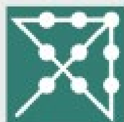
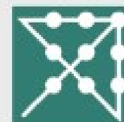
 Yardeni Research 

MORNING BRIEFING
March 31, 2022

Financials, Defense & Fusion

Check out the accompanying chart collection.

Executive Summary: Today, Jackie takes a timely look at prospects for the S&P 500 Investment Banking & Brokerage industry. If the buoyant reception investors gave to Jefferies' challenged but better-than-expected Q1 results is a bellwether, the industry may be poised to reverse its sector-lagging streak. … Also: A look at how the fiscal 2023 defense budget may take shape as it winds its way through Congress. … And: Fusion holds immense promise for producing carbon-free energy—if scientists can clear a big hurdle. They're making progress.

Financials: Looking Up? If Jefferies Financial Group's stock is any indication, the selloff in bank and brokerage stocks may have run its course. The company's earnings for the quarter ending February 28 were down sharply y/y, but the poor results were expected. The shares, which had fallen almost 25% since early November 3, have rallied almost 4% since earnings were reported Monday after the market close.

The S&P 500 Financials sector has performed better than Jefferies, thanks primarily to insurance-related industries in the sector. Here's how some of the industries in the S&P 500 Financials sector have performed ytd through Tuesday's close: Reinsurance (10.5%), Consumer Finance (3.4), Insurance Brokers (2.7), Financials sector (1.1), Regional Banks (-0.2), Investment Banking & Brokerage (-2.5), Diversified Banks (-4.3), Financial Exchanges & Data (-7.6), and Asset Management & Custody Banks (-10.3) (*Fig. 1*).

Despite the lagging banks and brokers, the Financials sector has been one of the S&P 500's top-performing sectors so far this year. Here's the performance derby for the S&P 500 and its 11 sectors ytd through Tuesday's close: Energy (38.0%), Utilities (3.3), Financials (1.1), Industrials (-1.0), Materials (-1.2), Consumer Staples (-1.4), Health Care (-2.0), S&P 500 (-2.8), Real Estate (-5.2), Information Technology (-5.8), Consumer Discretionary (-6.0), and Communication Services (-9.8) (*Fig. 2*).

There's much to like about banks and brokers. Most don't have direct exposure to Russia's economy. They don't have supply chains that are in tangles nor do they have to pay for oil. Their stocks haven't soared like tech stocks, so they don't have sky-high valuations. And if inflation becomes a problem, they should benefit as long as long-term interest rates rise faster than their short-term cost of funds.

Here's a look at what Jefferies reported and a roundup of some important banking metrics:

(1) *Waiting for the calm.* Stock offerings don't often get done in volatile markets, and this year isn't an exception. Only $52.0 billion of global IPOs were underwritten in Q1, roughly a quarter of the $207.7 billion underwritten in Q1-2021, according to WSJ *data* provided by Dealogic. The secondary stock offering picture is similar, with $67.8 billion underwritten in Q1, less than half of the $194.8 billion underwritten in Q1-2021 (*Fig. 3*). Global debt issuance has dropped 27.1% ytd to $1.9 trillion, and global mergers and acquisitions have fallen 30% in Q1 y/y to $977.2 billion.

Wall Street's sharp slowdown this year resulted in a 30.4% drop in Jefferies' Q1 revenue to $1.7 billion and a 51.0% decline in income before taxes to $392.3 million. Here's how Q1 revenue did y/y in a number of Jefferies' business lines: advisory (up 74.6% to $543.8 million), debt underwriting (24.2% to $245.2 million), equity and fixed-income capital markets (-46.3% to $479.8 million), and equities underwriting (-68.5% to $156.1 million).

Jeffries' March 28 *press release* explained that net revenues in the equities business were hurt by market volatility and global instability, net revenues in the fixed-income business were depressed by lower trading volumes amid inflation concerns and interest-rate uncertainty, and net revenues in the (much smaller) asset management business were reduced by lower investment returns and lower revenues from strategic affiliates than a year ago.

Despite the dour results, Jefferies's Q1 revenues beat the analysts' consensus by 8.5%, and its earnings per share of $1.23 beat analysts' $0.92 estimate, a March *article* by Zack's Equity Research stated. The beat sent the shares off to the races.

