January 31, 2017

# OPTIMISM vs DELIVERABILITY

Robert B. Albertson – Principal & Chief Strategist
(212) 466-7946 ralbertson@sandleroneill.com

Weison Ding – Director
(212) 466-8005 wding@sandleroneill.com

*** At Current Prices, Financial Sector Expectations May Be Too High**
*** Impact from Economic Stimulus the Most Reliable Positive**
*** Rate Relief has Further Upside**
*** Regulatory Relief Unclear**

Most will agree the Trump Administration's early actions are radically more complex than usual to translate into a general economic outlook and even more daunting to evaluate by sector. Recent executive orders have been politically confrontational and may limit Congressional cooperation. Cynics suggest we may be heading toward three-way-gridlock: Republicans, Democrats and President Trump. This is a premature characterization in our view, but there are many other legislative battlegrounds ahead of comprehensive financial sector reform.

We view the run up in financial stocks to be based on more positive assumptions than can be supported at the moment. Business optimism should certainly translate into business spending beneficial to the financial services sector. Interest rate relief is also reasonably likely. Comprehensive tax reform is unlikely until next year and regulatory relief for financials is in, at least temporarily, an amorphous state without key regulatory appointments and concrete discussions. It's "half-a- loaf" for now.

**Financial Stocks Likely to Pause / Retreat Until More Surfaces:** Financials have lost only a little ground after a spectacular post-election gain. Fundamentally, this may be an interim high until elements of the incoming Administration's economic possibilities and regulatory plans become clearer. The NASDAQ Bank Index is currently 26% higher than before the election. The 10-year Treasury rate remains up 65 basis points or roughly 35% higher. Yet bank earnings estimates for 2018 have risen only about 8%, leaving sharply higher forward price/earnings ratio valuations supporting most of the move.

While there has been extensive coverage of cabinet appointments and early policy moves by the new Administration, actions and intents directly impacting financial institutions have so far been relatively limited. This should be no surprise considering higher, or at least earlier priorities for areas such as foreign policy, health care reform, tax reform, and infrastructure spending. But it has left investors searching for a firmer foundation underpinning the likely nature of any regulatory "relief" or reform.

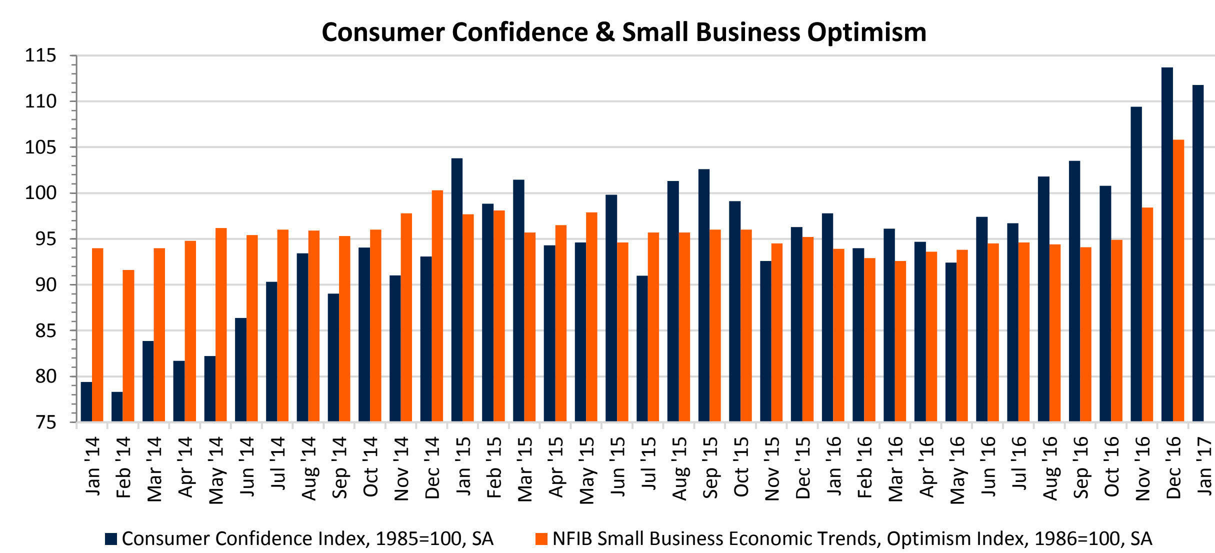
Prior to the election, we had consistently been arguing that the U.S. economy was in an elongated cycle of moderate growth with almost certain interest rate elevation, which would be particularly good for banks.  Immediately following the election, investors quickly envisioned four positives for financials: Infrastructure spending, tax reform, interest rate and regulatory relief.

The first three interrelate and are clearly important enhancements to our economic environment outlook. In combination, U.S. real GDP may do better than its 2% current trend, but the longer term trend line remains compressed by weak labor force growth, which has been heavily influenced by demographics. Nonetheless the interest rate outlook, based on the Fed's "dot plot" reacted almost immediately. Consumer and business confidence has done likewise.

