19.

(5) *Earnings forecasts mostly improving.* Loan growth, strong capital markets, a steeper yield curve, and the absence of large loan loss reserves could boost earnings in 2021 compared to last year for many industries in the S&P 500 Financials sector. The S&P 500 Diversified Banks’ annual revenues are forecast to drop 3.6% in 2021 after falling 4.1% last year, and earnings are expected to jump 40.8% this year after plummeting 45.7% in 2020 (*Fig. 10* and *Fig. 11*).

A mixed pattern is also expected for the S&P 500 Regional Banks. That industry is forecast to have revenue 0.2% higher this year after it rose 11.0% in 2020 (*Fig. 12*). But earnings are expected to fall 2.2% this year compared to last year’s 13.7% drop (*Fig. 13*).

Analysts also expect mixed results from the S&P 500 Investment Banking & Brokerage industry, with revenue dropping 0.6% and earnings improving 5.8% in 2021 compared to the 12.0% revenue gain and 0.1% earnings decline experienced in 2020 (*Fig. 14* and *Fig. 15*).

Earnings have been revised upward sharply by analysts covering the S&P 500 Investment Banking & Brokerage industry, with the net earnings revisions index at 43.0% in December, 38.3% in November and 30.8% in October (*Fig. 16*). Analysts have also been growing more bullish about the Regional Banks, with the net earnings revisions index at 36.6% in December, 30.3% in November, and 13.3% in October (*Fig. 17*). There's been less optimism about the Diversified Banks, and therein may be the opportunity for contrarians, with the net earnings revisions index at 10.8% in December, 3.5% in November, and -0.4% in October (*Fig. 18*).

Disruptive Technologies: Connecting the Dots. The Consumer Electronics Show is always fun to watch, as it provides a glimpse into how we will work and live in the future. Each week, we try to highlight the latest marvels in technology and medicine. The start of 2021 seemed an apt time to look at how many of these technologies are interconnected. We've grouped them in four big buckets: digitalization, medical miracles, evolving energy, and robots on the rise. Let's take a look both at what we uncovered over the past year and what we look forward to following in the year ahead:

(1) *Behold the power of digitalization.* Never did we appreciate the advent of the Internet and cloud computing more than when Covid-19 closed down the economy. Only then was it apparent that so much of what we do could get done online. Working, shopping, and banking were all done with the click of a mouse. Want dinner? Use the iPhone to order in. Want entertainment? Stream *The Queen's Gambit* on Netflix. Need to keep the teens entertained? Let them play video games with their friends virtually on Xbox. Miss your relatives and friends? Schedule a Zoom call.

In this brave new world, you never even need to get off the couch. The Internet of Things has connected our iPhones to the oven, dishwasher, thermostat, outdoor sprinklers, and stereo system. The pervasiveness of digitalization has made semiconductors as important as steel, oil, and concrete in eras gone by.

The pace of change should continue to race ahead as software becomes imbedded with artificial intelligence, helping it make us more productive than ever before. And while it's unlikely we'll have quantum computers on our desks, the ability to tap into their power in the cloud may unleash a wave of scientific innovation, particularly in pharmaceutical development.

(2) *The evolution of energy.* Elon Musk did more than just create the first commercially successful electric cars. He unleashed the imagination—and entrepreneurial spirit—of

hundreds of scientists looking for a better way to move us from point A to point B. Over the next year, many new electric car models will be introduced, some from upstarts like Nio and Lucid and some from industry giants like General Motors and Ford.

But it's early innings in the move away from gasoline-powered cars. Scientists are still working to make better batteries using materials that can replace cobalt, are cheaper, and easier to source. Separately, the potential to use hydrogen to power cars, trucks, ships, and trains is gaining attention, too. And hyperloops and their use of magnets—also a Musk brainchild—also seem filled with possibility to move us faster and farther than ever before without generating carbon dioxide.

Solar panels harnessing the sun have always seemed to make the most sense to us. Solar panels on every roof could generate some portion of the electricity each household uses. More attractive solar panels from Musk combined with more powerful batteries just might make this a reality in the years to come. This week at CES, the Sion, a minivan with solar panels embedded into each of its car panels, is being showcased. The car only has a range of about 160 miles, but its solar cells will get it an additional 10 miles a day, a January 11 article in InsideEVs reported.

President-elect Biden is widely expected to make developing green energy a priority by doling out research funds and tax breaks. If society does go green, it could sharply reduce demand for oil in years to come.

