



MORNING BRIEFING

October 17, 2019

Happy Bankers. Brawling Brokers.

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

(1) No recession in bank earnings reports. (2) Banks find profits in a flat yield curve world. (3) Firing on all cylinders. (4) Provisioning for rainy days. (5) Credit quality remains solid. (6) Asset management: Passive passes active. (7) Discount brokers go for broke with no fees for trading. (8) Competing for fee-based AUM. (9) Flying in a graphene tube with fast charging, high-powered AA batteries.

Financials: Beating a Low Bar. A slew of earnings out of the S&P 500 Financials sector confirmed that the economy continues to perform well. Loans are up, the consumer is healthy, and the stock market is near a record. Despite lower interest rates, banks have managed to increase their returns on equity to respectable levels. As always, there are clouds to watch closely, including loan losses, which may have bottomed. Also, Wall Street's brokers and asset managers are in a bit of a dog fight, as disruption roils those industries and may dent results over the next year. Here's Jackie's look at highlights from some of the latest earnings reports.

(1) *Banks overcome flat yield curve.* JPMorgan and Bank of America Q3 earnings laid to rest fears that they couldn't perform well in a flat yield curve environment. Net interest margin is under pressure, but the country's two largest banks still managed to grow adjusted profits and beat expectations ([Fig. 1](#)). JPMorgan's stock even managed to make a new high this week.

Bank of America's Q3 net interest margin fell to 2.41% from 2.45% a year ago, but net interest income still rose slightly to \$12.3 billion, up from \$12.2 billion a year earlier. Despite the flat yield curve, the bank's businesses performed well. Net income rose in Consumer Banking (5%), Global Wealth and Investment Management (8%), and Global Banking (3%). The bottom line declined 8% in Global Markets due in part to a gain on the sale of an equity investment in Q3 2018, according to the company's [press release](#). Otherwise, sales and trading revenue and investment banking fees rose.

Likewise, JPMorgan's net interest yield on average net interest earning assets declined to 2.41% from 2.53% a year earlier, but net interest income rose 2%. The bank also managed to grow the bottom line by 8% y/y. Net income rose 5% at Consumer & Community Banking and 7% in the Corporate & Investment Bank, but results declined 14% in Commercial Banking and 8% in Asset & Wealth Management.

Bank of America's consumer and commercial loans were each up 6%, while JPMorgan's average total loans were up 3% excluding the impact of loan sales. Commercial and industrial loans at all banks have fallen in four of the last six weeks and are down 1.6% from their peak at the start of May ([Fig. 2](#)). Loans are still up y/y by 5.1%, but given the uncertainty about trade

wars, this is certainly a data point to watch ([Fig. 3](#)).

Credit quality remains strong at two of the nation's largest banks, but it's no longer improving as it has been in recent years. Instead of benefiting from reserve releases, the banks are modestly increasing loan reserves. Bank of America's provision for credit losses was \$779 million, up \$63 million y/y. In the 2018 quarter, the bank had enjoyed a \$70 million reserve release, primarily from energy exposures in its Global Banking division. JPM's provision for credit losses jumped to \$1.5 billion, up 60% y/y, which it attributed to "reserve releases and net recoveries" in 2018.

Most importantly, the large banks are proving they can post decent returns on capital, something that was questioned in the days after massive regulation was imposed on the industry in the wake of the Great Recession. Recent moves by the Trump administration to loosen regulations and capital requirements have helped. Bank of America's return on average common shareholders' equity was 11.2%, excluding a charge, and at JPMorgan it was 15%.

Bank of America and JPMorgan are both members of the S&P 500 Diversified Banks stock price index, which has climbed 21.0% ytd, but remains 8.5% below its 1/26/18 record high ([Fig. 4](#)). The industry's revenue and earnings growth rate have peaked and net earnings estimate revisions are decidedly negative, but earnings are still growing. The Diversified Bank industry's revenue is forecast to grow 0.5% this year and decline 0.1% in 2020 ([Fig. 5](#)). And after growing earnings by 25.6% in 2018, earnings growth is forecast to slow to 10.1% this year and 4.0% next year ([Fig. 6](#)). Not much good news is expected, as the Diversified Banks' forward P/E is 10.1, slightly below its average over the last 25 years.

(2) *Battling brokers.* Disruption is battering asset managers and brokers from all angles. Assets in low-cost index funds recently topped the assets in higher-cost, actively managed funds. The robo-advice market is growing, with Vanguard as the most recent entrant. Companies like Zoom and CrowdStrike, are opting to directly list their shares instead of paying Wall Street to underwrite an IPO. And new players like KKR want to get a piece of the IPO business that's left.