Looking forward, the IPO calendar remains extremely light, according to Renaissance Capital. IPO volume may not return to last year's peak anytime soon because it was inflated by IPOs of special purpose acquisition corporations (SPACs). Many SPACs since have fallen sharply, casting doubt on that type of offering.

But a number of large issues are waiting in the wings for the markets to settle down. Renaissance notes that future offerings may come from Bausch & Lomb, Mattress Firm, Turo, a car-sharing platform, and Aleph Group, a digital ad firm. The S&P 500 volatility index dropped to 18.9 on Tuesday from a recent high of 36.5 on March 7 (*Fig. 4*). If the calm continues, we'd expect to see equity offerings pick up again.

Jefferies is too small to be in the S&P 500 Investment Banking & Brokerage industry, but it has many similar business lines (*Fig. 5*). Analysts collectively forecast that the S&P 500 Investment Banking & Brokerage industry's revenue will drop 6.9% this year and improve by 5.3% in 2023 (*Fig. 6*). Earnings are expected to follow a similar pattern, dropping 17.0% this year only to jump 11.6% in 2023 (*Fig. 7*). The industry's forward P/E has fallen roughly 1.5ppts in recent months to 12.4 (*Fig. 8*).

(2) *Yield-curve watching.* Concerns about a flattening yield curve have pressured the shares of commercial banks. The yield curve often drives banks' net interest margin (NIM)—which is the difference between the net interest rate banks receive on their loans and the net interest rate they pay on their deposits. When the yield curve steepens, the NIM tends to increase, and when the curve flattens, it shrinks.

Banks' collective NIM has been falling in fits and starts since it peaked at 3.48% in Q4-2018. It fell to a low of 2.50% in Q2-2021, only to start rising to 2.56% in Q4 as the economy improved and the 10-year Treasury yield rose (*Fig. 9*).

With the 10-year Treasury yield's backing up in recent weeks, to 2.41% as of March 29, it was hoped that NIM would continue to improve. But the sharp increase in inflation has investors who look forward 12 months anticipating that the Fed will move aggressively to raise the Fed funds up to 2.56% (*Fig. 10*).

The problem is that the NIM has never been a good predictor of bank earnings. While NIM has declined over the past three decades, net interest income and net operating income have increased, for the most part (*Fig. 11*). Banks' loan portfolios have risen over the years, as has their capital markets activity (*Fig. 12*). Loan portfolios surged when Covid-19 struck and companies wanted some dry powder. They've been shrinking ever since but look ready to start increasing again later this year (*Fig. 13*).

(3) *Stay home.* Compared to other US banks, Citigroup may have the largest exposure to the Russian economy at $10 billion. It has a consumer bank in Russia and corporate clients with business ties there. Citi said before the Ukraine war started, it had intended to sell the consumer bank in Russia; the war certainly will make that tougher, if not impossible. That said, $10 billion is tiny compared to the bank's $667.8 billion loan portfolio.

While most US banks have little to no direct exposure to Russia, larger banks may have secondary exposure if they've made loans to European companies. Europe may be headed for a recession because of the Ukraine war and high energy prices.

Perhaps for this reason, smaller banks' stocks have been outperforming their larger counterparts in recent weeks. The S&P 500 Regional Banks industry's stock price index has fallen only 0.2% ytd, while the Diversified Banks index has lost 4.3%.

The S&P 500 Regional Banks industry is also expected to have better earnings than the S&P 500 Diversified Banks industry this year and next. Analysts are forecasting the S&P 500 Regional Banks industry's earnings will drop 4.6% this year and rise 16.0% in 2023 (*Fig. 14*). Meanwhile, the S&P 500 Diversified Banks' earnings are expected to drop 21.4% this year and increase 15.6% in 2023 (*Fig. 15*).

Defense: Let the Negotiations Begin. The Biden administration has unveiled its fiscal 2023 defense budget, which includes a 4.1% y/y increase in spending to $773.0 billion in fiscal 2023, up from $742.3 billion this fiscal year. Another 3.6% jump to $801 billion is slated for fiscal 2024. The fiscal 2023 increase includes a 4.6% pay increase for military and civilian personnel.

