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Banks Slow the Slow-Motion Melt-Up

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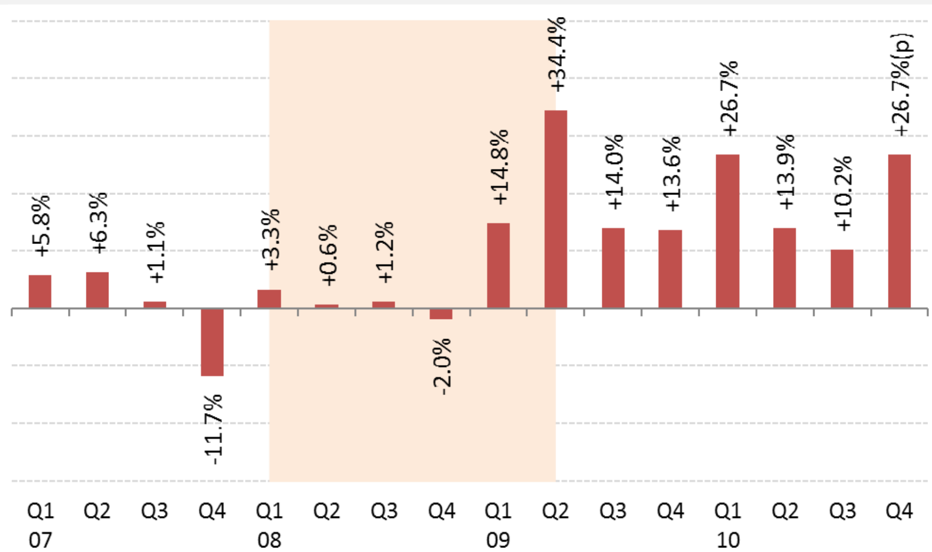
Misses at three big banks haven't changed the overall earnings outlook.

Two weeks into earnings season, with some disappointing results in the financial sector, there's a little chill on the slow-motion melt-up in stocks. The financial sector makes up a disproportionately large share of expected earnings growth. But we don't see this week's misses as a game-changer, and we're even skeptical that it will amount to much of a correction.

- For three months we've been talking about stocks moving back to all-time highs in 2011 driven by a virtually inevitable return to peak forward earnings per share (see "Sell On *Good* News" October 20, 2010).
- Back then we were 12.0% from the October 2007 forward S&P 500 EPS peak. Now we're now only 7.1% away, so "virtually inevitable" is getting to be just plain inevitable.
- Overall so far, this earnings season has been strong (please see the chart below). With 53 out of 429 companies reporting, the

Unweighted average EPS surprise **Recession**
(p) = preliminary, 53 out of 429 S&P 500 companies, quarters ended 12/31/10



Source: Zacks, NBER, TrendMacro calculations

Update to strategic view

US STOCKS: Earnings disappointments in the financial sector have slowed the slow-motion melt-up in stocks. But we don't expect much of a correction. We see no risk here to the fundamental idea of a march back to all-time high forward earnings and all-time high levels of the stock market.

US FINANCIAL STOCKS: Misses by Bank of America, Citigroup and Wells Fargo have disproportionately dinged earnings season so far. But this is a sector-specific problem -- in a post-subprime post-Dodd/Frank world, there's a recovery model for the financials, but no growth model.

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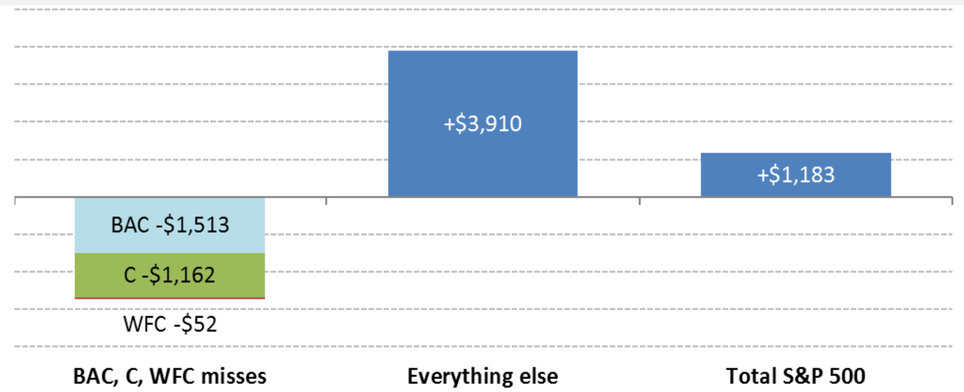
unweighted average EPS surprise has been +26.7%, tying for second best since the recession trough.

