MORNING BRIEFING
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Financials, Materials & Robots

The next *Morning Briefing* will be on January 17.

Check out the accompanying chart collection.

Executive Summary: Yes, most banks and brokerages' Q4 results will be down y/y, but investors already knew that. As long as earnings reports don't bring much new negative news, the S&P 500 Financials sector's rebound may continue, buoyed by easy y/y comparisons ahead. … Also: The World Bank's global growth forecast for this year is now a grim 1.7%. But you'd never know it from the surge in metals prices and the S&P 500 Materials sector since October. The strong dollar, China's lockdown unlocking, and Europe's energy resourcefulness no doubt have helped. … Also: How robots are about to transform farming, EV fueling, and manufacturing productivity.

Financials: Looking Forward to Easier Comps. Over the next two weeks, big banks and brokers will be reporting Q4 results that are expected to fall y/y. But if the earnings reports don't contain any negative surprises, the strong rebound occurring in the S&P 500 Financials sector may continue as investors focus on 2023, when y/y comparisons are much easier than they were in 2022.

Jefferies Financial Group kicked off the earnings season for the S&P 500 Financials sector on Monday, reporting fiscal Q4 (ended November 30) earnings of $0.57 per share, down 53% y/y but hitting the consensus estimate of Wall Street analysts. Jefferies shares—which swooned more than 30% during the first half of 2022—since have recouped almost all of their lost ground and are down only 3.4% over the past year. After the earnings release, the shares rallied, ending Tuesday up 3.8%, besting the S&P 500's 0.7% Tuesday gain. The firm doesn't provide earnings guidance; but it didn't announce any negative surprises, and that was enough to gladden investors.

The S&P 500 Financials sector has outperformed the S&P 500 from the index's October 12 low through Tuesday's close. Here's the performance derby for the S&P 500 and its 11 sectors since the market's low-water mark: Materials (19.3%), Industrials (19.2), Financials (17.3), Utilities (16.3), Real Estate (12.0), Consumer Staples (11.1), Health Care (10.4), S&P 500 (9.6), Energy (9.4), Information Technology (8.4), Communication Services (4.0), and Consumer Discretionary (-4.5).

Within the Financials sector, all of the industries but one—Regional Banks—has outperformed the S&P 500 since its October 12 low: Reinsurance (37.6%), Asset Management & Custody Banks (32.1), Multi-line Insurance (21.3), Diversified Banks (20.5), Multi-Sector Holdings (19.8), Investment Banking & Brokerage (18.1), Financial Exchanges & Data (16.1), Property & Casualty Insurance (15.1), Life & Health Insurance (13.8), Insurance Brokers (12.4), Consumer Finance (10.0), and Regional Banks (3.9) (*Table 1*).

Let's take a look at some of the areas that will influence what type of year Financials sector companies face in 2023:

(1) *Pros and cons of higher rates.* The jumps in interest rates during 2022 were a double-edged sword. Higher interest rates meant that banks' loans brought in more interest income. Loans and leases outstanding for all commercial banks is at a record high of $12.0 trillion, and the collective net interest margin rose to 3.14% during Q3-2022 (*Fig. 1* and *Fig. 2*).

Conversely, however, high interest rates killed banks' mortgage business, with the interest rate on the 30-year mortgage at 6.65% (*Fig. 3*). The mortgage refinancing business dried up; so did demand for new mortgages, as home sales fell sharply (*Fig. 4* and *Fig. 5*). At this point, it's tough to see the activity declining much further, which could be setting the industry up for easier comparisons this year.

Wells Fargo, however, isn't waiting around to see what happens. On Tuesday, the bank announced plans to dramatically shrink its home lending business, blaming the move on the scandals and fines that have plagued the division. Wells Fargo no longer will purchase mortgages from third parties, but it will continue to provide mortgages to existing customers and minority borrowers.

It will be important to watch the spring home selling season for signs that buyers are returning to the market now that rates have stopped advancing. Equity investors seem confident that the worst may be behind us. The S&P 500 Homebuilding stock price index is up 26.6% since the October 12 market low.

(2) *Investment banking comps could get easier.* With both the stock and bond markets falling last year, CEOs put the breaks on acquisitions and selling stocks or bonds. As a result, 2023 y/y investment banking revenue comparisons look much, much easier than they were at the start of 2022.