A 4.1% increase doesn't sound very large considering the rate of inflation and the state of the world today. But dig a little deeper, and you see the ultimate increase is likely to be greater:

(1) *What's not included.* The budget numbers and the percentage increases cited above don't include supplemental spending, Byron Callan, a research analyst at *Capital Alpha Partners*, pointed out this week. In the current fiscal year, supplemental spending is budgeted at $14.3 billion and includes $4.3 billion for Operation Allies Welcome (the US government's efforts to help and resettle Afghans, particularly those who worked on behalf of the US), $6.5 billion for Ukraine, $895 million for natural disasters, and $350 million to clean up a fuel leak at the Red Hill storage facility in Hawaii, according to a Defense Department *budget overview*.

It's also likely that Congress will increase defense spending beyond the administration's request. In fiscal 2022, Congress added $27 billion to the administration's original request of $715 billion. If Congress adds another $27 billion of spending to the defense budget request, and if the supplemental budget amounts to $14.3 billion again, the total defense budget for fiscal 2022 would be $814.3 billion, which would be a 7.6% jump over the comparable spending this fiscal year.

(2) *Focus on tech.* As we expected, the Defense Department is planning a large boost in R&D and tech spending. There's a 9.5% jump to $130.1 billion in spending on research,

development, test, and evaluation. The department plans to develop and put into use hypersonic missiles on land by fiscal 2023, at sea by fiscal 2025, and in the air by fiscal 2027. Even if it's successful, the US still trails China and possibly even Russia when it comes to hypersonic missiles.

The department is also spending $16.5 billion on science and technology, $3.3 billion on microelectronics, $250 million on 5G, and an undisclosed amount on artificial intelligence. The budget focuses on cybersecurity, earmarking $11.2 billion for cyberspace activities, including operationalizing Zero Trust Architecture across the military and defense agencies, increasing cybersecurity support to the defense industrial base, and growing the cyber mission force teams.

(3) *Defense stocks wilt.* Defense shares lagged the broader market after the release of the fiscal 2023 defense budget proposal and news that Ukraine and Russian officials were sitting down at the negotiation table.

The S&P 500 Aerospace & Defense industry stock price index rose 0.2% on Tuesday, while the S&P 500 Industrials sector was up 0.9% and the S&P 500 was up 1.2% (*Fig. 16*). The industry continues to outpace the S&P 500 on a ytd basis, rising 12.1% ytd through Tuesday's close compared to the S&P 500's -2.8% return.

If we're lucky, the bombing will stop in Ukraine. But that's unlikely to result in a drop in defense spending anytime soon. The war and the chumminess of Russia and China just over a month ago should serve as wakeup calls that will keep US defense spending climbing for years to come.

Disruptive Technologies: The Latest on Fusion. Fusion holds the potential to generate limitless carbon-free energy, and that promise has attracted a lot of ink of late. But there have been setbacks as well as wins on the way to its fulfilment.

The big stumbling block: Scientists haven't cracked how fusion can be produced using less energy than it generates. But as we've discussed before, there's lots of money being thrown at the scientific problem, and some of the world's biggest brains are working on it. Let's take a look at some of the recent headlines:

(1) *Going small.* Most fusion reactors are big, if not huge. Avalanche Energy is moving in the opposite direction. It's trying to create fusion in a small space—as small as a large shoe box, to be exact. Doing so would bring down the cost of development and ultimately bring

down the cost of production, if it’s successful.

Founded in 2018 by Robin Langtry and Brian Riordan, alumni of Jeff Bezos’ space company Blue Origin, Avalanche Energy’s micro-fusion reactors are modular. Six theoretically can work together to power a car or many could be used to power a cargo ship. It stays small by avoiding the giant magnets or lasers used by the competition.

The startup has received funding from Azolla Ventures, Congruent Ventures, and Lowercarbon Capital, among other investors, according to a March 30 *article* in GeekWire.

(2) *New record set.* Scientists at the Joint European Torus (JET) in the UK report that fusion done with tritium and deuterium generates more energy on a more sustained basis than was ever generated before. JET’s tokamak produced 59 megajoules of energy over a fusion pulse of five seconds. This is more than twice the 21.7 megajoules generated by fusion done in 1997 over four seconds, a February 9 *article* in *Nature* reported.

The JET results are a good sign that the $22 billion International Thermonuclear Experimental Reactor (ITER) being built in France should work when it begins experiments in 2025. Both JET and ITER use the same fuel for fusion, and both use magnetic fields to confine the super-heated gas of hydrogen isotopes known as plasma. The JET plant is considered a mini ITER.

