



MORNING BRIEFING

January 17, 2019

Is the Bear Market Over?

The next Morning Briefing will be sent on Tuesday, January 22.

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

(1) 1987 all over again? (2) Six S&P 500 sectors have rebounded from bear-market territory. (3) Easing does it for Fed, ECB, and PBOC. (4) Financials making a comeback. (5) Despite flat yield curve, interest margin remains high. (6) Commercial and industrial loans are growing. (7) Less mortgage lending. (8) Lower tax rate and more buybacks. (9) Financials are cheap. (10) US and China race for AI dominance. (11) Big Brother is watching. (12) Chinese use AI to direct traffic and check into hotels.

Video Podcast. [Analysts Lower the Bar for Earnings Season](#). The Q4 earnings-reporting season is underway. Industry analysts responded to cautious guidance from company managements during the Q3 earnings season by cutting their Q4 estimates, making them easier to beat.

Strategy: Rollercoaster. Joe and I have compared the correction from September 20 through December 24 to the 1987 bear market. In both cases, there was no recession and earnings continued to grow. The 1987 event was a one-day flash crash exacerbated by computer-driven “portfolio insurance” algorithms. The most recent selloff felt like a series of flash crashes, especially during December, which also were worsened by algos.

While the S&P 500 was down 19.8%, just shy of a 20%+ bear market, six of the composite's sectors were in bear-market territory ([Fig. 1](#)). Here is their performance derby from worst to best: Energy (-27.9%), Consumer Discretionary (-22.6), Industrials (-24.1), IT (-23.1), Financials (-22.7), Materials (-22.2), S&P 500 (-19.8), Communication Services (-16.8), Health Care (-14.3), Consumer Staples (-11.5), Real Estate (-9.9), and Utilities (-2.4).

The 11.0% rally in the S&P 500, which started the day after Christmas and ran through Tuesday's close, was led by the sectors with the biggest losses. So none of those sectors are in bear-market territory for now ([Fig. 2](#)).

Helping to revive stocks around the world have been assurances by Fed officials that they might pause their rate-hiking. The other major central banks are also moving toward providing more liquidity. As we noted yesterday, European Central Bank officials are considering alternative measures to do so now that they have terminated their QE program as of year-end. Yesterday, the People's Bank of China injected a record US\$83 billion into the country's financial system to avoid a cash crunch—this after having slashed reserve requirements on January 4.

Bear markets often are preceded by a decline in stock prices in the Financials sector. So it was good to see that the S&P 500 Financials sector rallied 11.5% since December 24 through Tuesday's close after falling 22.7% during the preceding correction. In the next section, Jackie and I examine the latest developments in the US banking industry, which remains very healthy.

Financials: Not Bad Is Pretty Good. It's earnings week for the banks, and while not everything about the results coming in is perfect, bottom lines have been good enough—and expectations were low enough—for bank stocks to rally. In general, results were helped by higher net interest income, moderate loan growth, and lower tax rates. Banks continued to return capital to shareholders by paying dividends and repurchasing shares. Those positives were moderately offset by weakness attributable to declines in the equity and fixed-income markets as well as a drop in mortgage originations.

With a handful of banks' earnings reports in hand, Q4 credit quality remained solid as the economy plugged along. Those solid results probably helped the S&P 500 Financials stock price index outperform both the broader S&P 500 composite and six of the other S&P 500 sectors through Tuesday's close: Energy (8.2%), Communication Services (7.4), Consumer Discretionary (6.5), Industrials (5.0), Financials (4.3), S&P 500 (4.1), Real Estate (3.9), Information Technology (3.1), Health Care (2.2), Consumer Staples (2.1), Materials (2.0), and Utilities (-0.4) ([Fig. 3](#)).

Certainly, the strong start to the year could be in peril, a number of bank executives warned, if the federal government shutdown continues and if a trade agreement with China remains elusive. With that in mind, let's take a look at some of the highlights from earnings out of JP Morgan, Citigroup, Wells Fargo, and First Republic:

(1) *Improved interest income.* One worry weighing on bank stocks has been the flattening yield curve. In theory, the flatter the curve, the smaller is the difference between what banks earn on their loans and what they have to pay on their deposits. The difference between the 10-year Treasury yield and the federal funds rate shrank to 32 basis points in the early weeks of 2019, down from 115 basis points at the end of Q3 ([Fig. 4](#)).

