



MORNING BRIEFING

October 18, 2018

Bankers, Truckers & Fakers

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

(1) Taking it to the Street: JPM's Dimon and BAC's Moynihan have much good to say about their banks' Q3s. (2) Expanding bank behemoths with cheery CEOs can't be bad for the rest of us. (3) S&P 500 Diversified Banks' earnings expectations are up and share prices down: Does opportunity knock? (4) S&P 500 Trucking index has been lagging its Railroad counterpart; 3Q earnings reports confirm why. (5) Reading between the line items. (6) When deepfakes stop being funny.

Financials: Banks Give 'All's Clear.' Jackie and I like to skim through lots of transcripts of earnings conference. We are particularly fond of those of Bank of America and JP Morgan because both institutions touch so many different areas of the US economy. Together, they have \$2.8 trillion of total deposits, \$1.9 trillion of loans and leases, and \$3.2 trillion of assets under management. Despite stock investors' recent handwringing about the economy, executives from both behemoths have reported that their businesses are doing just fine, thank you. Their confidence undoubtedly helped spark Wednesday's 547.87 point rally in the DJIA. Here are highlights from their recent conference calls:

(1) *Economy growing nicely.* Executives from both JP Morgan and Bank of America noted the economy's strength in Q3 and seemed optimistic about the future, even if the future includes higher interest rates.

"The economy is strong, rates are going up. Most of us consider it a healthy normalization and going back to more of a free market when it comes to asset pricing and interest rates, et cetera. And we need that," said CEO Jamie Dimon on the 10/12 Q3 earnings [conference call](#). He added that the economy's strength could continue for "a while," as it's benefitting from rising wages and higher participation rates, pristine credit quality, housing that's in short supply, and extraordinarily high small business and consumer confidence.

The glass is also half full at Bank of America: "We are in [an] operating environment that has a strong, growing US economy, low unemployment, growing wage growth and strong consumer spending levels. Client engagement, optimism and activity remain good," said CEO Brian Moynihan in the company's Q3 [conference call](#) on 10/15.

(2) *Loans growing.* JPMorgan reported that core loans rose 7% y/y in Q3, and the net yield on interest-earning assets improved to 2.51%, up from 2.37% a year earlier. Banks haven't gotten much help from the Treasury yield curve—or the 10-year Treasury less the federal funds rate—which remains relatively flat, having stabilized just above 100, not far from readings posted last summer ([Fig. 1](#)). However, even the small improvement in yield on JPM's interest-earning assets has a big impact on the bank's large, growing loan book. Net interest income was up 8.7% to \$13.9 billion in Q3. A little less than half of JP Morgan's loans are variable rate, so they'll continue to reprice if interest rates increase.

One area of softness to watch: home mortgages. Mortgage fees and related income dropped 38.9% in

JPMorgan's Q3 y/y. The bank is not alone, as higher interest rates and lofty home prices are slowing home sales and reducing the demand for mortgages. New plus existing single-family home sales dropped to 5.38mu (saar) in August from a recent high of 5.76mu last November ([Fig. 2](#)). Higher rates also took a bite out of the index for applications to refinance mortgages, which fell to 913 last week, based on the four-week average, the lowest level since the end of 2000 ([Fig. 3](#)).

At Bank of America, loans grew on average by more than 3% across business lines during the quarter. One sluggish area was corporate loans, where demand for borrowing was low because companies are flush with cash. Companies "continue to make good money, and they also have cash they are repatriating. And lastly, they continue to benefit from tax savings, and they're using that to keep their debt levels in check," said Moynihan. Bank of America calculates that a 100bpt parallel increase in rates above the forward yield curve would increase net interest income by \$2.9 billion over the subsequent 12 months.