The most recent disruption comes from the brokers themselves. In quick succession, Fidelity, Schwab, TD Ameritrade, E*Trade Financial, and Interactive Brokers Group each eliminated the fees they once charged to trade US stocks, ETFs and options. At Schwab that will mean the loss of about \$100 million in revenue. The company is betting that the loss of trading revenue will be more than offset by an increase in assets under management, a 10/15 CNBC [article](#) reported.

Schwab's client assets reached a record high of \$3.8 trillion in Q3 and earnings per share of 70 cents were up from 65 cents last year and above the 64 cents that Wall Street analysts expected. Schwab shares, now around \$39, have gotten crushed since last May when they almost hit \$60. But it's not alone. The S&P 500 Investment Banking & Brokerage stock price index has fallen 27.2% from its 3/12/18 peak ([Fig. 7](#)).

Wall Street analysts have very modest growth expectations for the industry, which also

includes Wall Street firms Goldman Sachs and Morgan Stanley. Revenue growth is expected to decline this year by 0.8% and nudge higher by 1.6% in 2020 ([Fig. 8](#)). Earnings growth estimates follow the same path, down 2.7% this year and up 4.9% next year ([Fig. 9](#)). The industry's forward P/E has come down sharply to 9.2, from 14.9 on 12/14/17 ([Fig. 10](#)). Low expectations often make for interesting investment opportunities.

Disruptive Technologies: Science Takes Flight. In the 10/10 [Morning Briefing](#) we discussed the advent of Flight Shaming and highlighted the numerous players introducing electronic aircraft. It quickly became apparent that to make an electronic aircraft commercially viable, companies will need to develop new lightweight materials to reduce the weight of the plane and develop more powerful batteries. Innovations will undoubtedly benefit the electric vehicle market as well. Large organizations like NASA and Boeing are working with and competing against small startups in a race that would make the Wright brothers proud.

Here's a look at what some of the biggest brains in science are working on.

(1) *Stronger, lighter materials.* Lighter planes need less energy to get off the ground. For years, engineers have been working to lighten the load in order to improve traditional planes' fuel efficiency. For a large electric plane to work, materials will need to continue to get lighter and stronger.

One material under development is graphene. It's a version of carbon that's only one atom thick, but many times stronger than a carbon fiber. While some scientists doubt the ability to use graphene on a large scale, Sir Richard Branson hopes the material can be used in planes 10 years from now, according to a 4/6/17 [article](#) in *The Telegraph*.

MIT researchers fused flakes of graphene to create a 3-D, sponge-like material with a density of 5%, but with the strength 10 times that of steel, according to 3/1/17 [item](#) in TechBriefs.com. The new material was made using a high-resolution, multimaterial 3-D printer.

Boeing scientists have been working on the microlattice, which it calls "The Lightest Metal Ever." Work on the material dates back to 2007, but the company recently put out this [video](#) in 2015. Described as a 3-D, open cellular structure, microlattice is made of 99.99% air. It's both lightweight and excellent at absorbing forces. Boeing has been looking to use microlattice in items in the cabin, like overhead bins or in the floor to make them lighter.

A 10/15/15 [article](#) in Phys.org explained how Boeing made the microlattice: In a 2011 research paper "the researchers described making the material first by creating a template and then by coating it with electroless nickel plating—afterwards the template was removed via etching. The result was a material that got its strength from the lattice, similar to the way bones grow to be strong despite being light, though with the lattice it is taken down to the micro scale—the lattice was a network of extremely tiny tubes with walls that had a thickness of just 100 nanometers, all made of a nickel-phosphorus alloy, though it is still not clear if the same materials were used in the newly updated microlattice."

NASA and General Electric are partnering to develop a new inverter that uses GE's silicon

Carbide, which works at high temperatures and is lightweight. Inverters change the direct current of batteries into the alternating current for a plane's propulsion system. Existing inverters are big and heavy. The new NASA/GE inverter will have more power density and is small enough to work on an electric plane.

"We're essentially packing 1 MW of power into the size of a compact suitcase that will convert enough electric power to enable hybrid-electric propulsion architectures for commercial airplanes," said Konrad Weeber, Chief Engineer of Electric Power at GE Research in a 9/25 ZDNet [article](#). "The next step is to build and demonstrate one that is altitude ready."

(2) *Better batteries*. Developing batteries powerful enough but light enough to be used in an aircraft will be key if large electric planes are to takeoff. Boeing and Safran announced a joint investment in Electric Power Systems (EPS), a private company that's developing aviation-grade energy storage systems, according to a 9/18 [press release](#). EPS developed an 850-pound lithium-ion battery pack used on NASA's X-57 Maxwell, an electric plane with many engines on its wings, according [Spinoff](#) 2019, a NASA publication. The X-57 is expected to make its first electric flight this year.

Boeing also invested in Cuberg, an advanced lithium metal battery technology company in 2018. Cuberg claims to have invented a battery that's less flammable and can produce roughly twice as much energy as a lithium battery that weighs roughly the same amount.

