



MORNING BRIEFING

July 19, 2018

Fancy Fintech & Punxsutawney Powell

See the [collection](#) of the individual charts linked below.

(1) So far, Q2 earnings looking good for Financials. (2) Talking about Fintech on earnings calls. (3) Banking on apps. (4) Goldman wants us to bank with Marcus. (5) BofA wants us to talk to Erica. (6) PNC using Fintech to go national. (7) A preview of 2019 earnings. (8) Fed Chairman Powell's 10 talking points.

Financials: Talking Fintech. Financial services stocks stalled this year after a monster run in the wake of the recession ([Fig. 1](#)). No major problems jump out from the few Q2 earnings reports we've perused. Asset quality is high, loan growth has picked up at many banks, and strong results have opened the door to ever-larger dividend increases and stock buybacks. And despite a flattening yield curve, banks managed to increase their net interest income.

With no fires to put out, executives at PNC Bank, Bank of America (BofA), and Goldman Sachs spent a lot of air time on Q2 conference calls discussing their institutions' latest technology offerings. Consumers' growing comfort with online and mobile banking is giving these institutions a new way to grow. Using online technology to gather deposits and sell banking products should allow banks to leverage their existing systems and expand margins while also defending their turf from the Internet banking upstarts that are trying to disintermediate the banking business. Let's take a look at what the execs had to say:

(1) *Goldman's Marcus.* News that David Solomon was chosen to become Goldman's new CEO stole the firm's Q2 earnings headlines. However, during the conference [call](#), CFO Marty Chavez gave investors an update on Goldman's effort at growing its virtual retail bank, called "Marcus" after founder Marcus Goldman.

In the US, the bank offers personal loans, savings, and financial management. Since its 2016 launch, Marcus has originated more than \$4 billion of consumer loans. It has \$23 billion of retail deposits and serves 1.5 million customers. Under consideration are new products including wealth management, credit cards, and others, Chavez said.

While the operation is small relative to the size of Goldman, Marcus loans may produce a return on equity in the high teens, and its retail deposits give Goldman a stable, low-cost funding source. A 2/27 *WSJ* [article](#) explained: "without expensive branch networks and legacy systems, Goldman executives believed they could outmaneuver large commercial banks. Meanwhile, the firm's \$900 billion balance sheet would be an advantage over online lending startups. Those firms rely on investors to buy their loans, leaving them vulnerable when markets clam up."

(2) *BofA's automation.* The nation's largest bank is looking at online banking as a way to make clients' lives easier and more efficient, while helping the bank to automate and reduce costs, said CEO Brian Moynihan on the Q2 conference [call](#). BofA has 25 million active mobile users, who collectively logged into their mobile apps nearly 1.4 billion times in Q2, and another 10 million users of other digital

channels.

The bank is also rolling out a virtual, digital assistant, Erica. (Why are all digital assistants female?) After just a few months since her debut, Erica has amassed 2 million users. The goal is to simplify and speed up transactions that can take longer when tapping through a mobile app menu. Users can simply ask Erica to send money to a friend or to pay a bill. Erica can also give consumers suggestions on how to manage their personal finances. Users with a balance in a checking account at month's end might be asked if they'd like to put that sum into savings or set up an appointment with a financial adviser, a 5/12/17 *WSJ* [article](#) reported.

"Customers are doing more of their regular deposit transactions on their digital devices. This quarter, we saw more deposit transactions by a person taking a picture of the deposit and sending over mobile phone than we did by a person handing their check to the teller," said Moynihan. "In fact, 76% of all our deposit transactions are now through ATMs and mobile deposit. This allows for more meaningful relationship management activities to take place in our centers as we invest more and add more teammates to do that."

BofA is also one of the banks supporting the Zelle payments system. Moynihan said the bank processed 35 million Zelle transactions in Q2, representing principal of more than \$10 billion, twice the pace of last year. In addition, BofA is selling products online: 24% of sales are executed digitally, including auto and mortgage loans. These "are just a set of examples about how the sustained investment coupled with the change in customer behavior coupled with the process improvement coupled with the operating excellence allows us to drive positive operating leverage while driving up customer delight," he explains, using a favorite word of Amazon's Jeff Bezos ("delight").