Bank of America's observation about sluggish loan growth jibes with Fed data. Commercial and Industrial (C&I) loans at all banks plus nonfinancial commercial paper has declined modestly, by 2.0%, after hitting a peak during the week of June 20 ([Fig. 4](#)). C&I loans have been in a flat trend since late June, and nonfinancial commercial paper has declined 16.6% over the period, though the former moved to the top of its range during first week of October ([Fig. 5](#)). The Fed's July [survey](#) indicated that banks reporting weaker C&I loan demand cited the following reasons: increases in internally generated funds, reduced investment in plant or equipment, and the shift of customers' borrowing to other lenders. US companies repatriated \$169.5 billion in foreign profits in Q2, after repatriating \$294.9 billion in Q1, a 9/19 [WSJ article](#) reported.

(3) *Credit quality holding.* JP Morgan reduced its provision for credit losses to \$948 million in Q3, down \$504 million from year-ago levels. Likewise, Bank of America's provision for credit losses fell to \$716 million in Q3, down from \$834 million a year ago. Provisions for loan and lease losses and net charge-offs at FDIC-insured institutions have come down sharply from their recessionary peaks, and are slowly inching higher ([Fig. 6](#)).

(4) *Returns improved.* Both banks' returns on tangible common equity have risen to levels unthinkable during the Great Recession: 17% at JPMorgan and 16% at Bank of America were reported for Q3.

(5) *Expanding geographically.* JP Morgan and Bank of America both are expanding—even though their branch networks shrank over the past year. JP Morgan recently opened its first branch in Washington, DC and plans hundreds of more branch openings in cities including Philadelphia and Boston. The bank's total branch count has declined to 5,066 in Q3 from 5,174 a year earlier.

Bank of America is expanding organically because banking laws prohibit it from making acquisitions. The bank is opening retail branches in cities where it already has other operations, such as asset management or commercial banking. Bank of America recently opened branches in Denver, Minneapolis, Indianapolis, and Pittsburgh and has plans to jump into Cincinnati, Columbus, Lexington, Cleveland, and Salt Lake City. That said, the number of its financial centers has declined to 4,385 from 4,515 a year ago. The bank believes its future success will require offering both digital and physical access to banking services, something it describes as a "high-touch/high-tech" service model.

(6) *Preparing for CECL.* Both banks were asked to estimate the impact of changes to accounting rules affecting current expected credit loss, or CECL. Under the new system, banks will need to estimate the expected credit loss over the life of the loan. That differs from the current system where banks recognize losses when they "reached a probable threshold of loss," explains a [primer](#) by SAS. JP Morgan's CFO Marianne Lake noted that analysts have estimated that in general bank reserves might

need to increase by 20%-30%.

Bank of America's CFO Paul Donofrio was a bit vaguer: "[T]here will likely be some increase to allowance upon adoption, but the amount of increase, the impact, is going to be dependent on the economic outlook and credit conditions on the date of adoption, and that's not until 1/1/2020. So, we'll just have to wait." An [article](#) in yesterday's *WSJ* indicated a handful of regional banks have met with Washington politicians and regulators in an effort to modify the rule. Proponents believe the rule will give investors more timely information. Detractors warn it will make banks less willing to loan during a recession.

(7) *Blockchain in action.* JPMorgan's Interbank Information Network (IIN), a blockchain for international payments, has 75 banks signed up. Here's how the bank describes its project: "IIN ... minimizes friction in the global payments process, enabling payments to reach beneficiaries faster and with fewer steps. Using blockchain technology, IIN reduces the time correspondent banks currently spend responding to compliance and other data-related inquiries that delay payments."

(8) *An underwhelming year.* JPM and BAC both are members of the S&P 500 Financials sector, which is down 4.3% ytd through Tuesday's close. Here's how that stacks up to the ytd performance of the other 10 S&P 500 sectors: Tech (13.9%), Health Care (12.5), Consumer Discretionary (12.1), S&P 500 (5.1), Utilities (2.1), Energy (1.4), Industrials (-0.7), Real Estate (-4.2), Financials (-4.3), Communications Services (-6.7), Consumer Staples (-6.7), and Materials (-9.8) ([Fig. 7](#)).

