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In a nutshell

- Still early in 1Q reporting, but it's clear we should bump-up our Banks 2018E* earnings
- We also bump-up our 2018E Technology sector EPS growth to 18% y/y in 2018
- Banks relative PE vs. S&P now back to normal, but this masks intrinsic value upside
- Banks are still cheap relative to a reasonable steady-state PE or PB multiple
- How to value Banks: Focus on normalized EPS and a fair cost of equity (COE)

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Americas CIO View

Sizing up Banks and Tech

Still early in 1Q reporting, but it's clear we should bump-up our Banks 2018E earnings

We raise our Financial sector 2018E¹ earnings from \$247bn to \$251bn as big banks and capital markets firms significantly exceed 1Q consensus estimates. Our 2018E Financial sector earnings remain below the bottom-up consensus, which is about \$260bn now or 3.5% higher. We estimate 25% year over year (y/y) growth for Financials in 2018 (~10% ex. tax cut), which is a bit lower than consensus probably owing to our view of no more than three U.S. Federal Reserve (Fed) hikes in 2018, a 10yr yield that doesn't materially exceed 3%, thus a flattening curve, and moderate paced loan growth that doesn't exceed nominal GDP growth. But the consensus estimate for Financials is within reach, if markets avoid any sharp dislocations and buybacks are strong. On this earnings outlook, the Financial sector is about 13.5x 2018 earnings and Banks are 12x. For this reason, we have difficulty understanding how the strong 1Q results so far and the expected full 2018 earnings for banks are fully priced-in. So this note includes some bank valuation measures and concepts.

We also bump-up our 2018E Technology sector EPS growth to 18% y/y in 2018

The 1Q earnings expectation for big Banks was high, but most big Banks beat them anyway on better than expected net interest margins and strong trading activities. The macro trends reported for 1Q give us confidence that the non-financial sectors, still mostly to report starting next week, will also post mid-single digit average beats. Capital expenditure (Capex) indicators related to spending on technology have shown meaningful acceleration, so we are confident that Tech beats estimates and in advance of these reports we raise our 2018E Tech sector earnings to \$306bn from \$302bn or 18% y/y growth. We will fine tune our estimates for the other sectors as earnings season advances, but risk is to the upside for our 2018E S&P earnings per share (EPS) of \$155. Right now, 1Q btm-up S&P EPS is \$36.62 or up 18.7% y/y. If the rest of the S&P 500 companies yet to report beat their 1Q estimates by 5%, 1Q EPS will finalize at close to our \$38.00 estimate or up 23% y/y. Inside we present our latest over, equal and under weights for each S&P 500 sector.

Banks relative PE vs. S&P now back to normal, but this masks intrinsic value upside

In this cycle, big Banks lagged the rest of the S&P 500 on price-to-earnings ratio (PE) repricing for many legitimate reasons. Their earnings were depressed for years with the zero Fed Funds rate. Their dividends and buybacks were restricted by regulators. Legacy

¹2018E: 2018 expected

litigation charges damaged their bottom lines and slowed their capital cushion rebuild. And it makes sense that Banks were among the last to recover this cycle given the last recession was caused by banks. But upon Fed hikes and the relaxing of payout restrictions over the past couple of years, Banks rallied strongly and outperformed most sectors. And the relative forward PEs of Banks vs. the S&P 500 have reverted back to their historic averages. S&P Banks traded at a 40% discount to the overall S&P in early 2016. Now Banks trade at a 28% discount, which compares to the 26% average discount since 1995. However, albeit in line with the historic average, we consider this PE discount too steep because Banks are no longer over earnings as they were (causing low relative PEs) in the last cycle and the S&P is no longer trading with a large growth premium to a steady-state valuation as it was two cycles ago.

Banks are still cheap relative to a reasonable steady-state PE or PB multiple

Banks haven't been able to deliver a similar level of return on equity (ROE) this cycle as before the financial crisis, hence they trade at a much lower multiple on their book value. With the surfacing deregulation bills and gradual climbing of rates across the curve on continuing Fed hikes, we think Banks profitability will improve and drive strong earnings-per-share (EPS) and dividend-per-share (DPS) growth. Banks are now trading at 1.25x book value, a sizable rise from 0.8x in early 2016, but still much lower than the 2.0x average during last cycle. Banks return-on-equity (ROE) is 8.5% now vs. last cycle's 15.3% average. We forecast Banks EPS growth of 25% vs. 18% for overall S&P in 2018. Banks dividend growth was 21% in 2017 vs. 7% for overall S&P. We expect Banks to continue to raise their dividends faster than elsewhere.

How to value Banks: Focus on normalized EPS and a fair cost of equity (COE)

Our focus in valuing banks is normalized EPS and a fair cost of equity, not long-term growth potential. We value banks using steady-state PEs based on $1 / \text{real COE}$ applied to normal EPS. This means the fair PB is not 1, but $\text{return on equity (ROE)} / \text{real COE}$. And that the fair dividend yield is $\text{real COE} * \text{dividend payout ratio}$. We think that 6.5% is a fair real COE or 8.5% nominal COE for S&P Banks. Thus, we see their fair PE as 13-15x 2018E EPS (adjusted for non-GAAP EPS quality). We expect S&P Banks ROE to improve to 10% or higher by 2019 and thus PB to rise to ~1.5x.

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Glossary

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Cost of equity (CoE)

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Dividend per share (DPS)

Dividend per share (DPS) is the sum of declared dividends issued by a company for every ordinary share outstanding.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Generally accepted accounting principles (GAAP)

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

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