But what about the financial sector?

- For this earnings season so far, on the surface all is well in the financial sector. Of the 10 S&P 500 sectors, it has the best unweighted average EPS surprise, +43.1%.
- But this is dominated by large beats at smaller firms. Weighted by shares outstanding, the sector has missed on average by 9.0%. Misses totaling $2.73 billion at just three banks -- Bank of America at $1.5 billion, Citi at $1.2 billion, and Wells Fargo at $52 million -- have taken away more than two thirds of the net positive surprises in the rest of the S&P 500 (please see the chart below).

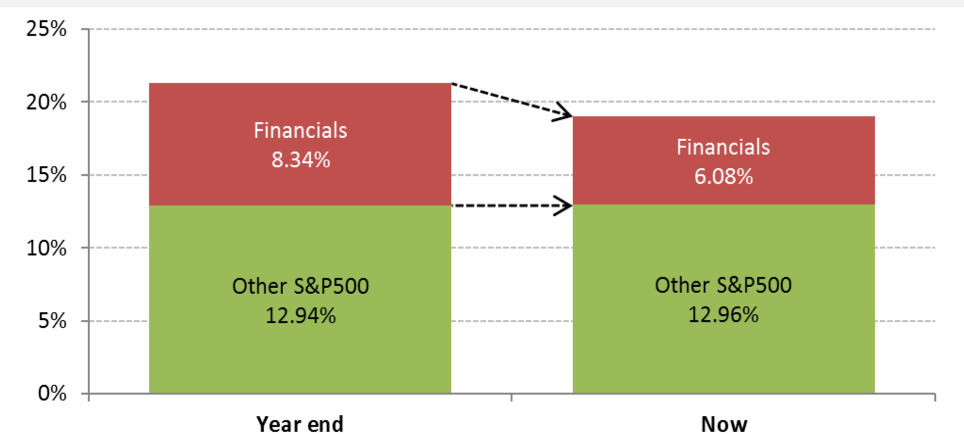
Cap-weighted dollar value of earnings surprises, USD millions
53 out of 429 S&P 500 companies, quarters ended 12/31/10



Source: Zacks, TrendMacro calculations

- Expected earnings growth in the financial sector has come down considerably since the onset of earnings season -- from 59.7% to 38.6% -- dragging down overall expected S&P500 earnings growth (please see the chart below), and sharply reducing the sector's

Contribution to S&P 500 12-month forward expected earnings growth



Source: Zacks, TrendMacro calculations

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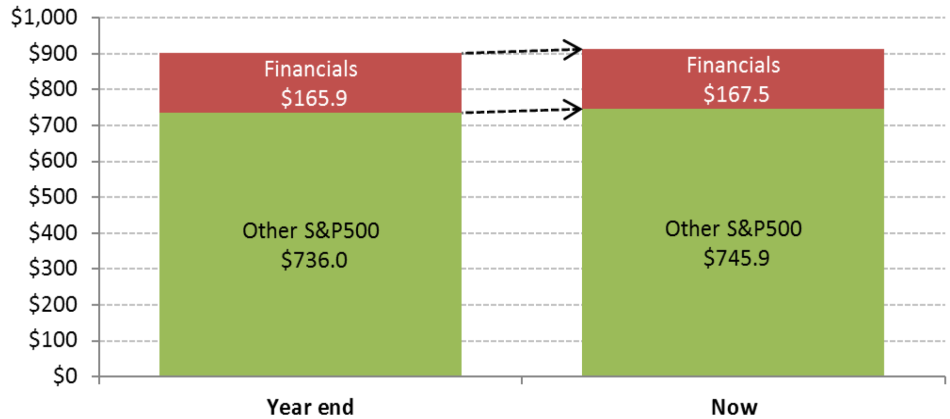
proportional contribution to overall expected growth.