Despite the pancake-flat yield curve, banks reported improved net interest income in Q4 helped by loan growth. Commercial and industrial loans rose \$221 billion y/y to new record highs ([Fig. 5](#) and [Fig. 6](#)).

JPMorgan's net interest income rose 9% y/y to \$14.5 billion "driven by the impact of higher rates as well as loan growth," the company's [press release](#) stated. C&I loans were up 1% at JPMorgan, "reflecting a decline in our tax exempt portfolio given tax reform. Adjusting for this, we would have been up 4%, which is still below the industry as we focus on client selection, pricing and credit discipline," said CFO Marianne Lake on the company's [conference call](#).

At Citi, the overall net interest margin (NIM) improved slightly to 2.71% in Q4, up from 2.65% a year earlier. Citigroup's corporate lending in its Institutional Clients Group rose 9% y/y. Citi's net interest revenue on core loans (which excludes trading securities and legacy assets) jumped to \$11.7 billion, up from \$10.3 billion a year earlier.

First Republic's total net interest income jumped 16.3% in 2018 y/y to \$2.5 billion even though the net interest margin dropped to 2.96% in 2018 from 3.13% the year prior. First Republic grew its loan portfolio, which is heavily tilted toward single-family mortgage loans, by 20.7% last year.

(2) *Rough capital markets.* The selloff and volatility in the stock and bond markets during Q4 took their toll on banks' trading and asset management operations. During the quarter, the S&P 500 fell by 14.0%, and the yield on US high-yield corporate bonds jumped by 1.87ppts to peak at 8.05% on December 26 ([Fig. 7](#) and [Fig. 8](#)).

JPMorgan's Q4 trading revenue fell 5.7% to \$3.2 billion, with fixed-income revenue dropping by 15%. At Citi, fixed-income markets revenues fell 21% y/y, which the company attributed to "volatile market

conditions and widening credit spreads, particularly in December,” its earnings [press release](#) stated.

The stock market's decline also took a toll on banks' asset management arms. At Wells Fargo, total assets under management declined 8% y/y, hurt by equity and fixed-income net outflows, the sale of an asset manager, and lower market valuations.

JPMorgan's asset and wealth management arm attributed a 2% decline in assets under management, to \$2.0 trillion, to lower market levels, offset by inflows into “liquidity and long-term products.” The division's net revenue dropped 5% y/y and its net income fell 8%.

(3) *Fewer home sales, fewer mortgages.* The backup in interest rates and the drop in new and existing home sales last year took a toll on the mortgage market. The 30-year mortgage rate spiked up to 4.99% during November 2018, from a recent low of 3.73% during September 2017, falling back a bit to 4.42% in mid-January ([Fig. 9](#)). The backup has hurt new plus existing single-family home sales, which tumbled 10.4% from November 2017's cyclical high of 5.76 million units (saar) to 5.16 million units by October 2018—the lowest level since February 2016 ([Fig. 10](#)). Likewise, refinancings dried up ([Fig. 11](#)).

Wells Fargo is one of the banks that's most exposed to the mortgage market. Its mortgage originations of \$38 billion were down 17% q/q and 28% y/y, according to the company's [Q4 Quarterly Supplement](#). The bank wasn't alone. Citi's mortgage originations fell 23% y/y, and JPMorgan's were down 30%, according to a 1/15 MarketWatch [article](#).

In addition to a tough mortgage market, banks are facing tough competition from non-bank lenders, the MarketWatch article concludes. “Among those people who do find houses to buy or a reason to take out a different mortgage, more are using ‘non-banks’ like Quicken Loans and LoanDepot than old-fashioned deposit-taking institutions. As of the end of last year 59% of all mortgages were made by non-banks,” according to Urban Institute data quoted in the article.

(5) *Lower taxes and bigger buybacks.* Banks continued to benefit from the tax-rate cut put in place at the start of this year by the Trump administration. Next year, those cuts will be anniversaried, making y/y comparisons tougher. JPMorgan's full-year tax rate was a bit above 20%, and in Q4 Citi's effective tax rate was 21%.