The two banking giants are part of the S&P 500 Diversified Banks stock price index, which is also down by 4.2% ytd ([Fig. 8](#)). The index may just be consolidating after enjoying a strong run from early 2016 through late last year. Or investors may be anticipating the above-mentioned CECL accounting change before analysts include it in their estimates. Analysts call for the industry to grow revenues by 3.3% this year and 3.6% in 2019 ([Fig. 9](#)). Earnings are forecast to jump 26.0% and 13.2% this year and next ([Fig. 10](#)).

Because the industry's stock price index has stalled while earnings have continued to climb, its forward P/E has fallen to a reasonable 10.9, down from 13.7 in December 2017 ([Fig. 11](#)). On a price-to-book basis, the stocks don't look quite as attractive. JPM's tangible book value per share is \$55.68, just around half of the bank's Tuesday closing stock price of \$108.62. Similarly, BAC's tangible book value is \$17.23, well below its stock price of \$28.53.

Transports: Driven by Labor. Our 10/4 [Morning Briefing](#) pointed out the sharp divergence in the recent performances of the S&P 500 Railroads and Trucking stock price indexes. Starting this summer, the Railroad index continued to chug higher while the Trucking index went into reverse ([Fig. 12](#)).

The two transportation indexes moved in opposite directions even as the freight indicators we watch continued to climb or remain in record territory. Both indexes fell sharply in the market's recent selloff, but the S&P 500 Railroad stock price index remains up ytd, by 18.4%, while the S&P 500 Trucking stock price index has lost 0.9% ytd.

We speculated that the Trucking index was faltering because the industry is much more labor intensive (one truck, one driver) and much less fuel efficient than the railroad industry. Railroads can have one or two conductors manning trains with more than 100 railcars. Tuesday's earnings reports from JB Hunt Transport Services and CSX largely confirmed our theory. Let's take a look:

(1) *Peer beyond the bottom line.* JB Hunt's top and bottom lines look great. It's what's in the middle that may worry investors. The trucking company's total revenue, including fuel surcharges, jumped 19.9% in

Q3 y/y to \$2.2 billion. However, its operating expenses jumped even more sharply, by 21.3%, to \$2.0 billion.

Part of the surge in expenses can be blamed on the double-digit percentage increase in drivers' salaries, which sent JB Hunt's salaries, wages, and employee benefits 21.3% higher y/y to \$495.4 million in Q3. Other expenses jumped sharply too: Operating supplies and expenses rose 17.2% to \$79.2 million, general and administrative expenses, net of dispositions, increased by 44.4% to \$42.4 million, insurance and claims soared 72.3% to \$45.6 million, operating taxes and licenses rose 22.9% to \$13.2 million, and communications and utilities came in at \$7.1 million, up 23.5% y/y.

Because expenses rose so much faster than revenues, operating income increased by only 5.9%. However, the company's bottom line grew far faster than 5.9% because JB Hunt's income taxes fell sharply thanks to the Trump administration's tax cuts. After taxes are accounted for, net earnings rose by 30.6% y/y to \$131.1 million.

(2) *Same sector, much different picture.* CSX also enjoyed gains in its top line: Revenue improved by 14.1% in Q3 y/y, bringing it up to \$3.1 billion. However, at the railroad company, labor and benefits in the quarter actually fell 4.1% y/y to \$695 million. The company also benefitted from an 18.3% drop in equipment and other rents to \$89 million. Those declines were somewhat offset by a 30.7% jump in fuel expense.

All tallied, total expenses at CSX dropped 2.1% y/y to \$1.8 billion, allowing the company's operating income to soar 49.0% to \$1.3 billion. Like JB Hunt, CSX also enjoyed a reduction in its tax bill. As a result, its net earnings after taxes almost doubled to \$894 million last quarter, from \$459 million a year earlier. Share repurchases meant the company's earnings per share fared even better, rising by 105.9% y/y.

The moral of the story: Sometimes the bottom line is not the bottom line.

Tech: Beware Deepfakes. If fake news is bad, fake videos—known as “deepfakes”—have the potential to be even worse. The technology exists to use the images of people saying and doing things that they've never said or done.