Global investment banking revenue peaked in Q4-2021 at $33.9 billion, more than twice the $15.5 billion of investment banking revenue generated in Q4-2022, according to *Dealogic* data in the *WSJ*. Revenue from M&A transactions dropped from $14.1 billion in Q4-2021 to $7.8 billion in Q4-2022. Equity capital markets revenue fell from $8.3 billion in Q4-2021 to $2.9 billion last quarter. Revenue from debt capital markets shrank from $6.1 billion in Q4-2021 to $3.1 billion last quarter. And revenue from loans dropped from $5.4 billion in Q4-2021 to an amount that didn't register on the chart last quarter, $1.7 billion.

During the course of 2023, comparisons to last year will get easier and easier. Here's the progression of global investment banking revenue data from Dealogic since the Q4-2021 peak: Q4-2021 ($33.9 billion), Q1-2022 ($24.8 billion), Q2-2022 ($19.2 billion), Q3-2022 ($18.0 billion), and Q4-2022 ($15.5 billion).

Jefferies' fiscal Q4 net investment banking and capital markets revenue dropped to $1.05 billion, down sharply from the $1.6 billion of a year earlier but not much worse than the August quarter's $1.1 billion. As fiscal 2023 proceeds, Jefferies' y/y comparisons will be easier.

Flat or rising equity and bond markets could provide even more of a tailwind. Jefferies noted that while its fixed-income capital markets business was down for the year, revenue in its final quarter was up more than 71% y/y, "and we carried that momentum through the first month of fiscal 2023."

(3) *Reducing shares outstanding.* Jefferies has been using the past year to repurchase shares, and that has benefitted the bottom line. The weighted average basic shares outstanding fell to 239.3 million in the November quarter, down 8.5% from 261.6 million shares in the year-earlier quarter. And the company said its board of directors has increased the share buyback authorization to $250 million.

(4) *Clouds to watch.* There's the potential for rain on the banks' bullish-outlook parade if they need to increase reserves on expectations that defaults will start to rise. So far, credit quality has remained high for both businesses and consumers. The US corporate bond default rate is under 2.0%, and Fitch Ratings *expects* it to rise only to 2.5%-3.5% this year and 3.0%-4.0% in 2024.

But the 8.16% yield on high-yield corporate bonds may be indicating that the default rate could rise more than expected (*Fig. 6*). The higher yield on the high-yield index can partially be attributed to the jump in Treasury yields. But the spread between high-yield bonds and

the 10-year US Treasury also has increased, to 455 basis points (*Fig. 7*).

Consumer debt levels are high, but as of Q3 consumers generally were current on their credit card payments, and the household debt service ratio remained low (*Fig. 8* and *Fig. 9*). JPMorgan CEO Jamie Dimon continues to believe the US consumer is strong. “Their balance sheets are in good shape, they’re spending 10% more than pre-COVID, they have more in their checking account, companies are in good shape, and that’s driving a strong economy,” he *told* Fox Business on Tuesday.

Commercial bank allowances for loan and lease losses ticked up slightly at the end of last year (*Fig. 10*). It’s certainly something to track when many of the large banks and brokers report earnings later this week. And recent job losses, primarily in technology-related industries, will keep us watching for any uptick in the unemployment rate.

(5) *Analysts’ expectations.* The S&P 500 Investment Banking & Brokerage industry is expected to see revenue drop 10.0% in 2022 and then increase 6.3% this year (*Fig. 11*). After falling 27.1% last year, the industry’s earnings are expected to jump 16.2% in 2023 (*Fig. 12*).

The S&P 500 Diversified Banks industry should see the modest 2.8% increase in revenue in 2022 improve to an 8.0% jump in revenue this year (*Fig. 13*). The improvement in earnings is forecast to be even more dramatic, as 2022’s 23.4% drop in earnings becomes a 15.3% increase in 2023 (*Fig. 14*).

Because it has less exposure to the capital markets, the S&P 500 Regional Banks’ results weren’t hurt as much as those of the Diversified Banks and Investment Banking industries last year, so Regional Banks’ expected rebound isn’t as dramatic. The S&P 500 Regional Banks industry is expected to grow revenue by 11.2% in 2022 and 9.4% in 2023 (*Fig. 15*). Earnings for the industry are forecast to drop 3.1% in 2022 and jump 9.6% this year (*Fig. 16*).