Rolls-Royce says it has built the most powerful battery ever for an electric plane. It's hoping to use that battery in a plane that can break the current speed record of 210 miles per hour, set by an electric Siemens plane in 2017. A B787 Dreamliner with a traditional combustion engine travels about 560 mph and the Rolls-Royce plane dubbed ACCEL (Accelerating the Electrification of Flight) aims to travel 300 mph next year, a 9/7 [article](#) in Globtrender reported.

"We believe that pure electric, or all-electric, propulsion will power smaller aircraft in the foreseeable future, while larger aircraft will rely upon hybrid electric solutions that combine electrification with evolutions of the gas turbine," Paul Stein CTO at Rolls-Royce, according to a 6/19 [article](#) in The Manufacturer. The company agreed to acquire Siemens' eAircraft business, where employees are developing all-electric and hybrid propulsion systems.

Before electric planes become widely deployed, manufacturers will have to overcome the long time it takes to charge a battery. Zap&Go is working on a battery made of materials other than lithium and cobalt, to reduce the flammability of the battery, while increasing how quickly it can be charged. Its electric battery has Carbon-Ion (or C-ion) cells. The battery charges up in roughly five minutes and has 20-30 years of operational life, so the total cost of ownership is far lower than lithium batteries. The battery can also be recycled, the company's [website](#) explains.

CALENDARS

US. Thurs: Headline & Manufacturing Industrial Production -0.2%/-0.3%, Capacity Utilization 77.7%, Housing Starts & Building Permits 1.320mu/1.342mu, Jobless Claims 215k, Philadelphia Fed Manufacturing Index 7.1, DOE Crude Oil Inventories, EIA Natural Gas

Storage, Williams, Evans, Bowman. **Fri:** Leading Indicators 0.1%, Baker-Hughes Rig Count, Clarida, George, Kaplan. (DailyFX estimates)

Global. Thurs: UK Retail Sales Including & Excluding Fuel, 3.1%/2.9% y/y, China GDP 6.1% y/y, China Industrial Production 5.0% y/y, China Retail Sales 7.8% y/y, Japan Headline, Core, and Core-Core CPI 0.2%/0.3%/0.5% y/y, BOE Liabilities/Credit Conditions Survey, UK Sovereign Debt To Be Rated By Fitch, Lowe, Visco, Knot, DeCos. **Fri:** UK Government Sits To Discuss Brexit, Carney, Cunliffe. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings rose edged down w/w from their record highs. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 9.1%, with the earnings measure down 0.1ppt w/w. Forward revenues growth is down 0.9ppt 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 7.8ppts from a six-year high of 16.9% last February but has improved 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 8.5% in 2018 to 4.2% in 2019 and 5.5% in 2020. They're calling for earnings growth to slow sharply from 23.9% in 2018 to 1.6% in 2019 before improving to 10.1% in 2020. The forward profit margin was steady w/w at a five-month low of 12.0% and is down 0.4ppt from a record high of 12.4% in September 2018. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts are expecting the profit margin to drop 0.3ppt y/y from 11.9% in 2018 to 11.6% in 2019 before improving to 12.1% in 2020. The S&P 500's forward P/E rose 0.2pt w/w to 16.6 from a seven-week low of 16.4, which compares to an 18-month high of 17.4 in late July. 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 gained 0.03pt w/w to 2.00 from a seven-week low of 1.97, which compares to an 11-month high of 2.10 in late July. That's up from 1.75 during December, when it was the lowest since November 2016, and 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 rose w/w for three of the 11 S&P 500 sectors, and forward earnings was up for four of the 11 sectors. Consumer Staples and Health Care had 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. Forward P/S and P/E ratios have declined from recent multi-year or record highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. However, all sectors remain well above their multi-year lows during December 2018. 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 one sector now: Financials. The forward profit margin rose to 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. Utilities is the only sector still at a record high. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information