- But this is to some extent a red herring. While expected *growth rates* have come down, the *dollar value of forward earnings* has risen, both in the S&P 500 overall and in the financial sector (please see the chart below).

12-month forward expected earnings, USD billions



Source: Zacks, TrendMacro calculations

- The main reason why *growth rates* have fallen is not that expected earnings have been downgraded -- they haven't been. It's because *trailing earnings* reported over the last two weeks, whether expected or not, have been so strong. In the financial sector, while year-ahead expected earnings *growth* has fallen by $15.4 billion since year-end, that's *more than* explained by a $17.0 billion gain in *trailing* earnings over the same period.
- There are no surprises here. Obviously, as we move from the earliest stages of the recovery from the Great Recession, the *rate* of earnings growth will naturally slow even as the *dollar amount* of growth continues to rise. Our key forecast concerns the latter -- we are saying that the *dollar value* of forward earnings will make new highs during 2011 (again, see "Sell On *Good* News" October 20, 2010). We are on track for that to happen sooner rather than later during the year.
  - And parenthetically, we don't see why anyone should be surprised by less than brilliant performance in the financial sector (see, among many of our comments to this effect, "Goldman Sucks" April 19, 2010). While expected growth rates for the financial sector have fallen this earnings season, they've actually increased for the rest of the S&P 500.
- Granting that the dollar value of forward earnings will indeed make new highs, the question of whether the stock market will do so depends on the forward earnings multiple. For stocks to get back to the October 2007 highs, the forward multiple would have to get back to 15.1, from 13.3 where it is today.
- We are sensitive to the critique we hear from many clients that as *growth rates* slow, the multiple should have an increasingly hard

time achieving that. Fair enough, but we're not asking for the moon. We're only looking for a forward multiple increase from here of 1.8.

- We've already had an increase of exactly that since the lows at mid-year 2010, when we called the turnaround in stocks (see "Betting Against a "'Double Dip'" June 30, 2010). Over the same period, the expected earnings growth rate has *fallen* -- almost cut in half, from 35.0% at mid-year to 19.0% today.
- So the forward multiple cannot be exclusively a function of expected growth rates -- but may also include a qualitative factor related to the market's expectations for the quality and reliability of growth. We think the market's expectations along those lines have already improved dramatically, on the back of QE2 and the re-orientation of the US political process in favor of capital (see "The Pendulum Swings Back" November 2, 2010). We think there will be continued improvement as political developments evolve this year.

Strategically, we stand by our call for a continued slow-motion melt-up in stocks. Very short-term, the matter of sentiment has become increasingly interesting.

- We argued several weeks ago that sentiment had not become excessively bullish -- and the widespread claims to that effect were themselves evidence that sentiment was still cautious (see "A Question of Sentiment" January 6, 2011).
- Since then, we've seen a little evidence of capitulation. It's just anecdotal, but it got our attention when one of our long-standing perma-bear debating counterparties on *The Kudlow Report* turned bullish last week.
- So maybe the motion of the slow-motion melt-up has to slow a bit. But we aren't expecting anything serious on the downside, and continue to believe that the stage is set for a march back to the 2007 highs in 2011.

Bottom line

Earnings disappointments in the financial sector have slowed the slow-motion melt-up in stocks. But we don't expect much of a correction. We see no risk here to the fundamental idea of a march back to all-time high forward earnings and all-time high levels of the stock market. Misses by Bank of America, Citigroup and Wells Fargo have disproportionately dinged earnings season so far. But this is a sector-specific problem -- in a post-subprime post-Dodd/Frank world, there's a recovery model for the financials, but no growth model.