MORNING BRIEFING
April 22, 2021

Banks and DApps

Check out the accompanying chart collection.

(1) Crosscurrents in banking. (2) Banks' deposits are up, and borrowing is down. (3) Companies don't need bank loans. (4) Banks holding lots of Treasuries and cash. (5) Net interest margins feeling the squeeze. (6) Released reserves save the day. (7) Introducing dApps. (8) Bitcoin may dominate payments, but Ethereum dominates dApps. (9) Keeping an eye on the Binance Smart Chain.

Financials: Regionals Drowning in Cash. Despite a recovering economy, it must be an unsettling time to be a banker. Deposits are plentiful, but bankers aren't sure for how long. The economy is growing, but loan demand is minimal and banks' net interest margins are squeezed. Nonetheless, bank earnings look great because reserves are being released since the financial Armageddon that was widely expected at this time last year never materialized. Stock investors, however, generally don't give banks credit for one-time reserve releases.

Earlier this week, Zion Bancorporation and M&T Bank, two regional banks, reported Q1 earnings. Let's take a look at what they had to say about these trends:

(1) *Drowning in cash.* Most of us would love to have lots of extra cash lying around. Not so for bankers. Excess cash with nowhere to go only drags down returns. Total deposits at all commercial banks have jumped to $16.8 trillion, up $2.5 trillion and 17.5% y/y (*Fig. 1* and *Fig. 2*).

Deposits are a great source of relatively inexpensive funding. A surplus of deposits means that banks don't have to turn to the capital markets for funding. Commercial banks' borrowings have fallen by 22% y/y as of April 7 (*Fig. 3*). In fact, collectively banks' borrowings as a percentage of their total liabilities is lower today than it has been for the past two decades (*Fig. 4*).

(2) *Companies don't need bank loans.* Extra deposits normally would be used to fund new loans. The problem today is that demand for new loans is soggy at best. When Covid-19 first

struck in 2020, companies quickly tapped their revolving loans to ensure that they'd have enough liquidity to last during the shutdowns. Many companies didn't need that funding or replaced it with funding from the capital markets. While commercial and industrial (C&I) loans surged from $2.3 trillion outstanding at the start of 2020 to a record high of $3.1 trillion by early May, the amount of C&I loans outstanding subsequently has fallen back to $2.6 trillion (*Fig. 5* and *Fig. 6*).

Excluding Paycheck Protection Program (PPP) loans backed by the government, Zion's commercial loans and leases fell 7% y/y to $24.5 billion, and its consumer loans fell 11% y/y to $10.5 billion. At M&T, commercial loans increased by 6% including PPP loans but only 3% excluding them. M&T's Jones expects companies to hold onto more cash than they had in the past. But as supply chains return to normal, corporate borrowing should pick up to fund inventories.

"I think there's a little bit of crowding out, if you will, of the government providing funds, such that our customers don't need as much credit, which makes us sort of a little less confident on economic activity translating [into] loan growth as it has … in the past," said Zion's CFO Paul Burdiss on the call.

(3) *What to do with the cash?* Some banks have increased their investments in Treasury and agency securities, and they're holding onto much more cash. Banks are holding $4.0 trillion of US Treasury and agency securities, up $826 billion, or 26%, y/y, though off slightly from peak levels (*Fig. 7*). US Treasury and agency securities make up 26% of banks' total credit, the highest percentage in the past 20 years and up from 21% a year ago (*Fig. 8*).

Banks are also holding a lot more cash: $3.8 trillion compared to $1.7 trillion at the start of 2020 (*Fig. 9*). M&T's holdings of investment securities has fallen by 26% to $6.6 billion over the past year. M&T's Jones explained that while the bank did nibble when yields rose to the 1.7% area, it hasn't been a significant buyer of Treasuries because current prices "don't make much sense from a long-term perspective" and the bank is focused on "risk-adjusted returns."

Zion's Burdiss noted in the bank's Q1 conference call transcript on April 19 that the bank was unsure just how long the deposits would remain at the bank. As a result, the bank was exercising "extra caution and will likely hold more in money market investment than we would at times of greater certainty." In other words, the bank isn't investing all of its new funds from deposits into securities or other investments.