Share buybacks continued to have an impact. At Citi, average diluted shares outstanding fell 8%, and at Wells Fargo and JPMorgan diluted shares were down 5% y/y.

(6) *Banking on earnings.* JPMorgan, Citi, and Wells Fargo each are members of the S&P 500 Diversified Banks stock price index, along with Bank of America and U.S. Bancorp. The index has had a strong start to 2019, rising 6.8% ytd, after having a miserable 2018, when it fell 17.8% ([Fig. 12](#)).

Last year's decline has sent valuations in the industry tumbling. The industry's forward P/E stands at 9.3, down from 12.9 a year ago ([Fig. 13](#)). While earnings forecasts were trimmed by analysts in December, both revenue and earnings growth are expected to be respectable ([Fig. 14](#)). The industry is forecast to produce a 2.5% increase in revenues this year and an 11.3% improvement in earnings ([Fig. 15](#) and [Fig. 16](#)).

Tech: The Battle over AI. Last weekend, “60 Minutes” ran an insightful [piece](#) about how China aims to lead the world in artificial intelligence (AI). Scott Pelley interviewed venture capitalist Kai-Fu Lee, who has funded 140 AI startups, including Face++, a visual recognition system. While the US may be ahead in AI today, he contends China is right on Silicon Valley's heels, aided by the vast quantities of data produced by millions of Chinese citizens, who don't have the privacy hang-ups of their American

counterparts.

Dominating in AI is a priority for the Communist Party, according to its “Made in China 2025” plan. And China’s President Xi Jinping has said: “Advanced technology is the sharp weapon of the modern state.”

Well aware of China’s goals, the Trump administration has made ensuring the security of US corporations’ technology part of the trade negotiations with China. Vice President Pence, in a now-infamous speech to the Hudson Institute in October, made clear that the US has its eyes open.

“To win the commanding heights of the 21st century economy, Beijing has directed its bureaucrats and businesses to obtain American intellectual property –the foundation of our economic leadership—by any means necessary,” Pence said. “Beijing now requires many American businesses to hand over their trade secrets as the cost of doing business in China. It also coordinates and sponsors the acquisition of American firms to gain ownership of their creations. Worst of all, Chinese security agencies have masterminded the wholesale theft of American technology—including cutting edge military blueprints. And using that stolen technology, the Chinese Communist Party is turning plowshares into swords on a massive scale.”

When it comes to AI, Pence says the Chinese have built “an unparalleled surveillance state,” which includes the Great Firewall of China to restrict the flow of information to Chinese people. The country also aims to introduce the “Social Credit Score,” a ranking of citizens based on a secret methodology.

One’s Social Credit Score could be hurt by “bad driving, smoking in non-smoking zones, buying too many video games and posting fake news online,” a 10/29 [article](#) in Business Insider stated. Infractions are punished in various ways, including restricting travel (9 million people with low scores have been blocked from buying tickets on domestic flights, according to the article), banning one’s kids from the best schools, and blocking one from getting the best jobs.

Chinese newspaper *People’s Daily* may not cover China’s plans to use AI to control its citizens, but it does write often about AI advancements being put to use. Here’s a recap of some recent articles:

(1) *Bloomberg sees China winning.* China’s push to commercialize AI technologies and its 5G network rollout could help it become the global leader for technology and innovation, per a Bloomberg Intelligence study. Nowhere else in the world is the government so strongly backing AI dominance, said an analyst quoted in the article, who sees China out-producing the US in global technology patents by 2025 and dominating AI by 2030, “led by developments in transportation, corporate services, health care and finance” ([12/10](#)).

(2) *AI powers smart Chinese hotels.* Alibaba opened a hotel of the future powered by AI and robots last month. At the FlyZoo Hotel in Hangzhou, facial recognition systems allow customers to check in, open rooms, and access other hotel services. Lights, TVs, and curtains are controlled by Alibaba’s voice-activated digital assistant. Robots serve dishes, cocktails, and coffee ([12/18](#)).

(3) *AI directing traffic.* DiDi Chuxing, a Chinese ride-hailing company, has partnered with traffic police and Shandong University to use AI and big data to ease traffic. The system, called “JTBrain,” can cover 36 streets and 450 crossroads and “uses AI, big data and cloud computing to search for optimal traffic solutions.” In six-month tests, the system cut average commutes by 11% ([12/28](#)).