(3) *Robots on the rise.* Robots are coming in many shapes and sizes these days. Some are in the factory doing increasingly delicate work and making production more efficient and accurate. Others can be found in the fields, planting seeds with remarkable accuracy, or picking strawberries without causing a bruise. Drones are nothing more than flying robots that companies hope will bring a takeout order to your doorstep. And autonomous cars are driving robots, some of which are on the streets of San Francisco and Phoenix today without a human behind the wheel.

CES is renowned for its displays of new robots, most of which never go mainstream; but they do spark the imagination. This year, there are robots that disinfect, companion robots that eliminate the need for imaginary friends, and home robots to empty the dishwasher and pour a glass of wine, a January 11 CNET article reported.

Robots are growing ever smarter thanks to advances in artificial intelligence and computing power. Going forward, it will be just as important to watch what new tricks robots can perform as it is to keep an eye on their impacts on corporate profitability and on the unemployment rolls.

(4) *Medical miracles.* Thank goodness for scientists. Those who developed Covid-19 vaccines in a matter of months and not years will forever deserve our gratitude. We wrote about Pfizer's and Moderna's novel use of genetic sequencing and messenger RNA to create vaccines that are being rolled out across the country now.

Scientists are also using gene therapies to cure cancer and other illnesses. By snipping out bad genes and pasting in good ones, scientists using CRISPR technology are finding cures for the previously uncurable. Most recently, researchers showed that CRISPR could be used to eliminate simian immunodeficiency virus in monkeys. That virus is often used as a model for HIV in humans. So it's hoped that the same technique can be used to cure HIV in humans, a January 4 article in Managed Healthcare Executive reported.

CRISPR technology could mean we all live healthier, longer lives than ever expected.

CALENDARS

US: Thurs: Initial Claims 780k, Import & Export Prices 0.6%/0.5%, EIA Natural Gas Storage, Powell, Kaplan, Bostic. **Fri:** Retail Sales Total and Ex Autos 0.0%/-0.1%, Consumer Sentiment Index Preliminary 80.0, Headline & Manufacturing Industrial Production 0.4%/0.6%, Capacity Utilization 73.5%, Business Inventories 0.5%, Empire State Manufacturing Index 6, Headline & Core PPI 0.8%/1.4% y/y, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Germany Full Year GDP Growth (2020) -5.1%, China FDI, ECB Monetary Policy Meeting Accounts. **Fri:** Eurozone Balance of Trade €26b, France CPI 0.0%y/y, UK GDP -5.7%m/m/3.4%3m/3m/-12.1%y/y, Headline & Manufacturing Industrial Production -4.2%/-4.8% y/y, UK Balance of Trade, Enria. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) this week rose for the first time since the week of December 22, to 3.81 from 3.44 last week; it's been above 3.00 since the week of November 10. Bullish sentiment rebounded to 63.7% from 60.2% last week, ending a streak of declines from their 2020 high of 64.7% at the end of November. Meanwhile, bearish sentiment fell to 16.7% this week after rising from 16.8% to 17.5% last week, placing it only 0.5ppt above the 2.5-year low of 16.2% posted during the September 8 week. The correction count this week sank to 19.6% from 22.3% last week; in late November, the percentage was at 18.2%—which was the lowest since December 2006. The AAII Ratio climbed to 67.0% last week after falling from 66.5% to 63.2% during the final week of 2020. Bullish sentiment rose for the third week last week from 43.4% to 54.0% over the period, while bearish sentiment dipped to 26.6% after increasing from 22.0% to 26.8% the previous week.

