MORNING BRIEFING
October 14, 2021

JP Morgan, China & Methane

Check out the accompanying pdf and chart collection.

(1) JPM leads the bank earnings brigade. (2) Results helped by improving credit and strong capital markets. (3) Corporate loan demand still sluggish. (4) Yield curve may lend a hand in the future. (5) The hits keep coming in China's property market. (6) China's energy prices soar, and electricity service gets interrupted. (7) Xi wants "peaceful" reunification with Taiwan as he flies military jets nearby. (8) Environmentalists focus on methane. (9) Blaming the cows and sheep. (10) New foods and a mask might help gassy cows. (11) Old natural gas wells silently hurting the environment.

Financials: JPM Is Out of the Gate. Improving credit quality and a rising equity market helped JPMorgan turn in Q3 earnings that largely met expectations. The bank's revenue rose 1% y/y to $29.7 billion, and its net income jumped 24% y/y to $11.7 billion due to a reserve release. Excluding a reserve release and a tax benefit, the bank's profit was $9.6 billion, up from $9.4 billion a year ago. Going forward, the bank's fortunes may be decided by whether higher interest rates on loans will be large enough to offset the rising costs that the bank expects to incur.

JPM shares are up 30.1% ytd through Tuesday's close and sold off by 2.6% in trading Tuesday. They have performed in line with the S&P 500 Financials sector this year so far, which has turned in the second-best ytd performance among the 11 S&P 500 sectors.

Here's the performance derby for the S&P 500 and its sectors ytd through Tuesday's close: Energy (49.4%), Financials (30.6), Real Estate (24.2), Communication Services (19.7), Information Technology (15.3), S&P 500 (15.8), Industrials (12.6), Materials (12.0), Consumer Discretionary (11.6), Health Care (10.4), Consumer Staples (4.3), and Utilities (2.4) (*Fig. 1*).

Let's look at the details of JP Morgan's earnings release and some of the important financial metrics affecting the banking industry:

(1) *Equity & M&A provide a tailwind.* The S&P 500 is up 15.8% ytd though Tuesday's close, bringing its three-year gain to 57.2% (*Fig. 2*). The strong US stock market in recent years has helped JP Morgan's equity and M&A advisory business lines. During Q3, the bank's gross investment banking revenue jumped 60% y/y to $1.3 billion. Revenue in equity-

market-related activities increased 30% y/y to $2.6 billion. The fixed income markets weren't as helpful, with related revenue down 20% y/y due to lower results in commodities, rates, and spread products versus a strong year in 2020.

A strong stock market benefitted the bank's asset and wealth management division as well. Assets under management climbed 17% during Q3 to $3 trillion thanks to higher asset prices and net inlows, the bank reported. It's notable that loans in the asset & wealth management unit rose 20% y/y and 3% q/q, primarily driven by securities-based lending.

A rising equity market should also have benefitted other banks with capital markets exposure. The value of US initial public offerings and secondary equity issuance has fallen 12.9% in Q3 y/y, but is up 24.0% ytd, according to Dealogic data in the *WSJ* (*Fig. 3*). The value of US M&A deals was up 35.2% in Q3 for the whole industry.

(2) *Companies don't need loans.* With the capital markets wide open and balance sheets flush, companies' need for loans has dropped. In JPMorgan's Commercial Banking unit, commercial and industrial loans dropped 9% y/y and rose 1% q/q after excluding government-backed PPP loans. The segment's net interest income was up 1% y/y and flat q/q.

Drumming up loan business is an issue across the banking industry. Commercial & industrial (C&I) loans across all US commercial banks jumped in early 2020 when companies borrowed money as a safeguard against the uncertain economic impact of Covid-19. Since peaking in at $3.1 trillion the week of May 13, 2020, C&I loans have fallen 23% to $2.4 trillion (*Fig. 4*). JP Morgan CEO Jamie Dimon said in the company's Q3 *press release* that the bank is "seeing early signs of commercial real estate loan growth on modestly higher new loan originations in commercial term lending."

The potential improvement in net interest margins could help banks' bottom lines in the future. Through Q2, banks' net interest margins fell to 2.5%, lower than at any time over the past 37 years (*Fig. 5*). But in recent months as the economy has recovered, the US yield curve spread has steepened sharply to 144 bps, up from its 2019 low of -66 bps (*Fig. 6*). Higher-than-expected inflation data and rising energy prices have pushed up 10-year Treasury yields to 1.56%, while the Fed funds target rate remains close to zero and is only expected to rise slowly over the next year (*Fig. 7*).