At first, this functionality seemed harmless and comical. Who wouldn't like to see a young Harrison Ford inserted into “Solo: A Star Wars Story,” a deepfake video brought to our attention by a 10/16 Gizmodo [article](#)? Turns out, the video is just one of many broadcast on the YouTube channel [derpfakes](#). The creator has fake videos of Nicolas Cage, Hillary Clinton, and Vladimir Putin among others, which are comical primarily because it's clear that they're fake. We know that Harrison Ford is 76 and couldn't really be in the recent “Star Wars” film looking youthful.

But the 10/15 *WSJ* did a thought-provoking [piece](#) about the dark side of deepfakes. Fake videos become more problematic when they feature regular people or politicians doing or saying things that aren't obviously bogus, leaving viewers unable to judge the video's veracity. In addition, the mere existence of deepfakes is problematic because it theoretically allows politicians to disavow real videos by calling them “deepfakes.”

Perhaps most disconcerting is the idea of a fake video of a President saying he (or she) launched a nuclear war. If that fake video is sent to another country, say North Korea, that country might retaliate by launching nuclear weapons. Something funny has the potential to turn serious awfully quickly.

CALENDARS

US. Thurs: Leading Indicators 0.5%, Jobless Claims 215k, Philadelphia Fed Manufacturing Index 20.0, EIA Natural Gas Report, Bullard, Quarles. **Fri:** Existing Home Sales 5.300mu, Baker-Hughes Rig Count, Bostic. (Econoday estimates)

Global. Thurs: UK Retail Sales Including & Excluding Auto Fuel 3.6%/3.8% y/y, Japan CPI Headline, Core, and Core-Core 1.3%/1.0%/0.4% y/y, Australia Employment Change & Unemployment Rate 15k/5.3%, Kuroda. **Fri:** China GDP 1.6%q/q/6.6%y/y, China Retail Sales 9.0%, China Industrial Production 6.0% y/y, China Fixed Assets Ex Rural (ytd) 5.3% y/y, Canada Headline & Core CPI 2.7%/2.0% y/y, Canada Retail Sales 0.4%, Carney, Kuroda. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Our Bull/Bear Ratio (BBR) fell for the second week this week, slipping below 3.00 for the first time in 10 weeks to 2.84. It had climbed eight of the prior nine weeks from 2.90 to 3.32—which was its highest reading since mid-March. Movement continues to be centered in the bullish and corrections camps, with the former falling to a 15-week low and the latter rising to a 15-week high this week. Bullish sentiment sank -9.9ppts (to 51.9% from 61.8%) the past two weeks, after rising 7.3ppts (from 54.5%) the prior nine weeks, while the correction count increased 10.2ppts (29.8 from 19.6) over the two-week period, after falling -7.1ppts (from 26.7) the previous nine weeks. Two weeks ago, the former was at its highest reading since the end of January, while the latter was at its lowest since mid-February 2012. Meanwhile, bearish sentiment was once again little changed, ticking down to 18.3% this week; it has fluctuated in a narrow band between 17.6% and 18.8% since early June. The AAI Ratio dropped to 46.3% last week after advancing the prior three weeks from 49.5% to 64.5%. Bullish sentiment fell to 30.6% after rising the prior two weeks from 32.0% to 45.7%, while bearish rose to 35.5% after dropping from 32.8% to 25.1% the previous three weeks.

S&P 500 Q3 Earnings Season Monitor ([link](#)): With over 10% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the revenue and earnings surprise metrics remain very strong compared to Q2's stellar results and are not showing signs of a sharp slowdown. Of the 51 companies in the S&P 500 that have reported through mid-day Wednesday, 84% exceeded industry analysts' earnings estimates by an average of 4.2%; they have averaged a y/y earnings gain of 24.8%. On the revenue side, 69% of companies beat their Q3 sales estimates so far, with results coming in 0.4% above forecast and 7.8% higher than a year earlier. At the same point during the Q2-2018 reporting period, a similar percentage of companies (84%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.0%, and earnings were up a tad lower 24.4% y/y. With respect to revenues, a higher 74% had exceeded revenue forecasts at this point in the Q2 season by a higher 1.4%, and sales rose a greater 10.5% y/y. Q3 earnings results are higher y/y for 96% of companies, vs a slightly lower 95% at the same point in Q2, and Q3 revenues are higher y/y for 92% vs a similar 92% also a quarter ago. These figures will change markedly as more Q3-2018 results are reported in the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q3-2018 should mark the ninth straight quarter of positive y/y earnings growth and among the highest since Q4-2010; y/y revenue growth should be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but cost pressures are increasing.