**Interest Rate Relief has Upside:** Whether interest rates rise commensurately to expectations cannot be known.  Investor expectations are substantially lower than the "dot plot" after years of disappointment. Only one 25 basis point hike is generally assumed for 2017.  Therefore, meaningful upside to financial sector earnings from rate relief still remains.  Interestingly, analysts have generally been incorporating corporate tax relief far more readily than interest rate relief.

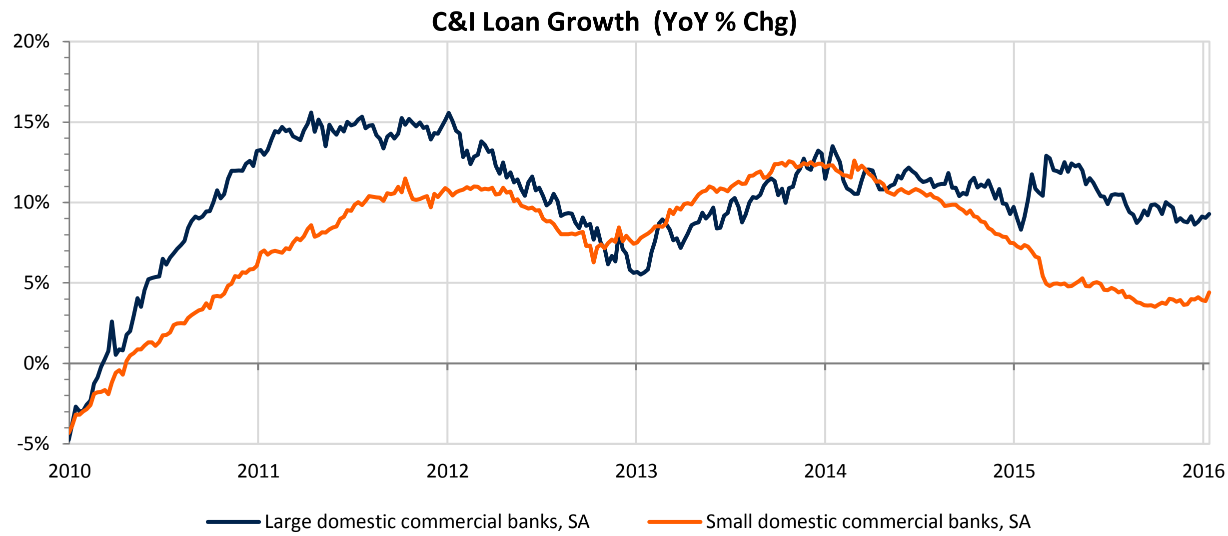
Nonetheless, solid job growth, steady consumer spending and gradually rising wage trends from late 2016 are all likely to not only continue but accelerate.  Trump policies for tax reform and infrastructure spending are very much additive to these trends and may well provide a "spillover point" to Fed data triggers, pushing them to act farther and faster than originally contemplated.

**Business Spending has the Most Promising Upside:** Consumer and business spending should ultimately follow sustained confidence.  Confidence in both sectors gained notably in December with Consumer Confidence further eclipsing a 15-year high in January.  The sharp spike on the commercial side was even more encouraging, suggesting the slowdown in business borrowing since 2015 may finally be coming to an end.  This had been our biggest domestic economic concern.




*Source: Conference Board, National Federation of Independent Business*

While many other Trump policy imperatives can be important and impactful, they will take many months to evolve and engage. But a sustained turnaround in business confidence should be visible and impactful in short order. Government has now turned unmistakably and sharply business friendly. This will become clearer with January and February business confidence data, in quarterly business spending by Spring and reaccelerating bank lending to businesses during the first half of 2017.




*Source: Federal Reserve*

Weakness in small business credit demand has been apparent for the last five quarters, as demonstrated by small bank commercial and industrial loan slippage in the exhibit above. We now have reason to expect a revival.

**Impactful Infrastructure Spending:** The power of a focused stimulus package could be dramatically more impactful on the economy, and jobs, than the broad, diffuse package of the American Recovery and Reinvestment Act of 2009. ARRA totaled $830 billion over its life and was roughly 6% of annual GDP when announced. However, the jobs created or "saved" was meager and costly. Dividing the total ARRA package by these jobs implied a $300,000 cost to each one saved or created.

Partly explaining its inefficiency, slightly more than $100 billion was directed at infrastructure, which was only about 0.7% of GDP at the time. Approaching 6% the intended Trump package for infrastructure is eight-fold larger than that. (As a historical reference point the Eisenhower 1950s interstate highway program was closer to 20% of GDP.) In context, ongoing annual infrastructure spending is estimated to be $500 billion - so another $100 billion would represent a 20% expansion. That moves the needle.

**Consolidation:** Some speculate a major motivation for banking consolidation, burgeoning regulatory burdens and costs, may wane. This is very presumptive without knowing how much can really change to meaningfully reduce resource costs pertaining to regulatory compliance. Without knowing who will be in place at the Fed, the FDIC and the OCC, it is even more unclear what areas of regulation can or will be reviewed and reformed.