China: Getting Dicey. China continues to face numerous problems simultaneously. The country's property market remains under stress, as home sales are falling and some weaker property developers are defaulting or postponing debt payments. An energy crisis is pushing up the price of coal and electricity, forcing companies to pay more and intermittently turn off their production. But China's President Xi Jinping is focused instead on China's reunification with Taiwan.

Xi has just over a year to clean up this mess before the 20th National Party Congress meets in November 2022. There, party leaders decide whether Xi remains in his role for an unprecedented third term, now that term limits have been revoked. While there are no alternative contenders right now, Xi no doubt would like to enter the meeting in a position of strength. Let's take a look at some of the problems he'd probably like to resolve sooner rather than later:

(1) *The Evergrande fallout continues.* China Evergrande Group hasn't officially defaulted, but it hasn't paid the interest on its dollar-denominated bonds, and the clock is ticking. Meanwhile, some developers are reporting that September home sales fell by more than 20%-30% y/y. A handful of property developers have defaulted on or deferred debt payments. And yields on junk-rated dollar-denominated Chinese bonds have jumped north of 17%.

Sinic Holdings Group said it doesn't expect to repay a $250 million bond due October 18, and that not doing so may trigger cross-defaults on two other notes, an October 12 Bloomberg *article* reported. Modern Land (China) asked bond investors to defer by three months a $250 million bond payment due October 25. Fantasia Holdings Group didn't pay $206 million of principal due on a dollar-denominated bond. And Xinyuan Real Estate offered to pay only 5% of the principal on a note due October 15 and swap the remaining debt for bonds due 2023.

Local governments are acting to bolster the market. Harbin, a city in the northeast, is offering to provide subsidies of up to 100,000 yuan ($15,497) for homebuyers under 35, an October 13 *South China Morning Post* *article* reported. The city is also allowing developers to presell homes earlier than previously allowed. Eight other cities are barring developers from cutting home prices too deeply and in some cases instituted minimum prices, an October 12 *WSJ* *article* reported, citing Chinese state media.

Despite the doom and gloom, a Morgan Stanley analyst upgraded China's property sector to "attractive," believing that default risks and property market weakness are priced into property stocks. In addition, she believes that policy easing looks "more likely now" and that easing would support property stocks, an October 12 CNBC *article* reported.

(2) *Energy crisis continues too.* Coal prices hit new highs on Monday in China, as floods have hurt coal production in northern China—the latest in a string of problems that have weighed on electricity production. The country went so far as to allow power companies to charge market prices for electricity sold to industrial users, while consumers, agricultural users, and public welfare initiatives continue to be charged fixed prices.

Power shortages, which are expected to continue through year-end, are hamstringing a wide range of industries. Manufacturers of everything from semiconductors to cement, steel, and aluminum have been forced to suspend operations intermittently. Analysts and traders are forecasting a 12% drop in industrial power consumption in Q4 because of short coal supplies, an October 11 Reuters *article* reported. The price of coal futures hit ¥1,714 per unit on September 30, up 90% ytd (*Fig. 8*).

(3) *And while Rome burns . . .* China's President Xi continues to rattle sabers in Taiwan's direction. In a speech last weekend, he said: "To achieve the reunification of the motherland by peaceful means is most in line with the overall interests of the Chinese nation, including our compatriots in Taiwan." Lest anyone didn't get his gist, he continued: "No one should underestimate the Chinese people's determination, and strong ability to defend national sovereignty and territorial integrity. The historical task of the complete reunification of the motherland must be fulfilled, and it will definitely be fulfilled."

China's military backed Xi's threat by saying on Monday that it had conducted drills on China's beaches located across the sea from Taiwan. China has also been regularly flying military aircraft into Taiwan's air defense zone. Fifty-two Chinese aircraft flew into the space on Monday during the day, and four followed at night.

Disruptive Technologies: Focus on Reducing Methane. With the COP26 climate conference slated for October 31 in Glasgow, headlines are full of items about how to slow or reverse climate change. In addition to reducing CO2, scientists are focused on reducing methane because it has a warming effect that's more than 30 times greater than CO2.

The US and EU launched in September a Global Methane Pledge, the supporters of which promise to cut methane emissions by at least 30% from 2020 levels by 2030. Thirty-four countries—including Argentina, Canada, Germany, Ghana, Indonesia, Iraq, Italy, Japan, Mexico, and the UK—have indicated their support for the pledge, which will be formally launched at COP26. However, the agreement doesn't have the support of four of the top five emitters of methane, China, Russia, Brazil, and India.

Here are the major sources of methane, according to a September 23 McKinsey *report*: livestock (25%-30%), coal mining (10-15), gas (10-15), oil (10), rice cultivation (7-10), biomass burning (8-10), wastewater (7-10), solid waste (7-10), and other (2).

Fortunately, scientists in companies and academia have come up with a host of new technologies to reduce methane emissions:

(1) *Blame the cows.* Environmentalists aim to reduce the methane produced by cows and sheep burping and defecating. Fortunately, there may be some easy, relatively inexpensive solutions to the gassy problem.

A cow feed, Bovaer, contains an organic compound that inhibits cows' methane production by up to 80%, a September 30 *article* in *The Guardian* reported, without affecting the taste or production of the cows' milk or meat. Bovar, which was approved for use in Brazil and Chile, is produced by DSM, a Netherlands-based provider of nutritional and pharmaceutical ingredients and chemicals.

Another feed additive, Kowbucha, is being developed by the New Zealand Agricultural Greenhouse Gas Research Centre, which is also evaluating which cows produce the most and least methane.

Meanwhile, scientists at the University of New Hampshire have found that feeding cows seaweed reduces methane production by up to 20%, an October 12 CNBC *article* reported. At the University of California, Davis, researchers have determined that three ounces of seaweed a day can reduce methane emissions by more than 80%, The Guardian article noted. Scientists also are determining which seaweed is most effective and developing inland sources, so it can be grown near where it would be used.

As much as 95% of an animal's methane emissions come from its mouth and nose. A UK company, ZELP, created a mask for cows that it claims neutralizes about 50% of the methane cows emit. The mask sits just above a cow's nostrils and captures the methane expelled. When the methane level gets high, the mask sends the gas to a mechanism that converts the methane into CO_2 and water, which is expelled from the mask. The process reduces methane's global warming potential to less than 1.2% of its original value, a January 1 *Wired* *article* reported. Cargill plans to distribute the mask to dairy farmers next year.

(2) *Targeting energy.* Vast amounts of methane are released during the production and

combustion of oil, gas, and coal. Methane is emitted from the production of coal, and the solution—until the recent gas shortage—has been to stop using coal and switch to natural gas or renewables.

However, the production of natural gas—the “clean” fuel that we’ve come to depend on—can also release methane. It leaks from natural gas wells and pipelines. Satellite images show large amounts of methane pouring out of Texas’ Permian Basin, Russia, and Central Asia. The technology exists to reduce the methane emitted; the question is how to incentivize companies to pay for and use the technology. If known technology were to be deployed across the oil and gas value chain, the International Energy Agency (IEA) estimates that about 75% of total oil and gas methane emissions could be avoided, a 2020 IEA *report* stated.

(3) *Impressive field work.* Bloomberg produced a damning *article* on October 12 about the methane that’s leaking from old, decrepit gas wells scattered around the US. It explains that large, well funded energy companies often find and drill wells. As production declines, wells are sold to a smaller company—which often happens more than once. However, the smaller companies often lack the financial means or desire to maintain wells or plug them at the end of their life to prevent gas leaks.

Regulators don’t collect the money upfront to plug wells. The Interstate Oil & Gas Compact Commission estimates that there may be up to 800,000 orphaned wells around the country.

In mid-September, the Environmental Protection Agency (EPA) proposed tightening requirements that oil and gas operators find and fix leaks and do more to prevent them in the first place, reported a September 20 S*cientific American* *article*. The proposals, under review by the White House, are expected to be finalized next year.

One environmental organization, the Clean Air Task Force, suggests that the EPA more frequently inspect oil and gas infrastructure and that the industry reduce venting and flaring at wellheads and improve storage.

Calendars

US: Thurs: Headline & Core PPI 0.6%m/m/8.7%y/y & 0.5%m/m/6.7%y/y, Initial & Continuous Jobless Claims 320k/2.675k, Natural Gas Storage, Crude Oil Inventories, IEA

Monthly Report, Williams, Barkin, Bostic. **Fri:** Retail Sales Headline, Core, and Control Group -0.2%/0.5%/0.4%, Consumer Sentiment Total, Current Conditions, and Expectations 73.1/82.0/70.3, Empire State Manufacturing Index 27.0, Business Inventories 0.6%, Import & Export Prices 0.6%/0.6%, Baker-Hughes Rig Count, IMF Meetings, Williams. (Bloomberg estimates)

Global: **Thurs:** Spain CPI 1.1%m/m/4.0%y/y, Japan Industrial Production -3.2%, China New Loans & Social Financing $1.22b/$2.96b, China M2 8.2% y/y, BOE Credit Conditions Survey, Enria, Elderson, Tennreyro. **Fri:** Eurozone Trade Balance €16.1b, France CPI -0.2%m/m/2.1%y/y, Italy CPI -0.1%m/m/2.6%y/y. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) rose for the first time in five weeks this week, to 1.85, after falling the prior four weeks from 2.49 to 1.80 over the period, which was the lowest since early May 2020. It was as high as 4.00 in mid-July, which was the highest since late January 2018. Bullish sentiment increased to 42.1% this week after falling 12.2ppts (to 40.4% from 52.6%) the prior four weeks—to its lowest percentage since early April 2020—while the corrections account fell to 35.2% after climbing by 10.8 ppts (37.1 from 26.3) the prior four weeks to its highest percentage since early March 2020. Bearish sentiment was little changed at 22.7% this week, hovering just above 22.0% for the fifth week. The AAII Ratio was unchanged at 40.9% last week, as bullish sentiment fell from 28.1% to 25.5% and bearish sentiment fell from 40.7% to 36.8%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked up 0.1ppt last week to a record high of 13.2%. Since the end of April, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.9ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings per share both rose w/w. They've both been making new record highs since the beginning of March and for the first time since February 2020. Forward revenues growth dropped 0.7ppt w/w to a 10-month low of 7.9%. That's down from a record high of 9.6% growth at the end of May and should continue to move lower due to base effects. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth of 13.1% was down 1.1ppt w/w to a 13-month low, and should also continue to move lower due to base effects. That's down from its 23.9% reading at the end of April, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. On a positive note, analysts have been raising their forecasts this year for 2021 and 2022 revenues and earnings growth and the profit margin. They expect revenues to rise 15.0% in 2021 (which held steady w/w) and 6.9% (down 0.1ppt w/w) in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 46.3% in 2021 (up 0.1ppt w/w) and 9.4% in 2022 (up 0.2ppt w/w) compared to a 13.4% decline in 2020. Analysts expect the profit margin to rise 2.8ppts y/y in 2021 to 12.9% (unchanged w/w) from 10.1% in 2020 and to improve 0.4ppt y/y to 13.2% in 2022 (unchanged w/w). The S&P 500's weekly reading of its forward P/E dropped 0.2pt w/w to a 17-month low of 20.4. That compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio dropped 0.01pt w/w to a four-month low of 2.69. That compares to a record high of 2.81 at the beginning of September and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues and earnings rise for five of 11 S&P 500 sectors. Seven sectors are at or near record highs in their forward revenues, earnings, and profit margin: Communication Services, Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, and Materials. Energy still has all measures below record highs. Financials, Real Estate, and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, a y/y improvement is expected for all but Utilities. Four sectors are expected to see margins decline or remain flat y/y in 2022: Financials, Health Care, Materials, and Real Estate. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Currently, three sectors are at record highs. Here's how they rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (24.7%, down from its 24.9% record high three weeks earlier), Financials (18.9, down from its 19.8 record high in early August), Communication Services (17.0, new record high this week), Real Estate (16.2, down from 17.0), Utilities (14.6, down from its 14.8 record high in early May), Materials (13.3, new record high this week), S&P 500 (13.2, new record high this week), Health Care (11.1, down from its record high of 11.2 in April 2018), Industrials (10.2, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, 7.7), Consumer Discretionary (8.0, down from 8.3), and Energy (8.1, 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 bottomed at cyclical lows on May 28, 2020 after 14 weeks of Covid-19-related declines. Forward revenues and earnings have risen 19.0% and 53.2%, respectively, since then to new record highs. The forward profit margin has risen 3.1ppts to 13.2%, exceeding its prior record high of 12.4% in late 2018. During the latest week, seven of the 11 sectors posted gains or remained steady at new highs in either their forward revenues, earnings, or profit margin. Here's how the S&P 500 and its 11 sectors rank by their changes in forward revenues and forward earnings since May 28, 2020: Energy (forward revenues up 29.0%, forward earnings up 1,727.1%), Materials (28.7, 94.9), Information Technology (26.2, 43.5), Communication Services (22.7, 55.9), Industrials (23.8, 72.2), S&P 500 (19.0, 53.2), Financials (17.9, 65.5), Health Care (14.7, 26.9), Consumer Discretionary (14.5, 95.6), Consumer Staples (11.9, 19.3), Real Estate (9.9, 25.1), and Utilities (0.3, 5.4).

Global Economic Indicators

Eurozone Industrial Production (*link*): Headline production in the Eurozone, which excludes construction, contracted 1.6% in August after gains of 1.4% and 0.2% the prior two months—moving 1.3% below its pre-pandemic levels as supply-chain disruptions depressed production of many products. Among the industrial groupings, all categories but energy (+0.5%) fell, with capital goods posting the biggest decline. Capital goods output fell for the third time in four months, by 3.9% m/m and 5.3% over the period, while consumer durable goods output contracted 3.4% following a four-month jump of 5.3%. Despite August's decline, the latter remained 1.0% above its pre-pandemic level. Meanwhile, intermediate goods production dropped 1.5% in August after climbing four of the prior five months by 2.3%, slipping back to its pre-pandemic level in August after being above for five months. Consumer nondurable goods output retreated 0.8% in August after jumping 10.9% the first seven months of this year to a new record high. Looking at the top four Eurozone economies, here's how they performed since bottoming last April, and relative to their pre-pandemic levels: Italy (+78.7% & +1.5%), Spain (+48.8 & -0.7), France (+47.1 & -3.9), and Germany (+27.8 & -10.1). The changes in industrial production for the month of August were mixed bag, with France (1.0%) posting the biggest increase in production and Germany (-4.1) the biggest decline, output in Spain ticking up 0.1%, and in Italy ticking down 0.2%.

UK GDP (*link*): The UK recovery continued in August after stalling in July, though undershot expectations, as supply shortages and high energy prices still hamper growth. Real GDP expanded 0.4% in August after slipping 0.1% in July, leaving the economy 0.8% smaller than its pre-pandemic level. The service sector, which accounts for roughly 80% of the UK economy, made the biggest contribution to growth in August, expanding 0.3% after slipping 0.1% in July, as restrictions on social distancing were eased on July 19. Production industries, which include manufacturing, advanced 0.8% in July, as the reopening of an oil field production site, which was temporarily closed for planned maintenance, posted an impressive gain for the second month. Meanwhile, manufacturing activity rebounded 0.5% in August, following a two-month decline of 0.7%, which reflected staff and supply-chain shortages. Construction output contracted for the third time in four months, by 0.2% in August and 2.2% over the period.

UK Industrial Production (*link*): Output advanced 0.8% in August, the most since March and quadruple the expected 0.2% forecast, led by a 16.0% increase in mining & quarrying following a maintenance closure. Production is 1.3% below its pre-pandemic level. Meanwhile, manufacturing production expanded for the first time in three months, up 0.5% in August, after declines of 0.6% and 0.1% the previous two months; it had increased 2.9% during the four months through May. Looking at the main industrial groups, capital goods production rebounded 2.3% from July's 1.2% drop, remaining in a volatile flat trend around recent highs, 8.9% below its pre-Covid level. Intermediate goods output fell for the second month, by a total of 2.3%, after increasing 3.6% during the five months through June; it's still 2.3% above its pre-pandemic level despite the recent dip. Consumer durable goods production contracted for the first time in four months, by 0.7%, following a three-month advance of 6.9%, while consumer nondurable goods output dipped 0.1% after increasing 3.4% during the three months through July; the former is 2.4% below its pre-pandemic level, while the latter is 1.2% above its pre-pandemic level.

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