(3) *PNC: Going national, digitally.* PNC is working on a digital banking offering that will be available on a national basis, but the bank will focus its marketing in areas where it doesn't currently have a core branch presence, explained CEO William Demchak in the Q2 conference [call](#). The bank is also building out a "thin" branch network to complement the online bank offering.

"What we are doing is chasing deposits with low ... marginal cost to them, because we don't have a big physical plan cost associated with the deposits," said Demchak. Given the bank's brand, he believes PNC should be able to grow the digital deposit base at least as quickly as some of the other larger digital players in the market. "You now have the ability through digital marketing and social media to get brand awareness for a thin branch network in a way that you just didn't have available twenty years ago," he explained. The ultimate goal is to sell those digital savings customers other PNC banking products.

Because of the lower costs involved, PNC expects to offer higher yields on deposits coming in through its digital bank offering. That prompted us to look at Bankrate.com, where some of the highest yields on FDIC-insured savings accounts are being offered by the online arms of banks both small and large.

Salem Five Direct—the online arm of Salem Five, a bank in Massachusetts—is offering 2.05% on a FDIC-insured account. Citizens Access, another online bank, is offering 2.0% on a \$5,000 minimum deposit. A little further down the list were Marcus and Vio Bank, both offering 1.8% on savings accounts. Vio is a division of MidFirst Bank, a privately owned bank, so it can offer FDIC coverage. For those comfortable with virtual banking, the Internet has been evening the playing field between the industry's giants and the small fry.

Earnings: Looking to 2019. With the Fourth of July now squarely in the rear-view mirror, it's not too soon to flip the calendar and take a peek at what 2019 may hold for earnings. Things are sure to get

tougher without a tax cut juicing the bottom line, but there are still some positives to anticipate. With the price of oil north of \$65, earnings in the S&P 500 Energy sector should continue to gush higher, and with the unemployment rate around 4%, robust consumer spending should help the S&P 500 Consumer Discretionary sector.

Here's what analysts are forecasting for the S&P 500's earnings in 2019 compared to expectations for this year: Energy (18.2%, 99.1%), Industrials (12.6, 18.9), Consumer Discretionary (12.5, 18.3), Financials (10.2, 30.5), S&P 500 (10.0, 22.3), Technology (9.7, 23.5), Health Care (8.8, 12.9), Materials (7.8, 28.8), Consumer Staples (7.1, 11.4), Utilities (5.4, 5.9), Real Estate (4.2, -12.7), and Telecom Services (2.8, 14.1). Let's take a gander at what analysts expect for some of the S&P 500 industries they see growing the fastest and slowest this year and next:

(1) *Energized profits.* Given that Energy is the S&P 500 sector that's expected to grow earnings fastest next year, it's logical that this sector's industries are among the S&P 500's top performers. The S&P Oil & Gas Drilling industry is expected to grow earnings sharply after returning to a small profit in 2018. Also among the top 10 fastest growing industries in 2019 are: Oil & Gas Equipment & Services 49.2%, Oil & Gas Refining & Marketing (37.3), and Oil & Gas Exploration & Production (23.9).

(2) *Born to shop.* Beyond the concentration in Energy, the S&P 500's fastest-growing industries are a bit more eclectic. Leisure Products is the second-fastest grower, expected to increase earnings by 100.2% next year, up from the 48.5% forecast growth this year. The S&P 500 Leisure Products stock price index—consisting solely of Hasbro and Mattel—has had a tough year, down 18.8%, hurt by the bankruptcy of Toys “R” Us, one of their largest customers ([Fig. 2](#)). But more recently, the stocks have showed some signs of life, rising 4.5% ytd, and earnings estimates have ticked ever so slightly higher after free-falling for roughly the past two years ([Fig. 3](#)).

The S&P 500 Internet & Direct Marketing Retail index, a perennial fast-grower with Amazon and Netflix as members, is expected to see earnings jump 40.7% in 2019, slowing moderately from this year's expected earnings growth of 68.3% ([Fig. 4](#)). Bear in mind that Netflix is expected to be yanked out of the S&P 500 Consumer Discretionary sector and placed in a revamped S&P 500 Communications Services sector this fall.