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Builders both broke ground on fewer homes in September

and applied for fewer permits to start future projects, facing continued challenges in the form of lot shortages and high labor & materials' costs and the added challenge of Hurricane Florence's impacts. Total starts slumped -5.3% last month to 1.201mu (saar) after gains of 7.1% and 0.6% the prior two months; starts have shown little change so far this year, down -0.7% ytd. Single-family starts slipped -0.9% to 871,000 units (saar) after a two-month gain of 3.3%, while volatile multi-family starts plunged -15.2% to 330,000 units (saar) after jumping 20.4% in August. The former is up 2.8% ytd, while the latter is down -9.1%. Building permits decreased for the fifth time in six months, by a total of -9.9%, to 1.241mu (saar) after a 4.3% increase the first three months of this year to a new cyclical high. Multi-family permits dropped -25.9% during the six months through August, to 390,000 units (saar)—the lowest since March 2016. Single-family permits climbed 2.9% to 851,000 units (saar) after a -5.2% loss and a 2.3% gain the previous to months; they're down -3.0% ytd. Meanwhile, the National Association of Home Builders/Wells Fargo Housing Market Index (HMI) for October ticked up to 68. Of the index's three components, buyer traffic (to 53 from 49) saw the largest gain—crossing the line into positive territory—while current sales conditions (74 from 73) and sales expectations in the next six months (75 from 74) each rose a point. According to NAHB Chairman Randy Noel, "Builders are motivated by solid housing demand, fueled by a growing economy and a generational low for unemployment. Builders are also relieved that lumber prices have declined for three straight months from elevated levels earlier this summer, but they need to manage supply-side costs to keep home prices affordable."

GLOBAL ECONOMIC INDICATORS

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) for September tumbled -23.5% y/y, though a steep decline was expected, as August sales surged 31.2% y/y ahead of the introduction of the new WLTP test at the beginning of September. Most EU countries recorded double-digit losses last month, including the five major markets. Here's a tally of the top five markets' September and August performances, respectively: France (-12.8% & 40.0% y/y), Spain (-17.0) & 48.7), the UK (-20.5 & 23.1), Italy (-25.4 & 9.5), and Germany (-30.5 & 24.7). During the first nine months of this year, sales increased 2.5% y/y—in line with growth expectations for this year. Among the five major markets, sales rose in Spain (11.7% y/y), France (6.5), and Germany (2.4) and fell in Italy (-2.8) and the UK (-7.5).

Eurozone CPI ([link](#)): September's CPI rate accelerated slightly, matching its highest reading since the end of 2012. September's report shows the rate rose back up to 2.1% y/y—matching its flash estimate—after easing from 2.1% in July to 2.0% in August, above the ECB's target rate of just under 2.0% for the fifth month. Looking at the main components, energy (to 9.5% from 9.2% y/y) once again had the highest annual rate in September. The rate for food, alcohol, and tobacco (2.6 from 2.4) also moved higher, while rates for services and non-energy industrial goods were unchanged at 1.3% and 0.3%, respectively. The core rate—which excludes energy, food, alcohol, and tobacco—was unchanged at 0.9%; it was at 1.1% in July, which matched May's eight-month high. Of the top four Eurozone economies, inflation rates in France (2.5% y/y), Spain (2.3), and Germany (2.2) were above the Eurozone's 2.1% rate, while Italy's (1.5) was below. Ireland (1.2) and Greece (1.1) once again posted the lowest rates among the Eurozone countries.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333

Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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