



MORNING BRIEFING

April 18, 2019

Financials Going High Tech

**We wish you all the best during Easter and Passover.
We will be back on Tuesday, April 23.**

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

(1) Bankers upbeat on economy. (2) Financials: From laggard to leader? (3) Nothing to fear but shadowy fintech upstarts. (4) Old bankers learning new tricks. (5) JayDee watching shadows. (6) A by-the-way comment on leveraged loans. (7) Spending big bucks on high tech. (8) Marcus and Siri getting hitched. (9) Drones are already on the job, and helped Parisian firefighters fight Notre Dame fire. (10) Look up in the sky: More industries using drones to cut costs and increase productivity.

Disruptive Technologies I: Financials Going Digital. The economy is doing just fine, according to recent earnings reports out of some of the nation's largest banks. Credit quality is stable. Lenders are lending. The capital markets, which were quiet during Q1, have revived. And while a flattening yield curve could pinch profits a bit, it hasn't been enough to make CEOs sweat. Not yet, anyway.

The optimistic outlook emerging from recent earnings reports has sparked a rally in the S&P 500 Financials sector. Here's the performance derby for the S&P 500 sectors for the week ending Tuesday: Financials (3.6%), Industrials (2.2), Communication Services (2.1), Consumer Discretionary (1.9), Information Technology (1.7), Consumer Staples (1.4), Materials (1.2), S&P 500 (1.0), Energy (0.7), Utilities (-0.7), Real Estate (-1.9), and Health Care (-3.7).

The Financials sector's outperformance is quite a reversal from its lagging performance earlier this year. The S&P 500 Financials sector is up 14.7% ytd, compared to the S&P 500's 16.0% gain, making it the fifth-worst-performing sector ([Fig. 1](#)). If Financials can continue its winning ways, that just might be enough to push the S&P 500 to new highs. The Financials sector represents 12.8% of the S&P 500's market capitalization, making it the third largest of the S&P 500's 11 sectors, and it kicks in 18.7% of the index's earnings ([Fig. 2](#)).

Banks' and brokers' earnings reports did contain a number of references to the competition coming from fintech companies and challenger banks. These upstarts are targeting just about every business line a bank offers: savings, checking, loans, credit cards, and investments, to name a few. These players in the shadow banking system may be gnats compared to the traditional banking behemoths, but they have captured the attention of traditional banks, which are responding by spending billions on technology to develop their own high-tech offerings.

I asked Jackie to peruse the JPMorgan, PNC, and Goldman Sachs earnings calls to see whether the old bankers are learning new tricks. Here are some highlights:

(1) *Dimon peers into the shadows.* JPMorgan CEO Jamie Dimon's annual [letter](#) to shareholders and last week's Q1 [earnings conference call](#) both contained warnings that the growing shadow banking

system should be watched. In the letter, “JayDee” notes that the shadow banking industry has expanded because the rules and regs imposed on banks aren’t “necessarily imposed” upon non-bank lenders.

“While we do not believe that the rise in non-banks and shadow banking has reached the point of systemic risk, the growth in non-bank mortgage lending, student lending, leveraged lending and some consumer lending is accelerating and needs to be assiduously monitored,” he contends. During an economic downturn, if these non-bank lenders are not able to continue lending, “their borrowers will become stranded. Banks traditionally try to continue lending to their customers in tough times.”

Dimon’s annual letter also said burdensome regulations on bank mortgage lending and related capital allocation requirements have prompted JPMorgan to “intensely” review its role in originating, servicing, and holding mortgages. “The odds are increasing that we will need to materially change our mortgage strategy going forward.”

He reiterated those sentiments in the conference call, saying: “[N]on-banks are becoming competitors (in mortgage lending), and they don’t have the same regulations, the same requirements in the servicing or production.” For now, the bank is looking to reduce the mortgage loans it holds and replace them with agency mortgage-backed securities that have better “capital liquidity characteristics,” said CFO Marianne Lake. But the firm’s interest in remaining in that business line certainly appears to be under review.