(3) *Industrious Industrials.* Rounding out the top 10 fastest-growing industries are two industries in the S&P 500's Industrials sector and two in its Materials sector. Construction & Engineering is forecast to grow earnings by 25.8% in 2019 and 34.9% this year. Analysts are calling for fellow Industrials industry Agriculture & Farm Machinery to grow earnings by 22.2% in 2019 and 43.0% this year. Meanwhile, the S&P 500 Fertilizers & Agricultural Chemicals industry is expected to sprout 24.9% earnings growth in 2019 after 130.8% earnings growth this year, and Construction Materials is expected to grow earnings by 23.5% in 2019 and 37.0% in 2018.

(4) *Beware Dr. Copper.* Who's expected to struggle next year? Well, the S&P 500 Copper industry is at the bottom of the list, with earnings forecast to fall 39.7% next year as the metal in the industry's name has fallen in price by 17% since June 8 ([Fig. 5](#)). Not much better is the 12.9% decline in earnings expected next year for the S&P 500 Steel industry after a 102.1% jump in earnings this year, catalyzed by the Trump tariffs.

(5) *Writing off REITs.* Analysts expect numerous industries in the REIT sector to have negative earnings growth next year: Hotel & Resort REITs (-15.1%), Health Care REITs (-9.4), Industrial REITs (-5.3), and Residential REITs (-4.6). Despite their strong ytd performance, 31.1%, the S&P 500 Department Stores industry's earnings are expected to fall 1.9% next year. Two economically sensitive industries are also at the bottom of the list: S&P 500 Automobile Manufacturers, which analysts expect

will post a 0.5% decline in earnings in 2019 after a 7.3% drop this year, and Semiconductor Equipment, which is forecast to have flat earnings, 0.3%, compared to this year's much stronger 49.5% earnings growth.

The Fed: Punxsutawney Powell. In the movie "Groundhog Day," Bill Murray plays the lead character, a cynical reporter named "Phil." Phil gets stuck in a snowstorm in Punxsutawney, PA while covering the annual Groundhog Day celebration there. The groundhog, also named "Phil," sees his shadow, signaling that wintery conditions will continue. Phil, the man, awakens the next day to find that he must repeat the same day over and over again. Eventually, he leverages the predicament to his advantage.

Similarly, Fed Chairman Jerome Powell has been repeating the same outlook for the economy ever since he became the new Fed head on February 5 of this year. In his [Semiannual Monetary Policy Report to the Congress](#) on Tuesday, he continued to characterize the risks to the economic outlook as remaining balanced on the upside and downside—suggesting that the Fed will continue to gradually raise interest rates. Below are 10 quotes from his 7/17 testimony representing points he's made before:

(1) *Continuing to gradually increase rates.* "With a strong job market, inflation close to our objective, and the risks to the outlook roughly balanced, the FOMC believes that—for now—the best way forward is to keep gradually raising the federal funds rate."

(2) *Risks to the outlook are balanced.* "Overall, we see the risk of the economy unexpectedly weakening as roughly balanced with the possibility of the economy growing faster than we currently anticipate."

(3) *Inflation objective is symmetric.* "Many factors affect inflation—some temporary and others longer lasting. Inflation will at times be above 2 percent and at other times below. We say that the 2 percent objective is 'symmetric' because the FOMC would be concerned if inflation were running persistently above or below our 2 percent objective."

(4) *Low productivity explains low wage growth.* "Over a long period of time, wages can't go up sustainably without productivity also increasing. It's a different thing to say that higher productivity guarantees our wages. ... I don't think that's true."

(5) *Education & investment may solve low productivity.* "Part of [the productivity problem] is ... stagnation of educational achievement. ... It's also partly evolution of technology and investment. I think ... we had a number of years of very weak investment after the crisis because there was no need to invest."

(6) *Labor force participation is improving.* "So prime age labor force participation ... has been climbing here in the last couple of years. That's a very healthy sign. Because prime age labor force participation [has] been weak in the United States compared to other countries. So it's very troubling, and the fact that that's coming back up ... is a very positive thing."

(7) *Staying in his lane.* "I'm firmly committed to staying in our lane, and our lane is the economy. Trade is really the business of Congress. And Congress has delegated some of that to the Executive Branch."

(8) *Tax & trade difficult to predict.* "It is difficult to predict the ultimate outcome of current discussions over trade policy as well as the size and timing of the economic effects of the recent changes in fiscal policy."