Materials: Surging into 2023. The World Bank cut its forecast for global economic growth this year to 1.7%, down from its June forecast of 3.0%. The organization blamed high inflation, rising interest rates, lower investment, the Ukraine war, and the impact of Covid and an ailing real estate market in China, a January 10 *WSJ* *article* reported.

Commodity stock investors appear to disagree with the World Bank’s assessment. The S&P 500 Copper stock price index has risen 55.0% from the S&P 500’s October 12 low through

Tuesday's close. Not far behind is the S&P 500 Steel stock price index, up 23.6%, and the overall S&P 500 Materials sector has risen 19.3% during that period as well.

The Metals segment of the CRB Raw Industrials Spot price index—composed of copper scrap, lead scrap, steel scrap, tin and zinc—also has bounced, rising 17% from its October 31, 2022 low through Tuesday's close, though it remains 25% off its 2022 peak (*Fig. 17*). Copper futures have jumped 27% since bottoming on July 14 of last year (*Fig. 18*). And Midwest domestic hot-rolled coil steel prices recently popped 12% off their lows but remain very depressed compared to highs at the end of August 2021 (*Fig. 19*).

A weaker dollar could be boosting metals prices. The US trade-weighted dollar has declined 6.6% since its peak on October 19, 2022 (*Fig. 20*). But we wouldn't underestimate the positive impact that investors believe China's reopening and Europe's success so far in accessing fuel to power its factories and homes will have on the global economy.

Disruptive Technologies: Ubiquitous Robots. CES—billed as "the most influential tech event in the world," held in Las Vegas from January 5-8—featured the expected gaggle of cute robot dogs, smart toilets, and companion robots. But three innovations in particular caught our eye, two from this year's event: a fertilizing machine and a mobile electric vehicle (EV) charger. The last, from CES 2022, is still just a glimmer in the eye of a visionary robotics company, but an intriguing one that could dramatically boost productivity. Let's have a look:

(1) *Robots on the farm.* John Deere introduced ExactShot, a farm machine that can detect and fertilize individual seeds. It aims to reduce fertilizer use by as much as 60%, saving farmers money and reducing the amount of chemical put in the ground. Instead of shooting out a steady stream of fertilizer, the machine uses sensors to shoot out a burst of fertilizer that hits an individual seed and leaves the surrounding area untouched.

Expect field equipment to grow even more sensitive in upcoming years. "Eventually, we will literally treat every plant on an acre of a field differently based on what we're learning through our computer vision and machine learning technology," said a Deere executive in a January 6 CNET *article*. In the June 18, 2020 *Morning Briefing*, we discussed how robots were improving farm productivity and mentioned Deere's See & Spray machine, which can differentiate between a weed and a desired plant, spraying herbicides only on the weeds.

(2) *Robots in the garage.* Parky is a robot that contains a battery that can be used to charge an electric car. It aims to eliminate the problem of having all of a parking lot's EV chargers

taken by cars that have finished charging but haven't left the parking spot.

Parky was developed by privately held *EVAR*, a spin-off from Samsung Electronics C-Lab. A car can pull into a parking garage and park next to a designated pole. When the driver plugs in the car, a signal is sent to Parky with the car's location. Parky autonomously rolls over to the car's location, docks, and sends electricity from its battery to the car in need. When charging is complete, Parky returns to its own charging station and awaits the arrival of the next car that needs to be charged.

(3) *Controlling robots via the metaverse.* Today, a US-based engineer might have to travel to China to fix factory equipment in that country. A CES 2022 *presentation* by executives of Hyundai and Boston Dynamics—the robotics company that Hyundai purchased in 2021—describes engineers in the future saving their frequent flier miles and using the metaverse and robots to fix equipment on a factory floor on the opposite side of the world.