Non-bank lenders’ presence in the leveraged lending markets was also highlighted in the bank’s earnings conference call. Dimon noted that traditional banks own only about \$800 billion to \$900 billion of the \$2.3 trillion leveraged loans outstanding in the US. The remainder is owned by institutional investors and held in vehicles including CLOs.

JPMorgan is growing both the old-fashioned and the high-tech way. It is opening 90 branches this year in new markets. But it has also started a new digital investing platform, simplified the process to open a new deposit account digitally, and made applying for a mortgage online easier. The bank expects to spend \$11.5 billion on technology, half of which will be used to run the bank and half used to change the bank, which could include anything from creating new customer experiences to research and development.

(2) *Betting on Marcus*. Goldman Sachs’ large exposure to the capital markets hurt the firm’s Q1 results more than those of its banking counterparts. The trading and underwriting businesses took a while to rebound as the year began after the Q4 stock market drop and the government shutdown. Goldman’s Q1 revenues fell 13%, and EPS of \$5.71 beat expectations thanks to cost reductions but was down 21% y/y.

Much of the firm’s [conference call](#) focused on how Goldman plans to diversify its business. CEO David Solomon pointed out overarching factors that drive many of its new projects: “These elements include re-imagined products that address pain-points for corporations, institutions and consumers; new technology unburdened by legacy systems that often slowdown innovation; digital delivery mechanisms that produce scale and efficiency and access to large customer population.”

Launched in 2016, the firm’s online retail banking platform Marcus has \$46 billion in deposits. Because Marcus doesn’t have branches, it can offer higher interest rates on its deposits. This week it’s offering 2.25% on its online savings account. And Goldman seems intent on growing its offerings through the online portal.

Most recently, the firm announced that Marcus is expanding into credit cards through a partnership with Apple. The card being offered will be underwritten by Marcus and used by consumers on their iPhones to make purchases on Apple's iPay. Marcus was bulked up almost a year ago when Goldman acquired Clarity Money, a free app that helps consumers manage their personal finances. Clarity had about 1 million customers at the time of the acquisition.

Goldman has also embraced technology in its institutional business by offering Marquee, a digital platform where institutions can access Goldman content, risk analytics, pricing data, and trade. Coming up next: a digital cash management platform later this year and a digital wealth platform.

(3) *PNC: Going national digitally.* With less exposure to the capital markets than Goldman Sachs, PNC reported Q1 y/y earnings growth helped by a 4.8% increase in both net interest income and total loans. Revenue rose 4.3% y/y, and EPS climbed 7.4% to \$2.61.

With few surprises in its traditional business, CEO Bill Demchak spent a fair amount of time on the earnings [conference call](#) talking about the “digital onslaught” in retail banking and how PNC plans to be a survivor and a consolidator. In Q3, the bank launched a high-yielding, online savings account in markets outside of its East Coast branch network. The company will roll out a limited number of branches in select markets where online accounts have opened.

So far, the digital high-yield savings offering is attracting new clients, and “a significant percentage” of them are also opening a PNC Virtual Wallet account, which offers checking, money management tools, and an interest-rate bonus when combined with a high-yield savings account, according to Demchak's annual letter to shareholders (linked [here](#)). By expanding into digital banking, occupancy costs should drop, technology costs will increase, and the marginal cost of deposits will increase, he said on the conference call. While line items may change with the rollout of digital banking, overall cost ratios should remain unchanged as the bank aims to increase its market share and accelerate growth.

PNC's other digital offerings include: PNC Total Auto, an online tool powered by TrueCar to search for a new car, compare pricing, and apply for financing; Digital Advisor, which allows investment customers online access to their managed investment accounts; and a partnership with fintech company OnDeck that offers digital borrowing to small business customers outside PNC's retail branch network.