JET’s fusion didn’t produce more energy than was needed to create the reaction, as its Q value was 0.3 (i.e., less than the 1.0 that would indicate the same amount of energy produced as used). But scientists believe that if the same fusion were done in the larger ITER, the reaction would have a Q of 10.0, producing 10 times more energy than was put in. And that would be an enormous accomplishment.

(3) *Safety concerns and Russia.* ITER faces two dilemmas. First, France’s nuclear regulator ordered ITER to stop assembling its $25 billion reactor until safety issues are addressed. France’s Nuclear Safety Authority has concerns about neutron radiation from the facility, slight distortions in steel sections, and loads on the concrete holding the reactor, a February 24 *article* in *Science* reported. ITER staff said they’ll be able to satisfy the French agency’s request by April.

The second issue may be stickier. ITER is a partnership among the US, Europe, Russia, India, Japan, China, and South Korea. In the wake of the Ukraine invasion, Russia has been cut off from many joint research projects. ITER hasn’t commented on how it will

handle Russia's membership.

"ITER was jointly conceived and pushed forward in the midst of the Cold War by US and Russian leaders Ronald Reagan and Mikhail Gorbachev. It was a major moment for science diplomacy, but today the future of ITER as a channel of cooperation between Russia and the west is in question," a March 15 *article* in *Science Business* reported. There are no provisions for excluding a founding member, and it's that unlikely China and India would support pushing out Russia. In addition, ITER is relying on Russia to supply certain materials and components for the project. If the war continues, Russia's membership in the consortium may grow more problematic.

Calendars

US: Thurs: Personal Income & Spending 0.5%/0/5%; Core PCED 0.5%m/m/5.5%y/y; Initial & Continuous Jobless Claims 197k/1.35m; Chicago PMI 57.0; Natural Gas Storage; OPEC Meeting; Williams. **Fri:** Payroll Employment Total, Private, and Manufacturing 490k/480k/30k; Average Hourly Earnings 0.4%m/m/5.5%y/y; Average Weekly Hours 34.7; Unemployment Rate 3.7%; M-PMI 58.5; Construction Spending 1.0%; Motor Vehicle Sales; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: Eurozone Unemployment Rate 6.7%; Germany Retail Sales 0.5%m/m/6.1%y/y; Germany Unemployment Change & Unemployment Rate -20k/5.0%; France CPI; UK GDP 1.0%q/q/6.5%y/y; Italy CPI 0.9%m/m/6.4%y/y; Italy Unemployment Rate 8.7%; UK Nationwide HPI 0.8%m/m/13.5%y/y; Japan Tankan Index Large Manufacturers & Non-Manufacturers 12/5; Japan Housing Starts 1.1%; China Caixin M-PMI 50.0; Guindos. **Fri:** Eurozone CPI 6.6% y/y; Eurozone, Germany, France, Italy, and Spain M-PMIs 57.0/57.6/54.8/57.0/55.5; UK M-PMI 55.5. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) climbed back above 1.00, to 1.11 this week from 1.00 last week, after being below 1.00 the prior three weeks; it was at 2.15 in early January. Bullish sentiment increased for the third time in four weeks to 37.7% this week after slumping to 29.9% four weeks ago—which was the fewest bulls since

the start of 2019. Meanwhile, bearish sentiment slipped for the second week to 34.1% this week from 36.5% two weeks ago, which was the most bears since March 2020. The correction count sank for the sixth time in seven weeks, to 28.2% from 40.0% in early February—which just missed equaling March 2020's high count of 40.9%. The AAII Ratio climbed to 48.1% last week after falling the prior two weeks from 42.3% to 31.1%, as bullish sentiment climbed from 22.5% to 32.8% last week and bearish sentiment fell from 49.8% to 35.5%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin dropped 0.1ppt last week to 13.3% from a record high of 13.4%. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings were both back at record highs after ticking down briefly in early February. They have both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, 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 8.2%, up from its 12-month low of 7.1% from early December. That's down from a record high of 9.6% growth at the end of May 2021. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth rose 0.1ppt w/w to 9.6%. It remains above its 16-month low of 8.2% in early December. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked lower. They expect revenues to rise 9.1% (up 0.1ppt w/w) in 2022 and 5.4% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.9% in 2022 (up 0.2ppt w/w) and 9.8% in 2023 (up 0.1ppt w/w) compared to an earnings gain of 51.5% in 2021. Analysts expect the profit margin to remain steady in 2022 at 13.1% (down 0.1ppt w/w) compared to 13.1% in 2021 and to improve 0.6ppt y/y to 13.7% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.4pt w/w to a 19.3, up from a 23-month low of 18.6 three weeks ago. That's down from an eight-month high of 21.7 at the end of 2021 and compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.04pt w/w to 2.57, and remains barely above its 15-month low of 2.48 at the end of February. That's down from a record high of