(4) *Reserve releases save the day.* The dramatic fall in interest rates over the past year has pressured banks' net interest margins. At year-end, the collective net interest margin at all FDIC-insured banks fell to 2.68% (*Fig. 10*). Zion's Q1 net interest margin fell to 2.86% from 3.41% in Q1-2020, and M&T's dropped to 2.97% from 3.65% a year earlier.

Fortunately, the massive loan losses expected at the beginning of the Great Virus Crisis didn't materialize. As a result, banks have been releasing some of the reserves they set aside early in 2020 (*Fig. 11*). Zion released reserves totaling $132 million last quarter. Just one year earlier, the bank was increasing its provision for credit losses by $258 million. M&T released $25 million credit reserves in Q1-2021, compared to building its credit provisions by $250 million in Q1-2020.

M&T's Jones said on the company's conference call that "the improving economic outlook leaves us cautiously optimistic as to the ongoing effects of the pandemic compared with the greater levels of uncertainty in prior quarters." The bank assumes that unemployment will fall to 4.2% by the end of 2022 and that GDP will grow at a 6.2% annual rate this year.

(5) Both Zion and M&T are members of the S&P 500 Regional Banks stock price index, which has risen as of Tuesday's close by 19.9% ytd and 80.8% y/y (*Fig. 12*). That certainly tops the S&P 500's 10.1% ytd gain and 46.5% y/y return. Analysts are calling for the regional banks to grow revenue by 3.4% this year and 5.7% in 2022 (*Fig. 13*). The industry's earnings are forecast to grow even faster: by 12.6% this year and 7.4% in 2022 (*Fig. 14*). Though the industry's forward P/E at 14.0 is low relative to that of the broader market, it's close to the highs the industry has enjoyed over the past 25 years (*Fig. 15*).

Disruptive Technologies: It's All About the dApps. Bitcoin and other cryptocurrencies certainly have captured investors' imagination and dollars. Bitcoin is up 94% ytd after hitting new highs earlier this month when it broke through $60,000 (*Fig. 16*). But it's not alone. By some accounts, more than 7,000 cryptocurrencies exist.

How can investors figure out which cryptocurrencies will thrive? One way may be by looking at which are the most actively used in commerce. Bitcoin has had mixed news on this front of late. Turkey banned the use of bitcoin and other cryptocurrencies for payments starting at the end of April. The Central Bank of the Republic of Turkey said it acted because there is a lack of "supervision mechanisms" and a lack of "central authority regulation" for crypto assets, which can be excessively volatile, stolen, and used unlawfully, an April 16 MarketWatch article reported.

Conversely, more and more US companies are jumping on the bitcoin bandwagon. Customers can use bitcoin to buy a Tesla, pay for WeWork space, buy a Dallas Mavericks' ticket, or subscribe to *Time* magazine. PayPal's Venmo lets users buy, hold, and sell bitcoin, ether, litecoin, and bitcoin cash. Square customers can use its Cash App to buy or sell bitcoin. And all this is helping to raise our awareness of bitcoin as well as widen its use.

But in the developer community, dApps—short for "distributed applications"—may determine which cryptocurrencies gain in popularity. DApps are like apps, but they are run on a decentralized platform instead of on one platform.

There are 3,511 dApps, and more are created every day, though that pace has slowed from the frenzy seen in 2018 and 2019, according to data from State of the dApps. By far, most of the dApps—2,782—are on the Ethereum platform with 88,120 active daily users. The EOS platform only has 328 dApps, but its dApps have more daily transactions: 410,901 versus Ethereum's 243,140.

Ethereum describes itself as the "programmable blockchain." It invites developers to use its technology to develop dApps, just like developers would develop apps for Apple devices for Microsoft Office. The cryptocurrency used on the Ethereum network is ethereum, which has also had quite a year, rising 214% ytd (*Fig. 17*). While the dApps can use other cryptocurrencies, we'd guess that the more dApps developed on the Ethereum platform, the more popular and accepted ethereum the cryptocurrency will become.

There are all manner of dApps. There are financial dApps, though they are called "decentralized finance apps"—or "DeFi" apps—because they use blockchain technology. Some offer lending, borrowing, and trading of cryptocurrencies. There dApps for payments, crowdfunding, insurance, and investment management. There are dApps for music, artwork, and digital collectables, like Cryptokitties. And there are dApps for games and technology.