Technology (21.5%, down from 23.0%), Financials (18.3, down from 19.2), Real Estate (15.9, down from 17.0), Communication Services (15.1, down from 15.4), Utilities (13.1, record high), S&P 500 (12.0, down from 12.4), Health Care (10.6, down from 11.2), Industrials (10.3, down from last week's record high of 10.4), Materials (10.2, down from 11.6), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.7, down from 8.0).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With the large financials at the head of the earnings parade, the Q3-2019 earnings season is now picking up steam. Almost 9% of the S&P 500 companies have finished reporting, and their revenues and earnings are beating the consensus forecasts by 1.3% and 4.7%, respectively. Those are about the same rates as during the same point in Q2, but the percentages of companies showing a positive revenue surprise and positive y/y revenue growth are weaker. The early story for earnings is better, though—higher percentages show a positive surprise and positive y/y growth. Of the 43 companies in the S&P 500 that have reported through mid-day Wednesday, 84% exceeded industry analysts' earnings estimates. Collectively, the early reporters have a y/y earnings decline of 1.0%, primarily due to Micron Technology's earnings deceleration. On the revenue side, 61% of companies beat their Q1 sales estimates so far, with results 3.7% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps to 4.6% from -1.0% and revenue growth improves to 4.7% from 3.7%. Overall Q3 earnings growth results are positive y/y for 74% of companies, and revenues have risen y/y for 81%. While these figures will change markedly as more Q3-2019 results are reported in the coming weeks, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Headline sales fell for the first time in seven months in September, while core sales was unchanged at its record high. Total sales fell 0.3% last month, following an upwardly revised 0.6% (from 0.4%) increase in August; core retail sales—which excludes autos, gasoline, building materials, and food services—was unchanged at August's record high. We estimate real retail sales rose for the fifth straight month, by 0.1% in September and 2.4% over the period, while core retail sales rose for the seventh month, up 0.4% m/m and 3.8% during the seven months through September. We calculate that real retail sales accelerated 5.9% (saar) during Q3, the best quarterly performance since Q4-2017, while core retail sales (BEA uses the core retail sales measure to estimate personal consumption expenditures each month) expanded 6.7% (saar)—its strongest quarter since Q2-2017. In September, sales were mixed, with seven of the major 13 categories decreasing, five increasing, with sales at electronic & appliance stores unchanged. Dragging retail sales down last month were notable declines at building materials (-1.0%), motor vehicle (-0.9), and gasoline (-0.7) retailers, with sales at food & beverage, sporting goods, general merchandise, and nonstore (-0.3) retailers posting losses from -0.1% to -0.3%. In the plus column were sales of clothing & accessory (1.3), furniture (0.6), health & personal care (0.6), miscellaneous (0.5), and food & drinking establishments.

Business Sales & Inventories ([link](#)): Nominal business sales climbed to a new record high in August, while real business sales for July is back within a fraction of January's record high.

Nominal manufacturing & trade sales increased 0.2% for the second straight month in August, while real business sales edged up 0.1% in July, building on June's 0.8% rebound. It was the first back-to-back gains this year for both measures. Real sales of retailers ascended to another new record high in July while wholesalers' remained stalled just below January's record reading. Meanwhile, manufacturers' sales dipped 0.4%, following a 1.3% gain during the two months through June; it's within 1.2% of January's cyclical high. August's nominal inventories-to-sales ratio (1.40) held at its recent high, up from its recent low of 1.34 last June. Meanwhile, the real inventories-to-sales ratio climbed back up to its recent high of 1.46, up from its recent low of 1.41 at the end of 2017.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): September's CPI rate was below 2.0% for the 11th consecutive month and below 1.0% for the first time since November 2016; the core rate continued to fluctuate around 1.0%. The headline rate eased to 0.8% y/y, down from 1.0% in August and below the flash estimate of 0.9%; it was at a recent peak of 2.3% last October. Looking at the main components, food, alcohol & tobacco (to 1.6% from 2.1% y/y) had the highest rate, followed by services (1.5 from 1.3)—with the former decelerating from August's rate and the latter accelerating. The rate for non-energy industrial goods (0.2 from 0.3) continues to hover just above zero. Meanwhile, the rate for energy (-1.8 from -0.6) fell further below zero, after slipping below in August for the first time since November 2016; it's been steadily heading lower from March/April's rate of 5.3%. The core rate—which excludes energy, food, alcohol, and tobacco—ticked up to 1.0% y/y from 0.9% the prior two months; it's fluctuated between 0.8% and 1.1% the past five months. Of the top four Eurozone economies, rates for France (1.1% y/y) and Germany (0.9) were above September's headline rate of 0.8%, while Italy's (0.2) and Spain's (0.2) were below. Meanwhile, Cyprus (-0.5) and Portugal (-0.2) had the lowest rates among the Eurozone members—recording negative readings, while Slovakia (3.0) and the Netherlands (2.7) had the highest.

European Car Sales (*link*): EU passenger car registrations (a proxy for sales) rose at a double-digit rate of 14.5% y/y in September, though was boosted by a low base of comparison, as registrations fell significantly in September 2018 (-23.5%). Gains in four of the five major EU markets were in double-digits last month: Germany (22.2% y/y), Spain (18.3), France (16.6), and Italy (13.4), while the UK (1.3) registered only a small gain as Brexit-related uncertainties continued to affect consumer confidence. Looking at sales through the first nine months of the year, sales were down 1.6%, compared with the comparable 2018 period, with Germany (2.5% y/y) the only large market to record an increase, while Spain's (-7.4) was the weakest of the five major markets, followed by the UK (-2.5), Italy (-1.6), and France (-1.3).

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