(4) *A look at earnings.* Analysts expect the S&P 500 Financials sector to increase revenue by 5.3% this year and by 4.6% in 2020 ([Fig. 3](#)). Solid earnings growth is also forecast, at 8.6% this year and 9.5% in 2020 ([Fig. 4](#)). The sector's forward P/E, at 11.5, has rebounded a bit from December's six-year low of 10.2, but is well off its recent high of 14.9 in December 2017 ([Fig. 5](#)).

If projections are correct, Financials' earnings will be the fastest growing of the S&P 500 sectors this year, but the fourth slowest next year. Here are the earnings projections for the S&P 500 sectors in 2019: Financials (8.6%), Consumer Discretionary (7.8), Industrials (7.1), Health Care (5.5), Utilities (4.5), Communication Services (3.6), S&P 500 (3.2), Consumer Staples (1.3), Information Technology (0.6), Energy (-9.8), Materials (-11.8), and Real Estate (-18.0).

While Financials doesn't top the earnings growth charts for next year, its consensus projection is still competitive: Energy (30.1%), Consumer Discretionary (13.4), Industrials (12.3), S&P 500 (11.3), Information Technology (10.8), Communications Services (10.4), Materials (10.2), Health Care (10.1), Financials (9.5), Real Estate (8.7), Consumer Staples (6.9), and Utilities (5.9) ([Table 1](#)).

Disruptive Technologies II: Putting Drones to Work. In last week's 4/11 [Morning Briefing](#), we discussed the various ways companies are using drones to speed up the delivery of goods. Caffeine

addicts may soon find their dreams of waking up to a hot Starbucks latte delivered to the front doorsteps have come true.

While consumer drone testing continues, we are reminded that drone industrial applications are already widespread. That was apparent this week when drones helped Parisian firefighters battle the Notre Dame fire. The drones helped track the progress of the fire and find the best positions in which to aim fire hoses, according to a local press report quoted by The Verge in a 4/16 [article](#).

A 1/24 [article](#) by CBInsights lists another 38 ways drones are being used by industry. From their bird's eye view, drones are capturing beautiful images, conducting inspections, and keeping humans out of harm's way. Here are some of the most interesting drone activities on the list:

(1) *Drones keeping humans safe.* Drones allow us to see or reach dangerous or inaccessible areas without physically going there—the Notre Dame fire being a case in point. Drones help the US military with surveillance and reconnaissance. And drones fitted with thermal imaging cameras help emergency responders locate disaster victims.

Land Rover and the Austrian Red Cross in 2017 partnered to design “a special operations vehicle with a roof-mounted, thermal imaging drone. The vehicle includes an integrated landing system, which allows the drone to securely land atop the vehicle while in motion. This custom Land Rover Discovery, dubbed ‘Project Hero,’ hopes to save lives by speeding up response times,” CBInsights reported.

(2) *Easy inspections.* Drones are being used for all varieties of inspections. Insurance companies are using drones for inspections of storm-ravaged areas or dangerously high structures. Drones are inspecting for defects in ships, airplanes, telecommunications towers, and assembly lines. In the energy industry, they're used to inspect onshore and offshore equipment to extract, refine, and transport oil and gas in hopes of protecting the environment from leaks and spills. The mining industry and construction industry are using drones to survey operations, and drones are providing security companies with another set of eyes.

Two of CBInsights' most interesting inspection examples: “Surveillance drones outfitted with thermal imaging cameras are being deployed to detect abnormal forest temperatures. By doing so, teams are able to identify areas most prone to forest fires or identify fires just 3 minutes after they begin.” In addition, drones are being used to gather data about crops and even pollinate flowers.

(3) *Pretty pictures.* Drones are capturing images only seen in the past by pilots or birds. Drones are monitoring and tracking endangered animals, and allowing humans to observe animals without disturbing their habitat. Realtors are using drones to capture sweeping views of high-priced properties and to make videos of interiors. Drones are filming sporting events, capturing dramatic aerial scenes for Hollywood film producers and gathering video for news broadcasts. No helicopters needed.