The benefit of a dApp is that it is less susceptible to hacks and data leaks because its information is decentralized. Most of the applications we use on our phones and computers are centralized apps, controlled by one party and vulnerable to hacks. Miners and node operators on the Ethereum network can earn ethereum's token, ether. "Ether acts as 'fuel' for applications on the decentralized network. If a user on the Ethereum network wants to change a decentralized application or initiate an action, they must pay a small amount of Ether to 'gas' the transaction. This gives Ether an inherent value to everyone using decentralized applications on the Ethereum network," a primer on Benzinga explains.

DApp developers can make money the same way developers in the non-crypto world make money. They can run advertisements on their app. They can offer free basic services and then charge for the more premium offerings. If the dApp involves transactions, they might charge a fee that's a percentage of the transaction amount or a subscription fee.

But before assuming Ethereum will reign supreme, consider the Binance Smart Chain. "Just six months after its launch, the Binance Smart Chain (BSC) is the flavour of the month in the crypto space. The pitch of a cheap, fast and nearly identical version of the Ethereum DeFi experience has both developers and users excited," explained a March 24 article on Brave New Coin. "User numbers have shot from 35 unique addresses at the end of its first day of operations to over 60 million active users by March 21st. Transactions per day on the network have grown from 122 on day one to 2.53 million on March 21st."

The article notes that developers of dApps on Ethereum are creating the equivalent dApps on Binance. However, critics say that Binance has a more centralized system, which contradicts the entire point of using a blockchain-based system. The pros and cons of the systems are relatively complex, as is the entire ecosystem of cryptocurrencies, coins, tokens, and dApps. In fact, it makes the dollar's simplicity seem ingenious.

CALENDARS

US: Thurs: Leading Indicators 1.0%, Initial & Continuous Jobless Claims 617k/3.667m, Existing Home Sales 6,19m, Kansas Fed Manufacturing Index Chicago Fed National Activity, EIA Natural Gas Inventories. **Fri:** M-PMI & NM-PMI Flash Estimates 60.9/61.9, New Home Sales 886k, Baker-Hughes Rig Count. (DailyFX estimates)

Global: Thurs: Eurozone Consumer Confidence Flash -10.8, Eurozone Government Budget to GDP, France Business Confidence 99, ECB Interest Rate Decision & Deposit Facility Rate 0.0%/-0.5%, UK Gfk Consumer Confidence -12, Japan Core CPI -0.1% y/y, Buch. **Fri:** Eurozone, Germany, and France C-PMI Flash Estimates 52.8/56.8/48.8, Eurozone, Germany, and France M-PMI Flash Estimates 62.0/65.8/59.0, Eurozone, Germany, and France NM-PMI

Flash Estimates 49.1/50.8/46.5, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 58.2/59.0/59.0, UK Retail Sales Headline & Ex Fuel 3.5%/4.5% y/y, Lagarde, Wuermeling. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) moved further above 3.00 this week, as bullish sentiment moved further above 60.0%. The BBR climbed for the sixth week to 3.81 this week, after dropping the prior three weeks from 3.27 to 2.48—which was the lowest since early April. Bullish sentiment rebounded for the third week to 63.7% this week—equaling their peak rate shown during the first week of January and near its cyclical peak of 64.7% during late November 2020. It had retreated from 57.4% to 54.4% four weeks ago. Most of the three-week move up in bullish sentiment came from the correction camp, as its percentage sank 8.5ppts over the period to 19.6% after jumping from 23.8% to 28.1% four weeks ago. That 28.1% nearly equaled early March's 28.4% reading, which was the highest since mid-September 2020. Bearish sentiment inched down to 16.7% this week from 16.8% last week; it had dropped 3.9ppts (to 16.7% from 20.6%) the prior four weeks, with the current percentage just above their mid-January low of 16.5%. The AAII Ratio fell to 68.6% last week after climbing from 66.4% to 73.6% the previous week, as bullish sentiment fell from 56.9% to 53.8% and bearish sentiment rose from 20.4% to 24.6%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose to 12.3% this week. That's its highest level since December 2018. Forward revenues and earnings have been making new record highs since the beginning of March and for the first time since February 2020. The rapid pace of Covid-19 estimate cuts during the first half of 2020 has turned into a V-shaped recovery as analysts play catch-up from their lowball estimates prior to the better-than-expected earnings seasons since Q2-2020. Consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.1ppt w/w to 8.7%, down from a record high of 9.0% in mid-February. Forward revenues growth has come a long way from the 0.2% to which it had dropped in April 2020, which was the lowest reading since June 2009. Forward earnings growth gained 0.2ppts w/w to 22.3%. It had been at 22.8% at the end of January, its highest level since July 2010 and up substantially from its record low of -5.6% at the end of April. Analysts continue to boost their 2021 growth forecasts. They now expect revenues to rise 9.9% in 2021 and 6.7% in 2022 compared to the 2.2% decline reported in 2020. They expect an earnings gain of 28.8% in 2021 and 14.3% in 2022 compared to a 13.3% decline in 2020.