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 and Q3 earnings seasons. Consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues is now at its highest level since early March and is just 2.1% below its record high in mid-February. Forward earnings is at its highest level since mid-March and is now 5.5% below its record high in early March. Forward revenues growth edged down 0.1ppt w/w to 8.0% from the highest reading since April 2011. That's up from 0.2% in April, which was the lowest reading since June 2009. Forward earnings growth was down 0.3ppt w/w to 22.3% from its highest level since July 2010, but has risen 27.9ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 3.0% y/y in 2020 and rise 8.1% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 15.3% y/y in 2020 and a 23.2% gain in 2021 compared to a 1.5% rise in 2019. The forward profit margin rose 0.2pts w/w to 11.6%; that's the highest reading since mid-March and up 1.3ppts from 10.3% during April, which was the lowest level since August 2013. It's still down 0.8ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.5ppt y/y in 2020 to 10.0%—from 11.5% in 2019—and to improve 1.4ppt y/y to 11.4% in 2021. Valuations dropped for a fourth straight week from six-week highs in mid-October. The S&P 500's weekly forward P/E fell 0.3pt w/w to 22.4, which compares to a six-month low of 20.6 at the end of October. 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 ticked down less than 0.01pt w/w from its record high of 2.59. That compares to its prior record high of 2.53 at the beginning of September and is 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 all 11 S&P 500 sectors. Energy, Financials, and Industrials had both measures rise markedly this week. 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. During 2019, just two sectors' margins improved y/y: Financials and Utilities. Tech and Utilities are the only sectors expected to have an improved profit margin in 2020, whereas back in early March eight sectors were expected to see margins improve y/y. All but Real Estate are expected to improve during 2021. 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. The forward profit margin rose for all but Consumer Staples in the latest week. Real Estate has been improving in recent weeks from its lowest level since January 2012 and Energy from its record low. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.5%, down from 23.0%), Financials (16.0, down from 19.2), Utilities (14.4, a new record high), Communication Services (14.1, down from 15.4), Real Estate (12.8, down from 17.0), S&P 500 (11.6, down from 12.4), Health Care (10.8, down from 11.2), Materials (10.9, down from 11.6), Industrials (8.8, down from its record high of 10.5% in mid-December), Consumer Staples (7.5, down from 7.7), Consumer Discretionary (6.7, down from 8.3), and Energy (3.3, 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-related declines. Since then, S&P 500 forward revenues has risen 6.4%, forward earnings has gained 20.0%, and the forward profit margin has risen 1.4pt to 11.6%. Among the 11 sectors, all but Real Estate posted new post-Covid-19 highs during the latest week in either their forward revenues, earnings, or profit margin. The major laggards from their pre-Covid-19 highs: Energy, Financials, Industrials, and Real Estate. Among those four sectors, all but Real Estate appear to be on an upswing now. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Communication Services (forward revenues up 10.4%, forward earnings up 16.2%), Information Technology (10.1, 14.1), Materials (9.1, 34.4), Industrials (9.0, 31.3), Financials (8.3, 28.6), Health Care (6.4, 14.7), S&P 500 (6.4, 20.0), Consumer Staples (4.1, 9.4), Energy (3.2, 488.8), Real Estate (0.5, -9.5), Utilities (-1.0, 2.6), and Consumer Discretionary (-0.3, 42.2). Tesla's addition to the S&P 500 on 12/21 caused revenue and earnings forecasts to fall for the index and the Consumer Discretionary sector. Before then, S&P 500 revenues were up 7.1% and earnings 19.6%. The similar readings for

Consumer Discretionary then were 11.2% and 39.7%, which would have ranked the sector first in the revenues derby instead of last.

US ECONOMIC INDICATORS

CPI (*link*): December's core CPI ticked up 0.1% in December after rising 0.2% in November and holding steady in October; it had rebounded 1.4% over the four months through September after Covid-19 had caused record declines in apparel (-8.8%) and transportation services (-10.0) prices during the three months ending May. Monthly gains in the CPI have slowed four of the five months since posting a 0.6% increase in July—which the biggest monthly gain since 1991. The core CPI rose 1.3% (saar) during the three months through December, slowing from August's 5.0%, which was the highest since March 1991. The yearly rate remained at 1.6% again in December after accelerating from a nine-year low of 1.2% y/y in May and June to 1.7% in August and holding at that rate through September. Here's a ranking of the 12-month core rates on a December-over-December basis, from lowest to highest, for goods: apparel (-3.9% y/y), medical care commodities (-2.5), new vehicles (2.0), alcoholic beverages (2.8), tobacco & smoking products (5.1), and used cars & trucks (10.0). Yearly rates are on accelerating trends for alcoholic beverages, new vehicles, and used cars and trucks, though the latter is looking toppy. Prices of used cars & trucks contracted 10.0% (saar) during the three months through December after accelerating a whopping 60.3% during the three months through September. The yearly decline in apparel prices is slowing, as these prices rose 2.3% the final two months of 2020. Here's the same drill for the core services rates: airfares (-18.4% y/y), motor vehicle insurance (-4.8), physicians' services (1.7), owners' equivalent rent (2.2), motor vehicle maintenance & repair (3.4), rent of primary residence (2.3), and hospital services (3.0). The shelter components remain on steep decelerating trends, while the yearly percent change in medical services shows a moderate slowing in price gains; the yearly decline in airfares is narrowing. The headline CPI rate climbed back to September's 1.4% in December from 1.2% in both November and October. It had accelerated steadily from 0.1% (lowest since mid-2015) in May through September.

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