2.88 at the end of 2021 and a 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 for ten of the 11 S&P 500 sectors, but forward earnings rose for only two and the forward profit margin rose for one. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues and earnings well below record highs, but its profit margin of 10.2% was up 0.1ppt w/w to its highest reading since March 2008. Financials and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, all but the Utilities sector posted a y/y improvement. Four sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Consumer Staples, Financials, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.2%, down from its 25.4% record high three weeks earlier), Financials (18.5, down from its 19.8 record high in August 2021), Real Estate (16.2, down from its 19.2 record high in 2016), Communication Services (16.3, down from its 17.0 record high in October), Utilities (14.1, down from its 14.8 record high in April 2021), Materials (13.2, down from its 13.4 record high in December), S&P 500 (13.3, down from its 13.4 record a week earlier), Health Care (11.3, down from its 11.5 record high a week earlier), Industrials (10.1, down from its 10.5 record high in December 2019), Energy (10.2 [14-year high], down from a record-high 11.2 in 2007), Consumer Staples (7.5, down from its 7.7 record high in June), and Consumer Discretionary (8.0, down from its 8.3 record high in 2018).

US Economic Indicators

ADP Employment (*link*): "Job growth was broad-based across sectors in March, contributing to nearly 1.5 million jobs added for the first quarter in 2022," said Nela Richardson, chief economist, ADP. "Businesses are hiring specifically among the service providers which had the most ground to make up due to early pandemic losses. However, a tight labor supply remains an obstacle for continued growth in consumer-facing industries." Private payroll employment advanced 455,000 in March and 1.45 million ytd to a record-high 129.0 million—764,000 above its pre-pandemic level. ADP's employment report showed widespread gains, with service-providing companies adding 377,000 jobs and goods-producing 79,000. Leisure & hospitality (161,000) led gains among service-providing industries, followed by health care & social assistance (62,000), trade, transportation &

utilities (49,000), administrative & support services (36,000), professional & technical services (24,000), other services (21,000), financial activities (12,000), education (11,000), and management of companies (1,000)—with information services showing no change. Within goods-producing, manufacturing (54,000) continued to post impressive gains, averaging 50,000 per month the past six months, while gains in construction (15,000) jobs slowed in March after averaging 43,800 per month the prior five months. Meanwhile, natural resources and mining companies added 9,000 jobs—the biggest monthly gain since the record increases of 11,000 posted during both March 2012 and May 2011. Here's a tally of industry performances relative to their pre-pandemic levels: trade transportation & utilities (+715,000), professional & technical services (+478,000), construction (+260,000), administrative & support services (+175,000), financial activities (+48,000), manufacturing (+33,000), health care & social assistance (+10,000), education (-27,000), information services (-41,000), management of companies & enterprises (-48,000), natural resources & mining (-66,000), other services (-189,000), and leisure & hospitality (-583,000). Here's the same exercise by company size: small (+447,000), medium (+340,000), and large (-24,000).

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Index (ESI) took a hit in both the EU (-5.3 points to 107.5) and the Eurozone (-5.4 to 108.5) in March, led by a plunge in consumer confidence. Among the largest EU countries, March's performance tanked in France (-7.1 points to 105.7), Spain (-6.5 to 104.8), and Germany (-4.3 to 109.2), and to lesser degrees in Poland (-3.0 to 97.3) and Italy (-2.6 to 109.0). Meanwhile, the Netherlands (+0.5 to 103.3) bucked the trend and edged slightly higher. For the overall Eurozone at the sector level, consumer confidence (to -18.7 from -8.8) plunged, reflecting a collapse in households' expectations, while industrial (10.4 from 14.1) and retail trade (0.2 from 5.5) confidence also deteriorated. Meanwhile, services confidence (14.4 from 12.9) improved a bit, while construction confidence (9.8 from 9.9) was little changed.

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