The forward profit margin of 12.3% is up 2.0ppts from 10.3% during April, which was the lowest level since August 2013. It's just 0.1ppt from the record high of 12.4% in September 2018. Analysts expect the profit margin to rise 1.7ppt y/y in 2021 to 11.9%—from 10.2% in 2020—and to improve 0.9ppt y/y to 12.8% in 2022. Valuations rose strongly last week. The S&P 500's weekly forward P/E was up less than 0.1pt w/w to 22.3 and compares to a 17-week low of 21.3 at the beginning of March. That also 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 0.03pt w/w to a new record high of 2.75, which compares to its 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise w/w for ten of the 11 S&P 500 sectors and forward earnings increase for seven sectors. Forward P/E ratios for nearly all sectors now are back above their record or cyclical highs prior to the Covid-19 bear market. During 2019, just two sectors' margins improved y/y: Financials and Utilities. Consumer Staples, Tech, and Utilities were the only sectors with an improved profit margin in 2020. For 2021, all but Real Estate and Utilities are expected to improve y/y. Back in 2018, the forward profit margin was at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Now, only three sectors are at record highs: Materials, Tech, and Utilities. The forward profit margin rose for four of the 11 sectors last week: Consumer Discretionary, Energy, Financials, and Materials. Real Estate's has been improving since December's lowest level since January 2012, and Energy's is up from its record low in April 2020. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (23.6%, a new record high), Financials (18.4, down from 19.2), Communication Services (14.8, down from 15.4), Utilities (14.8, record high), Real Estate (13.9, down from 17.0), S&P 500 (12.2, down from 12.4), Materials (11.8, record high), Health Care (10.9, down from 11.2), Industrials (9.0, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, down from 7.7), Consumer Discretionary (7.0, down from 8.3), and Energy (5.8, 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. Forward revenues and earnings have risen 10.3% and 32.3%, respectively, since then to new record highs. The forward profit margin has risen 2.1pt to a 28-month high of 12.2%. During the latest week, all 11 sectors posted gains in either their forward revenues, earnings, or profit margin. Energy, Financials, and Materials have been particularly strong in recent weeks and have moved up in the forward revenues performance leaderboard. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Materials (forward revenues up 15.7%, forward earnings up 54.9%), Information Technology (14.9, 24.4), Communication Services (14.7, 27.1), Energy (12.5, 1030.2), Industrials (12.1, 37.7), Financials (11.9, 52.6), S&P 500 (10.3, 32.3), Health Care (9.8, 19.4), Consumer Staples (5.4, 12.2), Consumer Discretionary (4.0, 54.5), Real Estate (3.2, 0.9), and Utilities (-2.3, 4.1).

S&P 500 Q1 Earnings Season Monitor (*link*): With over 13% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by a well-above-trend 2.9%, and earnings have crushed estimates by 25.4% in large part due to loan loss reversals at the banks. At the same point during the Q4 season, revenues were 2.8% above forecast and earnings beat by 22.8%. The S&P 500's Q1 earnings surprise excluding Financials drops to 9.9% from 25.4%. For the 67 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 Q4 measures. The small sample of Q1 reporters so far has a y/y revenue gain of 6.8% and an earnings gain of 71.9%, which drops to 6.4% y/y when Financials are excluded. A whopping 87% of the Q1 reporters so far has reported a positive earnings surprise, and 81% has beaten revenues forecasts. Slightly more companies have reported positive y/y earnings growth in Q1 (76%) than positive y/y revenue growth (72%). These figures will change markedly as more Q1-2021 results are reported in the coming weeks, particularly the y/y earnings growth rate.

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