(4) *Alibaba and AI.* Alibaba has launched facial recognition payment equipment, dubbed “Dragonfly” ([12/28](#)). Working with China’s state-run Xinhua News Agency, Alibaba also has launched an AI-powered production platform, magic.shuwen.com, which will produce short news videos ([12/28](#)).

CALENDARS

US. Thurs: Jobless Claims 221k, Philly Fed Manufacturing Index 10.0, EIA Natural Gas Report, EIA Natural Gas Report. **Fri:** Headline & Manufacturing Industrial Production 0.3%/0.1%, Capacity Utilization 78.4%, Baker-Hughes Rig Count, Williams.(Econoday estimates)

Global. Thurs: Eurozone Headline & Core CPI 1.6%/1.0% y/y, Japan Headline, Core, and Core-Core CPI 0.3%/0.8%/0.3% y/y, BOE Credit Conditions & Bank Liabilities Surveys, Kuroda, Amamiya. **Fri:** UK Retail Sales Including & Excluding Auto Fuel 3.6%/3.8% y/y, Canada CPI -.04%/m/m/1.7%/y/y, Japan Industrial Production. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) continued to bounce back above 1.00 this week after falling below two weeks ago for the first time since late February 2016. The BBR rebounded to 1.67 from 1.18 last week and 0.86 two weeks ago—which was the lowest reading since mid-February 2016. Bullish sentiment has jumped 12.2ppts the past two weeks, to 42.1% from 29.9%—which was the fewest bulls since February 2016; bullish sentiment was as high as 61.8% in early October. Meanwhile, bearish sentiment dropped -9.4ppts over the same period, to 25.2% from 34.6%—which was the most bears since March 2016; it had fluctuated in a narrow band (below 20.0%) for most of H2-2018. The correction count (to 32.7% from 35.5%) has edged higher over the two-week span, remaining below the 41.1% reading at the end of November—which was the highest percentage since late September 2015. The AAI Ratio climbed for the fourth week last week, from 30.0% to 56.7% over the period, as bullish sentiment rose from 20.9% to 38.5% and bearish sentiment fell from 48.9% to 29.4% over the four-week span.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings forecasts both moved lower last week. Forward revenues is down 0.5% from a record high a week earlier, and forward earnings is now 1.4% below its record high in early December. Analysts expect forward revenues growth of 5.9% and forward earnings growth of 7.2%. Forward revenues growth remains near a seven-year high, but forward earnings growth is down from a six-year high of 16.9% in February to the lowest level since May 2016. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenue growth to slow from 8.8% in 2018 to 5.9% in 2019 and 4.9% in 2020. They're calling for earnings growth to slow sharply from 23.6% in 2018 to 6.4% in 2019 before improving to 10.9% in 2020. The forward profit margin fell w/w to a nine-month low of 12.1% from 12.2%, and is down 0.3ppt from a record high of 12.4% in mid-September. Still, that's up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500's forward P/E rose w/w to 15.1 from 14.5. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from a 16-year high of 18.6 at the market's valuation peak in late January. The S&P 500 price-to-sales ratio of 1.83 is up from 1.77 a week earlier and 1.75 during December, which was the lowest since November 2016 and down 19% from a record high of 2.16 in late January.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues fell w/w for eight of the 11 sectors, and forward earnings rose for just one sector. Utilities was the only sector to have both measures rise w/w. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. The forward profit margin appears to be rolling over from recent highs for all but Financials and Utilities. They were at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward

earnings had about tripled from the 18-year low in April 2016 through early November, but has tumbled 19.1% since then following an 8.7% drubbing in the latest week. Forward P/S and P/E ratios are now well below their 2018 highs for all sectors, and had been at multi-year lows during December for five sectors: Energy, Financials, Industrials, Materials, and Tech. Energy's forward P/E of 15.4 is elevated relative to historical levels, but continues to slowly return to normal after soaring in 2016 when revenues and earnings collapsed. 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. The outlook for 2019 shows lower margins are now expected y/y for 4/11 sectors: Communication Services, Energy, Health Care, and Real Estate. During the latest week, the forward profit margin fell for five of the 11 sectors, and nine are now down from record highs just a few months ago. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.3%, down from 23.0%), Financials (18.9, down from 19.2), Real Estate (15.5, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (at a record high of 12.9%), S&P 500 (12.1, down from 12.4), Materials (11.1, down from 11.6), Health Care (10.5, down from 11.2), Industrials (10.2, down from 10.3), Energy (6.8, down from 8.0), Consumer Staples (7.5, down from 7.7), and Consumer Discretionary (7.5, down from 8.3).