CALENDARS

US. Thurs: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.8%/0.7%/0.5%/0.5%, Business Inventories 0.3%, Leading Indicators 0.4%, Jobless Claims, Philadelphia Fed Manufacturing Index 11, M-PMI & NM-PMI Flash Estimates 53.0/55.0, EIA Natural Gas Report. **Fri:** Housing Starts & Building Permits 1.230mu/1.300mu. (DailyFX estimates)

Global. Thurs: Eurozone C-PMI, M-PMI, and NM-PMI Flash Estimates, UK Retail Sales Including & Excluding Auto Fuel 4.6%/4.0% y/y, Canada Retail Sales, Australia Employment Change & Unemployment Rate 15k/5.0%, Australia Business Confidence, BOE Credit Conditions & Bank

Liabilities Surveys. **Fri:** None. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) continued to rebound this week to its highest reading since early October. The BBR had been in a volatile flat trend before jumping from 2.52 to 2.85 the past three weeks; it was at 0.86 15 weeks ago—which was the lowest since mid-February 2016. Bullish sentiment has increased 13 of the past 15 weeks, by 24.9ppts, from 29.9% (which was the fewest bulls since February 2016) to a near seven-month high of 54.8% this week. It's the ninth reading above 50.0%. Bearish sentiment was at 19.2% for the second week—the lowest since mid-November—after bouncing in a range between 20.4% and 21.5% the prior 10 weeks. Meanwhile, the correction count ticked down for the third week, to 26.0%, after increasing for the first time in eight weeks during the final week of March to 27.4% from 25.5%—which was the lowest since early October. The AAll Ratio climbed for the second week last week from 55.0% to 66.4% over the period. Bullish sentiment rose from 33.2% to 40.3% over the two-week span, while bearish sentiment fell to 20.4% last week after rising the previous two weeks from 23.4% to 28.3%.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues edged down 0.1% below its record high a week earlier, and forward earnings weakened to 1.5% below its record high in early December. Analysts expect forward revenues growth of 5.6%, unchanged from a week earlier. However, forward earnings growth edged down 0.1ppt to 6.6% from an 11-week high of 6.7%. Forward revenues growth is down 0.7ppt from a seven-year high of 6.3% in February 2018, but is up from a 31-month low of 5.0% in mid-February. Forward earnings growth is down 10.3ppts from a six-year high of 16.9% last February, but that's up from a 34-month low of 5.9% in late February. 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 revenues growth to slow from 8.3% in 2018 to 5.2% in 2019 and 5.4% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 3.2% in 2019 before improving to 11.3% in 2020. The forward profit margin remained steady w/w at a 12-month low of 12.0%, and is down 0.4ppt 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 has moved higher in 13 of the past 15 weeks, and rose 0.1 point w/w to a six-month high of 16.8. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio rose 0.01 point w/w to 2.02 and is up from 1.75 during December. That was the lowest since November 2016, when the ratio was down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues and earnings rose w/w for five of the 11 S&P 500 sectors. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Energy's forward earnings is beginning to stabilize now after tumbling about 25% since early November. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, and are near or above their 2018 highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. The outlook for 2019 shows higher margins are expected y/y for just 4/11 sectors: Consumer Discretionary, Financials, Industrials, and Utilities. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all of the sectors, but early signs of a bottom are appearing. During the latest week, the forward profit margin rose 0.1ppt for Energy and edged down 0.1ppt for three sectors: Consumer Staples, Industrials, and Materials. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, down

from 23.0%), Financials (18.5, down from 19.2), Real Estate (15.4, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (12.9, down from 13.0), S&P 500 (12.0, down from 12.4), Health Care (10.4, down from 11.2), Materials (10.4, down from 11.6), Industrials (10.1, down from a record high of 10.4 in mid-March), Energy (6.9, down from 8.0), Consumer Discretionary (7.6, down from 8.3), and Consumer Staples (7.3, down from 7.7).