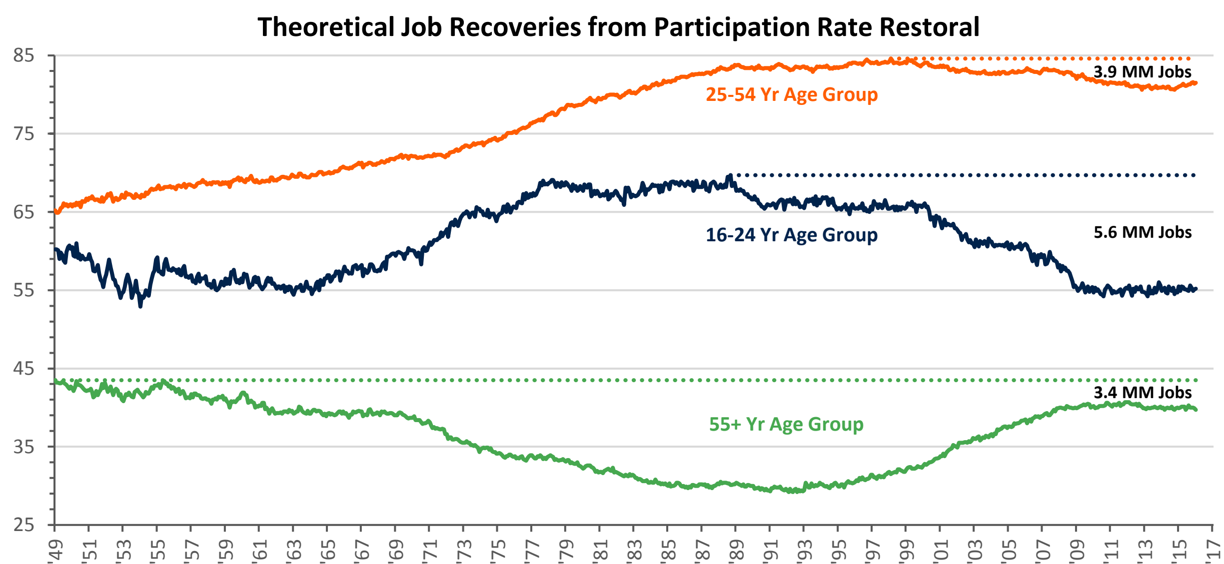
Having said this, it is difficult to conceive of appointments or policies that would further burden community and regional banks. It is also reasonable to assume the tone of regulation changes for the better even without specific rule alterations. This could actually prove helpful to consolidation over time, as the current approval process environment is cluttered with hurdles and uncertainties.

Higher acquirer stock prices, if they hold, will be far more important to sustain and even elevate consolidation activity then likely regulatory change. We continue to expect robust bank M&A unrelated to the political wind shift.

**Breaking Through the 2% Economic Trend Line Barrier?** We are more sanguine about short-term stimulative impact than any durable upshift in trend line economic growth. This stems from our long argued case that demographics have eroded labor force growth, which underlies consumer spending, the dominant GDP driver. In our September report we noted - “over the last 35 years the inter-recession GDP growth trend declined from 4.1% per annum in the mid-to-late 1980s to 3.5% for most of the 1990s to 2.6% prior to the Great Recession and only 1.8% since.” This stair step decline in growth trend is mirrored in consumer spending and parallel by declining labor force growth.

Surpassing the 2% economic growth trend in any meaningful way would require a sharp departure in demographic trends or labor force participation rate. The former seems unlikely in our view as it would rely on opening immigration policy to shift the demographic wave in place. The latter could work, but is more limited than assumed.

The civilian participation rate has fallen by 3.3 percentage points over the last nine years from 66% since the recession. This reflects an 8.4MM labor force loss. However, the following exhibit shows very different patterns by age group.




*Source: Bureau of Labor Statistics, Sandler O’Neill*

Participation rate in the largest working age group of 25-55 has fallen by only 1.3 percentage points from 82.8%, which works out to about 3.9MM in recoverable labor force. While not a small number, we estimate that a full participation recovery from this group would add only about 35,000 to the monthly payrolls over a symmetrical time period.

**Realistic Deliverability:** Economic reasons for market optimism are compelling, particularly from the sharp rise in confidence surveys. Until the early fog lifts to reveal various levels of Congressional support for the Trump Administration's goals markets are likely to pause or even falter. Executive orders cannot, alone, shift the future. So far they appear to have raised the political hurdles. This is in no small part due to the lack of Cabinet confirmations. We are only passing day 10 of potentially massive shifts in government directions. The best is, hopefully, yet to come - but the path may be tortuous.

* * *

This report has been prepared and issued by the Investment Strategy Group of Sandler O'Neill + Partners, L.P., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. The information contained in this report (except information regarding Sandler O'Neill and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice.

This report has been prepared and circulated for general information only and presents the authors' views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice.