Yardeni Research

MORNING BRIEFING
July 16, 2020

Banks Are Winning & Losing

Check out the accompanying chart collection.

(1) Americans are filling their tanks and hitting the road. (2) More upside surprises from the Citi Economic Surprise Index, and forward revenues and earnings too. (3) Banks reserving for lots of rainy days still ahead. (4) Capital markets and trading save the day for Q2 bank earnings. (5) Push for COVID-19 vaccines pushing possible candidates into late-stage trials. (6) Scientists also try harnessing plants to make vaccines fast and cheap. (7) Tesla's price cuts may signal drops in its technology and production costs—not its sales.

Good News: More of It. More Americans may be getting chills and fevers, but more of us are chillin' on the open road again too. While the COVID-19 case count is making record highs, so is gasoline usage in the US. The four-week average bottomed at 5.3mbd during the April 24 week, and is up 62% since then through the July 10 week (*Fig. 1*). It's been up every week since the bottom and still looks more like a V than a U, W, or Nike swoosh.

Gasoline usage is our favorite high-frequency economic indicator. We acknowledge that it may be getting boosts from more Americans driving to work rather than taking public transportation and more taking driving vacations in the USA rather than traveling abroad. Given that recent COVID-19 outbreaks are causing some states to reverse course on reopening their economies, we expect some weakness in this indicator in coming weeks.

Another surprisingly happy high-frequency economic indicator is the daily Citigroup Economic Surprise Index (*Fig. 2*). It has set record highs every day but two since June 15. It is up from a record low of -144.6 on April 30 to 243.4 on Tuesday.

Our favorite weekly fundamental stock market indicators are also starting to look up after taking dives from mid-March through the end of May. S&P 500 forward revenues, forward earnings, and the implied forward profit margin all have been edging higher in recent weeks (*Fig. 3*). All three are great coincident indicators of their comparable actual quarterly series. So they suggest that the worst was over during Q2 for S&P 500 revenues, earnings, and margins.

Banks: The Gift of Time. The Federal Reserve and the federal government have given the banks the gift of time—time to squirrel away enough reserves to face the tsunami of loan losses and delinquencies that look poised to hit over the next six to 12 months.

By paying extra unemployment benefits, by providing companies with forgivable loans that prevent layoffs, and by allowing consumers to postpone payments on loans, rent, and taxes, the fiscal policymakers have pushed off the days of reckoning. The monetary authorities flooded the financial markets with liquidity, averting a severe credit crunch. Collectively, their actions have led to higher incomes and saving, while the flight out of cities has boosted home prices. Let's take a look at the bunkers JPMorgan and Goldman are building during this highly unusual lockdown recession:

(1) *Playing defense*. The stimulus checks and the extra $600 a week in unemployment benefits have boosted household incomes, which jumped to $20.7 trillion in April from $18.7 trillion in March, easing to $19.9 trillion in May (*Fig. 4*). Likewise, existing home prices have risen recently despite the surge in unemployment; they rose 6.0% y/y in May, continuing an eight-year uptrend (*Fig. 5*).

But bankers recognize that today's government-supported economy has darkening clouds in the distance. Credit card and auto loan delinquencies were trending up before COVID-19 hit, and they'll certainly continue to do so as unemployment remains elevated (*Fig. 6*). In March, S&P Global Ratings forecast that the default rate for junk bonds would head to 10% over the next 12 months, up from 3% at the end of last year, a March 20 CNBC article reported.

The good news is that during this stimulus-induced break from reality, the banks have made hay. JPMorgan boosted loan-loss reserves by $8.9 billion in Q2 and $6.8 billion in Q1, bringing its total reserves up to $34 billion, more than double the level at the end of 2019. JPMorgan's reserve positions are more conservative than its base-case scenario for the US economy: unemployment of 10.9% in Q4-2020 and 7.7% in Q4-2021. Likewise, US Bancorp boosted its provision for credit losses by $1.7 billion in Q2 and $993 million in Q1, major jumps from last year's quarterly credit-loss provisions, which ran between $365 million and $395 million. And Goldman's provision for credit losses soared to $1.6 billion last quarter compared to $214 million in Q2-2019.

JPMorgan CFO Jennifer Piepszak explained on the bank's Q2 conference call that the brunt of its reserve-building may be over: "Given the increased uncertainty of the macroeconomic outlook … we've put more meaningful weight on the downside scenario this quarter. And so therefore, we're prepared and have reserved for something worse than the base case. And given CECL covers life of loan, if our assumptions are realized, we wouldn't expect meaningful additional reserve builds going forward."

If a base-case scenario materializes, the bank would be left with excess capital and be positioned to restart its share repurchases. "We don't expect that this year, but I wouldn't completely rule it out in the fourth quarter," said CEO Jamie Dimon.

(2) *Capital markets to the rescue.* In addition to keeping the consumer afloat, the government's stimulus programs have contributed to the roaring stock and bond markets. The Fed's willingness to buy corporate bonds and keep interest rates around zero has kept the capital markets open for business and the stock market flying. The S&P 500 is only 5.5% off its all-time high, and companies have pounced on the low-interest-rate environment to sell debt and prefund expenses (*Fig. 7*). Global debt issuance is up 20.1% ytd compared to last year, and global equity underwriting is up almost 50% ytd, according to the *WSJ*'s Dealogic rankings.

The trading and capital market operations of Goldman Sachs and JPMorgan both have benefitted from this environment. Goldman's global markets business rose 93% y/y in Q2, and its investment banking business line jumped 36%. At JPMorgan, trading revenue was up 79% in the quarter. These gains certainly helped the pair's bottom lines, but such boons often aren't reoccurring.

(3) *Investors remain wary.* It's certainly impressive that Goldman and JPMorgan managed to be solidly profitable last quarter given the economic backdrop. But the firms' stocks are 13.1% and 29.5% off their respective January highs as of Tuesday's close. Investors presumably remain concerned about potential loan losses.

For a broader perspective, the S&P 500 Diversified Banks stock price index is down 36.2% ytd through Tuesday's close and up 24.3% from its March 23 low (*Fig. 8*). The index's other constituents have fared worse ytd than JPMorgan's stock. Here's how much some have fallen so far this year: Wells Fargo (-54.9%), US Bancorp (-38.8), Citigroup (-37.2), and Bank of America (-31.5). Analysts expect the industry's collective revenue and earnings will drop 6.8%

and 57.7%, respectively, this year only to rebound by 1.4% and 80.7% in 2021 (*Fig. 9* and *Fig. 10*).

Disruptive Technology I: Developing New Vaccines. Historically, vaccines have been made by injecting a live virus into a fertilized chicken egg and letting it replicate. Scientists then extricate the virus-filled egg white from the egg and kill, thus deactivating, the part of the virus that infects people. It takes months to ensure that all of the virus in the egg white is dead. Making the flu vaccine each year, for example, takes six months or more.

So companies have been working to devise faster and less costly methods of making vaccines. This week brought good news from two companies using two different methods of vaccine production. Moderna, which uses messenger RNA, revealed more positive results from an earlier trial and announced that it's beginning its final vaccine trial on July 27. Separately, a company partially owned by Philip Morris announced that its plant-based vaccine would begin Phase 1 clinical trials. Leading the pack may be a vaccine developed at Oxford University. Here are some of the details:

(1) *Chimps lend a hand.* Oxford's COVID-19 vaccine candidate is considered the front-runner. Instead of using a live COVID-19 virus, Oxford scientists use a chimpanzee virus for the common cold that's weakened and genetically changed so that it can't replicate in humans. Inserted into this virus is genetic material that makes the proteins from the COVID-19 virus. It's hoped that when this contrived virus is injected into humans it will elicit a response that will give humans immunity to the COVID-19 protein.

A May 22 Oxford press release explained why that protein is so important: "The SARS-CoV-2 coronavirus uses its spike protein to bind to ACE2 receptors on human cells to gain entry to the cells and cause an infection. By vaccinating with ChAdOx1 nCoV-19, we are hoping to make the body recognise and develop an immune response to the Spike protein that will help stop the SARS-CoV-2 virus from entering human cells and therefore prevent infection."

The viral vector method was developed so that a vaccine could be developed quickly for any disease. The Oxford scientists previously used it to develop a vaccine for MERS, which in a 2018 small trial of 24 people proved safe. Oxford's COVID-19 vaccine has begun Phase 3 trials with 10,000 humans in Brazil, South Africa, the UK, and the US. If successful, the vaccine will be produced by AstraZeneca. Results from Phase 1 trials are expected by the end of July, and if Phase 3 trials are successful, a vaccine could be available late this year.

(2) *Moderna's vaccine inches closer to the finish line.* Investors learned more good news about Moderna's COVID-19 vaccine this week. The vaccine triggered an immune response in all 45 people who received the shot in the trial, and it was deemed safe and well tolerated.

Researchers found that antibody production increased after the second dose and resulted in "neutralizing activity similar to that seen in the top half of blood specimens taken from 41 people who had recovered from COVID-19 and who weren't in the vaccine study," a July 14 *WSJ* article reported. Antibodies were still detected two months after the vaccine was given. Yet unknown are how long the antibodies will last and how many antibodies are needed to fend off the disease.

Moderna also reported that it would launch Phase 3 trials with 30,000 high-risk adults on July 27. About half of the trial participants will receive the COVID-19 vaccine in two doses, four weeks apart, while the other half gets a placebo. Recall that Moderna used the genetic code of the COVID-19 virus to create messenger RNA. The messenger RNA in the vaccine enters the body's cells and makes proteins that prompt an immune response, which the body then can use to fight the virus.

(3) *Harnessing plants to create a vaccine*. A number of institutions are using plants to generate vaccines, including Canadian-based Medicago, in which Philip Morris International is an investor, and Kentucky BioProcessing, a subsidiary of British American Tobacco. It's hoped that using plants to produce vaccines will be a safer, lower-cost alternative that won't require the refrigeration needed for vaccines made using eggs. The process also would be faster, taking weeks instead of months to create a vaccine.

An April 4 *WSJ* article explained the process well: "Plant-based vaccines are generally made by infecting a plant—sometimes by dipping leaves in a liquid—with a bacteria that contains the genetic sequence of the desired protein. The bacteria hijack the plant cells to make large quantities of the protein in the space of about a week, which is then harvested from the plant and purified into a raw material for the vaccine."

Medicago announced on Tuesday that it has begun Phase 1 trials of its plant-based COVID-19 vaccine and soon will dose 180 volunteers. The volunteers will be given booster shots made by GalaxoSmithKline and Dynavax Technologies. Medicago believes it can make about 100

million doses of the vaccine by the end of 2021 and is building a facility in Quebec that could make a billion units a year by 2021, a July 14 Reuters article reported.

Disruptive Technology II: Rooting for Falling Tesla Prices. Earlier this week, Tesla announced a $3,000 price cut on its Model Y sports utility vehicle, and the doubters came racing out of the woodwork. Critics warned that the price cuts are being done to juice demand in a market that has been sapped of buyers due to COVID-19.

While Tesla's worldwide sales have fallen slightly over the past six months, they've held up far better than those of other manufacturers, a July 2 CNBC article reported. In Q2, Tesla said it delivered 90,650 vehicles, beating Wall Street analysts' average estimate of 72,000 vehicles according to FactSet and 83,000 according to a Bloomberg count. The company's Q2 deliveries were down only 4.8% y/y, while traditional manufacturers such as General Motors and Ford sustained Q2 sales drops of more than 30%.

Tesla's share of the electric vehicle market has jumped to 21% in China, up from 6% last year, and its global market share jumped about 3ppts y/y to 26% in H1-2020, according to ARK Investment Management analyst Sam Korus.

We'd suggest that the price cuts may have less to do with the auto market's slump and more to do with the fact that Tesla is more tech company than auto manufacturer. Tesla cars are computers with a battery and four wheels attached. As the company's technology improves and its production volumes increase, we would expect Tesla's costs to continue to decline, allowing the company to cut prices further.

This week's price cut wasn't the company's first. It also cut prices in May of this year and in March 2019, before anyone had ever heard of COVID-19. In last year's cuts, prices fell on the Model S vehicles by anywhere from $10,000 to $18,000 and the Model X vehicles' prices dropped by $8,000 to $18,000. In this week's news, the Model Y's price fell by $1,000 to $3,000, depending on the car's mileage and other bells and whistles.

ARK's Korus is betting that Wright's Law—which forecasts price declines resulting from production increases—will apply to Tesla. So far it has. For every cumulative doubling of its production, the Model 3's costs have fallen by roughly 15%, Korus explained in a September 4, 2019 report. It's a theory that we discussed in the July 3, 2019 *Morning Briefing* to explain why manufacturers might be more inclined going forward to adopt robots on their factory floors.

The ability to lower costs as manufacturing ramps up and technology improves gives Tesla the ability to cut prices, improve margins, or invest more in research and development. Just how much of that sanguine scenario is priced into the stock already, with a forward P/E of 227 on July 10, is another question entirely.

CALENDARS

US: **Thurs:** Retail Sales Total & Ex Autos 5.0%/5.0%, Initial & Continuous Jobless Claims 1,250k,/17,600k, Business Inventories -2.3%, Philadelphia Fed Manufacturing Index 20.0, NAHB Housing Market Index 60.0, EIA Natural Gas Inventories, Williams, Evans.
Fri: Consumer Sentiment Index 79.0, Housing Starts & Building Permits 1.169mu/1.290mu, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** European Car Registrations, UK Employment Change & Unemployment Rate -234k/4.2%, UK Gfk Consumer Confidence Flash Estimate -26, ECB Rate Decision & Deposit Facility Rate 0.0%/-0.5%, ECB Press Conference, Bailey. **Fri:** Eurozone Headline & Core CPI 0.3%/0.8% y/y, EU Meeting on Recovery Plan, Guindos, Schnabel. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) moved further above 3.00 this week. The BBR recorded its 15th increase in the past 16 weeks, climbing to 3.21 this week (the highest since the January 21 week); it had dropped from 2.89 to 0.72 (the lowest since February 2016) over the prior five weeks. Bullish sentiment soared 28.0ppts (to 58.1% from 30.1%) over the past 16 weeks to its highest percentage since mid-January. Meanwhile, bearish sentiment fell 23.6ppts (to18.1% from 41.7%)—indicating the fewest bears since January. The correction count has been in a volatile flat trend the past several weeks, fluctuating between 22.5% and 26.5%. It was at 23.8% this week. The AAII Ratio climbed to 38.9% last week after falling the prior three weeks from 47.4% to 32.6%. Bullish sentiment rose to 27.2% after a four-week decline from 34.6% to 22.2%, while bearish sentiment fell for the second week from 48.9% to 42.7% last week.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The rapid pace of COVID-19 estimate cuts has abated, and forecasts are showing increasing signs of recovery now. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues ticked up less than 0.1% w/w and is now

6.2% below its record high in mid-February. Forward earnings ticked down less than 0.1% w/w and is now 18.3% below its record high in early March. Forward revenues growth remained steady at 2.9% after jumping 1.2ppts a week earlier. Forward earnings growth of 5.2% was also steady w/w, after surging 4.4ppts a week earlier. Forward revenues growth is 3.4ppts below its seven-year high of 6.3% in February 2018, but is up from 0.2% in April, which is the lowest reading since June 2009. Forward earnings growth remains 11.7ppts below its six-year high of 16.9% in February 2018, but is up 10.8ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 5.2% y/y in 2020 compared to the 4.2% reported in 2019. That's down 0.1pts w/w and 10.4ppts since the start of the year. Analysts expect an earnings decline of 22.9% y/y in 2020 compared to a 1.4% rise in 2019. Their 2020 growth rate was unchanged last week on a w/w basis but is down 31.9ppt since the beginning of the year. The forward profit margin dropped 0.1ppt w/w to 10.4% from a 10-week high of 10.5%. That's up just 0.1ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 2.0ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 2.2ppt y/y in 2020 to 9.3%—from 11.5% in 2019—and to improve 1.8ppt y/y to 11.1% in 2021. The S&P 500's weekly forward P/E rose 0.4pt to 21.9. It's down 0.5pt from 22.4 on 6/11, which had been the highest level since early 2002, and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio rose 0.03pt w/w to 2.28 and is down 0.05pt from its record high of 2.33 on 6/11. That's up from the 49-month low of 1.65 in mid-March and compares to the previous record high of 2.29 in mid-February.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise w/w for eight of the 11 S&P 500 sectors and forward earnings rise for 7/11 sectors. Due to the sharp decrease in forward earnings this year, forward P/E ratios for nearly all sectors now are back above their recent record or cyclical highs prior to the bear market. However, forward P/S ratios remain below their highs for most sectors. Utilities is the only sector expected to maintain its profit margin in 2020, down from eight sectors expected to improve on a y/y basis in early March. During 2019, just two sectors improved y/y: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since 2018, it has moved lower for nearly all the sectors. In the latest week, the forward profit margin fell for Utilities and was unchanged for the remaining 10 sectors. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.8%, down from 23.0%), Real Estate (14.1, down from 17.0), Communication Services (13.3, down from 15.4), Utilities (14.0, down from a record high of 14.1% in early July),

Financials (13.8, down from 19.2), S&P 500 (10.5, down from 12.4), Health Care (10.1, down from 11.2), Materials (9.0, down from 11.6), Industrials (7.7, down from its record high of 10.5% in mid-December), Consumer Staples (7.2, down from 7.7), Consumer Discretionary (5.0, down from 8.3), and Energy (1.3, down from 8.0).

S&P 500 Sectors Forward Revenues and Earnings Recovery from COVID-19 Trough (*link*): The S&P 500's forward revenues and earnings as well as its implied forward profit margin appear to have bottomed on May 28 after 14 weeks of COVID-19 declines. Since then, S&P 500 forward revenues has risen 1.9%, and forward earnings has gained 3.8%. The profit margin ticked down 0.1pt w/w to 10.4% from a 10-week high of 10.5%. That compares to a cyclical low of 10.3% during May and June. On a sector basis, all but two sectors are rising from the lows in their forward revenues, earnings, and profit margins. Only Communication Services remains at a new low in its forward profit margin. In the latest week, Utilities posted new lows in their forward revenues and earnings. Here's how the sectors rank by their forward revenues change since May 28, along with their forward earnings change: Financials (revenues up 3.3%, forward earnings up 5.4%), Industrials (2.5, 6.9), Energy (2.6, 131.8), Communication Services (2.5, 1.9), Materials (2.4, 4.6), Consumer Discretionary (1.9, 9.8), S&P 500 (1.9, 3.8), Information Technology (1.9, 2.1), Health Care (1.2, 2.5), Consumer Staples (1.0, 1.7), Real Estate (0.0, -1.2), and Utilities (-1.5, -0.7).