S&P 500 Q4 Earnings Season Monitor ([link](#)): With just over 7% of S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and rising loan loss provisions in the Financials sector. Of the 36 companies in the S&P 500 that have reported through mid-day Wednesday, 83% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 21.5% and exceeded forecasts by an average of 2.0%. On the revenue side, just 61% of companies beat their Q4 sales estimates so far, with results coming in 0.2% above forecast and 7.8% higher than a year earlier. Q4 earnings growth results are positive y/y for 94% of companies, vs a higher 98% at the same point in Q3, and Q4 revenues have risen y/y for 86% vs a higher 95% during Q3. These figures will change markedly as more Q4-2018 results are reported in the coming weeks. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (88%) in the S&P 500 had beaten consensus earnings estimates by a higher 4.3%, and earnings were up a higher 24.3% y/y. With respect to revenues at this point in the Q3 season, a higher 71% had exceeded revenue forecasts by a higher 0.5%, and sales rose a tad lower 7.9% y/y. The early results for Q4 indicate a slowdown in revenue and earnings growth from Q3, but that comes as no surprise to investors. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q4 results ex-Financials and Real Estate, the earnings surprise improves to 3.4% from 2.0% and growth rises to 22.9% from 21.5%. The ex-Financials and Real Estate revenue surprise would be 0.4% instead of 0.2%, with revenue growth improving to 10.8% from 7.8%.

US ECONOMIC INDICATORS

Import Prices ([link](#)): Import prices in December posted another large decline, led by a second double-digit loss in petroleum prices, while the yearly rate showed the biggest decline in more than two years. Total import prices sank -1.0% last month following a downwardly revised -1.9% loss in November—which was the steepest since January 2015—with petroleum prices tumbling -25.7% over the two-month period, after a seven-month climb of 16.8%. Nonpetroleum import prices increased for the third time in four months, by 0.3% in December and 0.5% over the period, after falling -0.7% during the three months through August. The yearly rate for import prices fell -0.6% y/y—the first y/y decline in 26 months and the biggest since September 2016. The yearly rate for petroleum imports dropped from a recent peak of 44.6% in July to -14.4% y/y in December—the biggest drop since July 2016; the rate for nonpetroleum prices ticked higher, up 1.0% y/y from a recent low of 0.6% in November and September. The rate for capital goods imports (-0.2% y/y) remained negative, after falling below zero in October for

the first time since May 2017, while the rate for industrial materials & supplies (-3.0) has dropped dramatically from its recent high of 21.1% in July, posting its first negative reading since September 2016. Meanwhile, the yearly rate for consumer goods ex autos (0.6) continued to bounce around recent highs just below 1.0%, while autos' (0.3) rate remained in a volatile flat trend around zero; the rate for food prices (-0.8) turned negative in June for the first time in two years, and continued to fall in December—though has narrowed fairly steadily from July's -3.6% decline.

GLOBAL ECONOMIC INDICATORS

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) for December fell for the fourth straight month y/y, continuing the downtrend that began with the introduction of WLTP in September. Sales fell -8.4% y/y in December, with all major EU markets contracting except for Italy (2.0% y/y). Among the top economies, sales in France (-14.5) contracted at a much faster pace than Germany (-6.7), the UK (-5.5), and Spain (-3.5). For all of 2018, car registrations were basically flat with 2017, ticking up a modest 0.1%—though still marks the fifth consecutive year of growth—with almost 15.2 million cars registered across the EU. Most of last year's gain was centered in the Central European markets—which saw sales increase 8.0%. It was a mixed bag among the five strongest EU markets, with sales in Spain (7.0%) and France (3.0) expanding and sales in the UK (-6.8) and Italy (-3.1) contracting, while Germany's (-0.2) showed little change.

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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