The folks at Hyundai and Boston Dynamics envision a day when US-based technicians, instead of flying to China, simply put on a headset and gloves and connect to the metaverse, where a digital twin of the Chinese factory appears. In the digital factory is the image of a robot that's connected to an actual robot in an actual factory in China. The US technician would communicate with and manipulate the robot in China through the metaverse. Leveraging the capabilities of the Internet, the metaverse, and robots in tandem could dramatically increase productivity and, as one executive on the panel said, make time and distance irrelevant.

Last summer, the Boston Dynamics AI Institute was launched with $400 million of funding from Hyundai. Headed by Boston Dynamics founder Marc Raibert and Chief Scientist Al Rizzi, the institute will use the funding to advance artificial intelligence in robots. We'll be watching.

Calendars

US: Thurs: Headline & Core CPI 0.1%m/m/6.5%y/y & 0.3%m/m/5.7%y/y; Initial & Continuous Jobless Claims 215k/1.705m; Federal Budget Balance -$70.0b; Natural Gas Storage; WASDE Report; Harker. **Fri:** Import & Export Prices -0.9%/-0.5%; Consumer Sentiment Index Headline, Current Conditions, and Expectations 60.5/60.0/59.5; Baker-Hughes Rig Count; Harker. (Bloomberg estimates)

Global: **Thurs:** Germany Current Account Balance; China Trade Balance ¥76.2b; ECB Economic Bulletin; Mann **Fri:** Eurozone Industrial Production 0.5%m/m/0.5%y/y; Eurozone Trade Balance –€21.8b; France CPI -0.1% m/m/; Italy Industrial Production 0.3%; Spain CPI 5.8% y/y; UK GDP -0.3% m/m; UK Headline & Manufacturing Industrial Production -0.3%m/m/3.0%y/y & -0.2%m/m/-4.8%y/y; UK Trade Balance –£14.9b. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull-Bear Ratio climbed to 1.26 this week, after falling the prior three weeks from 1.37 (which matched its highest reading since the August 23 week) to 1.08. *Bullish sentiment* rebounded 4.8ppts to 41.4% this week after falling from 43.3% (the highest since the 45.1% during the August 23 week) during the week of December 6 to 36.6% last week—the lowest reading since early November. *Bearish sentiment* retreated to 32.9% this week after advancing from 31.4% in mid-December to 33.8% last week—which was the highest since early November. The *correction count* slipped to 25.7% after climbing steadily from 24.3% in early December to 29.6% last week, remaining well below its late September peak of 40.3%. Turning to the AAII Sentiment Survey (as of January 5), both optimism and pessimism about the short-term direction of the stock market fell, while neutral sentiment soared to a 40-week high. The *percentage expecting stock prices to rise* over the next six months slid 6.0ppts to 20.5% after jumping 6.2ppts (to 26.5% from 20.3%) during the final week of 2022. It remained below its historical average of 37.5% for the 53rd consecutive week, and was the second time in three weeks it ranked among the 60 lowest ever recorded since the survey began in 1987. The *percentage expecting stocks to fall over the next six months* fell for the second week from 52.3% to 42.0%, with pessimism remaining above its historical average of 31.0% for 56 of the past 59 weeks. It was at an unusually high level for the fifth successive week. The *percentage expecting stock prices will stay essentially unchanged* over the next six months soared 11.6ppts from 25.9% to 37.5%—the highest percentage since the March 31, 2022 week's 40.6%. The historical average is 31.5%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at a 20-month low of 12.6%. That's down 0.8ppts from its record high of 13.4% achieved intermittently from March to June. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.3pts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues rose 0.3% w/w and is now 0.2% below its record high in mid-October. Forward