US ECONOMIC INDICATORS

Industrial Production (*link*): Industrial output improved in June for the second straight month, though remained considerably below February's pre-crisis level. Output recovered 5.4% in June and 6.9% in the two months through June, after plummeting a record 16.6% the prior two months, leaving it 10.8% below February's level. Meanwhile, the move up in manufacturing was more impressive: an 11.3% rebound during the two months ending June after a two-month drop of 20.1%. By market group, there were lots of plus signs the past two months. Business equipment production rebounded 20.1% during the two months through June after a two-month plunge of 29.4%—driven by a 144.3% surge in transit equipment output, which had plummeted 65.5% and 25.8% in April and March, respectively. Production of industrial equipment climbed 12.5% over the two-month period, after sliding 22.7% during the two months ending April. Meanwhile, output of information processing equipment rose for the first time since February, rebounding 7.4% in June after a three-month slide of 8.5%. In the meantime, consumer goods production jumped 12.7% during the two months ending June, led by a 68.1% surge in durable goods production —which was driven by a 240.7% surge in

output of automotive products. Movements in nondurable goods production were much less dramatic: a 3.8% rise during the two months through June after a two-month setback of 7.5%.

Capacity Utilization (*link*): The headline capacity utilization rate advanced for the second month to 68.6% in June after sinking from 76.9% in February to a record low of 64.2% in April; it was at a cyclical high of 79.6% during November 2018. June's rate was 11.2ppts below its long-run (1972–2019) average but 1.9ppt above its trough during the Great Recession. Manufacturing's capacity utilization rate rebounded to 66.9% in June, 6.9ppts above its record low of 60.0% in April and 3.2ppts percentage points above its recession trough of June 2009. Utilities' capacity utilization rate moved up to 72.3% last month after sliding from 73.5% in February to a record low of 69.5% in May. The rate for mining fell steadily from 90.2% at the start of the year to 75.0% by June—which was the lowest since fall 1986.

Regional M-PMI (*link*): The New York Fed—the first district to report on manufacturing activity for July—showed manufacturing activity in the region is expanding again. July's composite index improved for the third month, by 95.4 points—from -78.2 in April to +17.2 this month)—its first positive reading since February. The new orders (to +13.9 from -66.3 in April) and shipments (+18.5 from -68.1) measures both recorded impressive gains over the three-month period. Over the same time span, the employment (to 0.4 from -55.3) measure showed that factories have stopped cutting payrolls, while the average workweek (-2.6 from -61.6) has become more stable. This month, delivery times were somewhat longer, according to the report, while inventories declined. Looking at pricing, input prices (to 14.9 from 16.9) this month are not much different from last month, while selling prices (-4.5 from -0.6) dipped a bit. Firms remained optimistic about the six-month outlook this month, though less so than in June. The future business conditions index fell to 38.4 in July after soaring from 1.2 in March to 56.5 (its highest in a decade) by June.

Import Prices (*link*): Import prices continued to rebound in June, along with petroleum prices. Import prices jumped 2.3% during the two months through June, after tanking 5.7% during the three months through April, with the drop in the yearly rate narrowing to -3.8% y/y from -6.9% in April. April's y/y decline was the steepest since year-end 2015 and was triggered by petroleum prices. Petroleum prices surged 42.9% during the two months through June after a three-month slide of 55.4%, narrowing the yearly decline to -38.6% y/y from April's record low of -58.7%. Meanwhile, nonpetroleum prices edged up 0.3% last month after a 0.2% uptick in May, following a 0.7% dip over the prior two-month period; the yearly rate was flat—narrowing from April's -1.1%. The rate for capital goods imports (-0.1% y/y) was in negative territory for

the 21st consecutive month, though is about to swing positive. Meanwhile, the rate for industrial supplies & materials (-16.3% y/y) narrowed from April's 26.6%—which was the lowest reading since November 2015. Rates for consumer goods ex autos (-0.2% y/y) and auto prices (0.6) remained near zero, while the rate for food prices was flat with a year ago, after falling 4.4% y/y in April. The US is importing deflation from its Asian trading partners, with import prices for goods from China (-0.9% y/y) and the NICs (-2.3) falling—though declines in both are slowing; Japan's rate is at zero. Meanwhile, there's no sign of inflation in EU (0.4) import prices.

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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