(9) *Open trade policy is good.* "[C]ountries that have remained open to trade—that haven't erected

barriers, including tariffs—have grown faster, had higher incomes, higher productivity, and countries that have ... gone in a more protectionist direction have done worse. I think that's the empirical result."

(10) *Fiscal policy outcome in a range.* "[L]ate in the cycle near full employment, the effects may be less. They may or may not be. There's a lot of uncertainty. One of the great things about the Fed is we get a healthy range of things, which is a healthy thing."

See the C-SPAN link [here](#) for the full transcript.

CALENDARS

US. Thurs: Leading Indicators 0.4%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 22.0, Weekly Consumer Comfort Index, EIA Natural Gas Report, Quarles. **Fri:** Baker-Hughes Rig Count, Bullard. (*Wall Street Journal* estimates)

Global. Thurs: UK Retail Sales Excluding & Including Auto Fuel 3.7%/3.5% y/y, Japan CPI Total, Core, & Core-Core 0.8%/0.8%/0.4% y/y, Australia Employment Change & Unemployment Rate 16.5k/5.4%. **Fri:** Canada CPI 0.0%/m/m/2.3%/y/y, Canada Retail Sales Headline & Ex Auto 1.0%/0.5%/m/m. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) climbed for the second week to 2.99 this week, after falling from 3.12 to 2.53 the prior three weeks. Virtually all the movement was between the bullish and correction camps. Bullish sentiment jumped 8.2ppts the past two weeks to 55.3% after a three-week fall of 8.4ppts (to 47.1% from 55.5%), while the correction count dropped 8.1ppts over the two-week span to 26.2%, following a three-week spike of 7.6ppts (34.3% from 26.7%). Bearish sentiment was unchanged at 18.5% this week—and has fluctuated in a narrow band between 17.6% and 18.6% the past six weeks. The AAIL Ratio climbed for the second week last week, rising from 41.1% to 59.6% over the period. Bullish sentiment rose from 27.9% to 43.1% last week, while bearish sentiment fell from 40.8% to 29.2% the past two weeks.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus per-share forecasts for forward revenues edged down last week for the first time in nine weeks from a record high, but forward earnings rose to another record. The forward revenues growth forecast was steady w/w at 6.0%, and forward earnings growth was unchanged at 13.9%. The forward profit margin remained steady at a record high of 12.2%, which is up from 11.1% prior to the passage of the TCJA in December and a 24-month low of 10.4% in March 2016. Forward revenues growth of 6.0% is little changed from an 80-month high of 6.3% at the end of February, and compares to a cyclical low of 2.7% in February 2016. The annual 2018 and 2019 revenues growth forecasts were steady w/w at 7.9% and 5.1%, respectively. Forward earnings growth of 13.9% is at a 26-week low and down from 16.9% in February, which was the highest since October 2010. Still, that's up 2.8ppts from 11.1% prior to the passage of the TCJA, and up 9.1ppts from the cyclical low of 4.8% in February 2016. Turning to the annual earnings growth expectations, the earnings growth forecasts were steady w/w at 22.3% for 2018 and 10.0% for 2019. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Financials forward revenues growth forecast was steady at 6.2%, and the forward earnings growth forecast remained at 13.1%. The S&P 500 ex-Financials forward profit margin was steady at 11.3%, which compares to a record high of 11.4% in mid-June and 10.4% before the TCJA. Valuations were higher w/w as the S&P 500's forward P/E rose to a three-week high of 16.5 from 16.1, which compares to a 16-year high of 18.6 at the market's peak in late January and its recent low of 16.0 in early May. The S&P 500 price-to-sales ratio improved 0.04ppt to 2.02, which compares to late January's record