earnings was up 0.6% w/w and is 4.2% below its record high in mid-June. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth was unchanged w/w at a 30-month low of 2.7%. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth rose 0.5ppt w/w to 4.5% from a 30-month low of 4.0%. 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. During 2022, analysts' revisions to their forecasts for 2022 revenues outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts fell 0.8ppt to 12.4% (unchanged w/w). They expect revenues to rise 11.4% (down 0.1ppt w/w) in 2022 and 2.4% in 2023 (down 0.1ppt w/w) compared to the 16.5% gain reported in 2021. They expect earnings gains of 7.6% in 2022 (down 0.1ppt w/w) and 3.0% in 2023 (down 0.2ppt w/w) compared to an earnings gain of 50.5% in 2021. Analysts expect the profit margin to drop 0.5ppt y/y to 12.4% in 2022 (unchanged w/w) compared to 12.9% in 2021 and to improve 0.1ppt y/y to 12.5% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.2pt w/w to 16.9. That remains above its 30-month low of 15.3 in mid-October and is down from a four-month high of 18.2 in mid-August. It also 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 0.03pt w/w to 2.13, but that's still up from a 31-month low of 1.98 in mid-October. That's down from a four-month high of 2.38 in mid-August and also compares to 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*): Looking at the 11 S&P 500 sectors, last week saw consensus forward revenues rise for nine sectors and forward earnings also rise for nine sectors. The forward profit margin rose w/w for four sectors: Communication Services, Information Technology, Materials, and Utilities. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Consumer Staples, Financials, and Health Care are the only sectors with forward revenues at a record high this week. Consumer Staples, Financials, and Utilities have forward earnings at a record high this week. Industrials' forward earnings still remains close to their recent record highs, but Energy's has given up its gains of the past six months. Since mid-August, all sectors have seen forward profit margins retreat from their record highs. Those of Industrials and Tech remain close to their post-pandemic highs, and Energy's is now down 0.5ppt from its 12.8% record high in late November. Only three sectors posted a higher profit margin y/y during 2020: Consumer Staples, Tech, and

Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Energy and Industrials are the only two sectors expected to see margins improve y/y for full-year 2022, followed by these five sectors in 2023: Communication Services, Consumer Discretionary, Financials, Industrials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.0%, up 0.1pt w/w from a 20-month low and down from its 25.4% record high in early June), Financials (18.0, unchanged w/w and down from its 19.8 record high in August 2021), Real Estate (17.3, unchanged w/w and down from its 19.2 record high in 2016), Communication Services (14.1, up 0.1pt w/w and down from its 17.0 record high in October 2021), Utilities (13.8, up 0.1pt w/w and down from its 14.8 record high in April 2021), Energy (12.3, unchanged w/w and down from its 12.8 record high in November), S&P 500 (12.6, unchanged w/w at a 20-month low and down from its record high of 13.4 achieved intermittently from March to June), Materials (11.5, up 0.1pt w/w from a 21-month low and down from its 13.6 record high in June), Health Care (10.1, unchanged w/w at a 30-month low and down from its 11.5 record high in March), Industrials (10.1, unchanged w/w and down from its 10.5 record high in December 2019), Consumer Discretionary (7.3, unchanged w/w at a 32-month low and down from its 8.3 record high in 2018), and Consumer Staples (7.1, unchanged w/w at a 56-month low and down from its 7.7 record high in June 2020).

S&P 500 Sectors & Industries Forward Profit Margin Since Peak (*link*): Since the S&P 500's forward profit margin peaked at a record-high 13.4% during the June 9 week, it has fallen 6.4% to 12.6% through the January 5 week. The drop has been paced by three of the 11 sectors, though all but the Energy sector is down since the peak. Here's the sector performance since the June 9 peak: Energy (up 3.0% to 12.3%), Utilities (down 0.5% to 13.8%), Industrials (down 2.6% to 10.1%), Consumer Staples (down 2.8% to 7.1%), Real Estate (down 3.8% to 17.3%), Financials (down 5.5% to 18.0%), Information Technology (down 5.5% to 24.0%), Consumer Discretionary (down 5.7% to 7.3%), S&P 500 (down 6.1% to 12.6%), Health Care (down 8.0% to 10.1%), Communication Services (down 12.4% to 14.1%), and Materials (down 15.7% to 11.5%). These are the best performing industries since the June 9 peak: Wireless Telecommunication Services (up 52.9% to 10.3%), Oil & Gas Refining & Marketing (up 31.4% to 4.5%), Oil & Gas Equipment & Services (up 16.8% to 10.7%), Airlines (up 15.8% to 4.7%), and Hotels, Resorts & Cruise Lines (up 14.8% to 11.4%). The worst performing industries since the June 9 peak: Alternative Carriers (down 39.5% to 5.3%), Copper (down 38.9% to 11.8%), Commodity Chemicals (down 37.9% to 6.4%), Home Furnishings (down 33.8% to 5.9%), and Gold (down 30.4% to 13.3%).

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