S&P 500 Q1 Earnings Season Monitor ([link](#)): With nearly 11% of S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics also have weakened substantially, but earnings continue to beat forecasts. Of the 54 companies in the S&P 500 that have reported through mid-day Tuesday, 80% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 3.8%, and exceeded forecasts by an average of 5.7%. On the revenue side, just 46% of companies beat their Q1 sales estimates so far, with results coming in 0.4% above forecast and 3.2% higher than a year earlier. Q1 earnings growth results are positive y/y for 69% of companies, vs a higher 94% at the same point in Q4, and Q1 revenues have risen y/y for 72% vs a higher 86% during Q4. These figures will change markedly as more Q1-2019 results are reported in the coming weeks. Looking at earnings during the same point in the Q4-2018 reporting period, a higher percentage of companies (83%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.0%, and earnings were up a higher 21.5% y/y. With respect to revenues at this point in the Q4 season, a higher 61% had exceeded revenue forecasts by a lower 0.2%, and sales had risen by a greater 7.8% y/y. The early results for Q1 indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. Q4-2018 had marked the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise drops to 5.2% from 5.7% and growth falls to 1.5% from 3.8%. The ex-Financials and Real Estate revenue surprise would be 0.1% instead of 0.4%, with revenue growth improving to 4.7% from 3.2%.

US ECONOMIC INDICATORS

Merchandise Trade ([link](#)): Trade likely gave a big boost to Q1 real GDP growth, as February's real merchandise trade deficit narrowed for the second month since posting its biggest gap on record at the end of 2018. February's deficit narrowed to -\$81.8 billion from -\$83.5 billion in January and -\$91.7 billion in December—which was the biggest gap in the history of the series going back to 1994. The January/February average monthly deficit was -\$82.6 billion, considerably smaller than Q4's average monthly gap of -\$87.4 billion. Real exports climbed 0.6% in February and 2.8% the first two months of this year, after contracting 1.5% in December, while real imports fell 2.5% during the two months through February after rebounding 3.4% in December. Over the first two months of 2019, real exports of autos (14.2%) and foods, feeds, and beverages (13.1) posted double-digit gains, followed by real exports of consumer goods less autos (4.0) and capital goods less autos (2.8); industrial materials & supply exports fell 1.9%. There was a broad-based decline in real imports over the two-month period, led by industrial materials & supplies (-7.2), foods, feeds, and beverages (-4.9), and capital goods less autos (-4.5); auto imports (-0.8) were fractionally lower over the two-month period, while consumer goods less autos advanced 2.5%.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): March's CPI rate confirmed the flash estimate, remaining below 2.0% for the fifth consecutive month, while the core rate fell below 1.0%. The headline rate ticked down to 1.4% y/y—from 1.5% in February—returning to January's nine-month low; the rate peaked at 2.3% in October. Looking at the main components, energy (to 5.3% from 3.6% y/y) once again recorded the highest annual rate in March, accelerating sharply. Meanwhile, the rates for food, alcohol & tobacco (1.8 from

2.3), services (1.1 from 1.4), and non-energy industrial goods (0.1 from 0.4) all eased in March. The core rate—which excludes energy, food, alcohol, and tobacco—sank to 0.8%, the lowest since last April. Of the top four Eurozone economies, Germany's (1.4% y/y) rate matched March's headline rate, while rates in France (1.3) and Spain (1.3) were just below. Italy (1.1) had one of the lowest rates, along with Ireland (1.1) and Greece (1.0); Portugal (0.8) had the lowest.

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) for March fell for the seventh straight month y/y, ever since the introduction of the Worldwide Harmonized Light Vehicle Test Procedure (WLTP) last September. Sales fell 3.9% y/y in March, with all major markets in the red, led by Italy (-9.6% y/y); sales declines in Spain (-4.3), the UK (-3.4), France (-2.3), and Germany (-0.5) were in the low single digits. Sales during the first three months of 2019 fell 3.3% from Q1-2018 levels, though German (0.2 y/y) sales were virtually flat with a year ago. Meanwhile, Spain (-6.9) and Italy (-6.5) posted the steepest sales' declines among the major markets; UK sales were 2.4% below a year ago.

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