high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenues forecasts rose w/w for 2/11 of the sectors last week, and forward earnings rose for 4/11 sectors. Consumer Staples and Materials had both measures improve w/w. The per-share measures for forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward revenues and earnings are back on uptrends after stalling during 2016-2017, and its earnings have about tripled from their 18-year low in April 2016. Looking at last week's readings for forward growth among the 11 sectors, just two had a w/w improvement in their forward revenues growth forecast (Financials and Utilities) as eight fell. Forward P/S and P/E ratios are down from their recent highs in early 2018 for all sectors. In the latest week, all but Telecom had their P/S ratio improve, and all but three sectors had their forward P/E rise: Energy, Telecom, and Utilities. Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.27 compares to a record high of 1.56 in May 2016, and its P/E of 17.1 is down to a 42-month low now from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's forward earnings includes gains from property sales and typically improves as the year progresses. Telecom was the only sector to have its forward profit margin rise w/w (0.1ppt to 13.7%) as the remaining sectors remained steady. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (18.7), Real Estate (16.2), Telecom (13.7), Utilities (12.5), S&P 500 (12.2), Materials (11.3), Health Care (10.5), Industrials (10.2), Consumer Discretionary (8.0), Consumer Staples (7.6), and Energy (7.4). Energy's forward profit margin is now the highest since December 2014. Among the remaining 10 sectors, all but two (Real Estate and Health Care) are at or near recent record highs.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With nearly 10% of S&P 500 companies finished reporting earnings and revenues for Q2-2018, the percentage of companies with positive earnings surprise results is higher compared to the same point during the Q1 earnings season, but companies' overall percent surprise for Q2 and their y/y growth rate metrics are a tad lower. Of the 49 companies in the S&P 500 that have reported through mid-day Wednesday, 90% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 27.3%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (74%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.4%, and earnings were up a higher 31.6% y/y. On the revenue side, 82% of companies beat their Q2 sales estimates so far, with results coming in 1.4% above forecast and 10.1% higher than a year earlier. At this point in the Q1 season, a higher 81% had exceeded revenue forecasts by a higher 1.7%, and sales rose a higher 10.9% y/y. Q2 earnings results are higher y/y for 98% of companies, vs a lower 93% at the same point in Q1, and Q2 revenues are higher y/y for 94% vs 93% also a quarter ago. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q2-2018 should mark the eighth straight quarter of positive y/y earnings growth and among the highest since Q4-2010. The strong results are mostly due to lower tax rates and improved business conditions, with a small benefit due to currency translation.

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Housing starts & permits dropped sharply in June as builders continued to be hampered by a shortage of lots and rising labor & materials costs, while buyers continued to be challenged by rising home prices and mortgage rates. Total starts plunged 12.3%, the steepest monthly decline since November 2016, to 1.173mu (saar)—the weakest activity since hurricanes Harvey and Irma struck in August and September of last year. June's decline followed a

smaller increase in May (to 4.8% from 5.0%) and a larger decline in April (-3.8 from -3.1). Builders broke ground on 9.1% fewer single-family homes last month than the prior month as starts sank to a six-month low of 858,000 units (saar) from 944,000 units in May. Meanwhile, volatile multi-family starts plummeted -19.9% to a 10-month low of 315,000 units (saar), following a 4.0% gain and a -15.1% loss the previous two months. Building permits fell for the third month, by a total of -7.6% to 1.273mu (saar)—the lowest since last September—as multi-family permits tumbled -19.6% over the three-month period to a nine-month low of 423,000 units (saar). Single-family permits edged up 0.8% last month to 850,000 units (saar) after falling -2.3% in May and rising 1.4% in April; they are down -3.1% ytd. Meanwhile, NAHB's housing market index was unchanged at 68 this month, with the components mixed: Current sales conditions remained unchanged at 74, while the component gauging expectations dropped two points to 73 and the metric charting buyer traffic rose two points to 52. "Builders are encouraged by growing housing demand, but they continue to be burdened by rising construction material costs," said NAHB Chief Economist Robert Dietz. "Builders need to manage these cost increases as they strive to provide competitively priced homes, especially as more first-time home buyers enter the housing market."

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): June's CPI rate matched its flash estimate, accelerating to a 16-month high of 2.0%, remaining at the ECB's goal for the second month. Looking at the main components, energy (to 8.0% from 6.1% y/y) had the highest annual rate in June—quadruple its recent low of 2.0% in March. Also moving higher were rates for food, alcohol & tobacco (2.7 from 2.5) and non-energy industrial goods (0.4 from 0.3), while the services (1.3 from 1.6) rate moved lower. The core rate—which excludes energy, food, alcohol, and tobacco—eased to 0.9% y/y, after accelerating to an eight-month high of 1.1% in May. Of the top four Eurozone economies, inflation rates in France (2.3% y/y), Spain (2.3), and Germany (2.1) were above the Eurozone's 2.0% rate, while Italy's (1.4) was below. Ireland (0.7) and Greece (1.0) posted the lowest rates among the Eurozone countries.

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