MORNING BRIEFING
January 26, 2023

Transportation, Semiconductors & Digital Wallets

Check out the accompanying chart collection.

Executive Summary: Shifts in consumer purchasing have left retailers overstocked and shippers of goods feeling the pinch. But the sense among transport company managements is that demand for their services will normalize this year. Transportation stocks have been rallying in anticipation. … Another industry impacted by shifts in consumer spending is semiconductors, as computer sales have slid dramatically. And like the transports, semiconductor stocks have been outperforming the broader market as investors look past the pain. … Speaking of pain, the big banks have finally bitten the bullet and decided to develop a digital wallet of their own.

Transports: Focused on the Future. There's no denying that the holiday shopping season was slower than hoped as consumers spent more than usual on experiences and less on packages for under the tree. Retailers of all stripes had excess inventory last quarter, and fewer goods than usual were shipped on the highways and railroad tracks crisscrossing the US. Investors are trying to determine when inventory levels will return to normal, allowing historical patterns of sales and shipping to resume.

Transportation stocks may be rallying in anticipation of the normalization. Most of the S&P 500 transportation-related industries' stock price indexes have outperformed the broader S&P 500 index since it bottomed on October 12 as well as since 2023 began. Here's the performance derby from October 12 through Tuesday's close: Airlines (27.9%), Trucking (16.5), Air Freight & Logistics (15.3), Railroads (12.6), and S&P 500 (12.3). The outperformance of Transportation shares has continued since 2023 began through Tuesday's close: Airlines (18.5%), Trucking (12.0), Air Freight & Logistics (5.1), S&P 500 (4.6), and Railroads (0.7).

The latest update on these industries comes from J.B. Hunt Transport Services' and Union Pacific's earnings reports. Here's a look at what their managements are observing about the shipping environment as well as some data about the state of transportation:

(1) *Divining the inventory correction's end.* The volumes being transported around the country peaked last year and have been falling ever since. Imported and exported container traffic at the West Coast ports has fallen 10.3% from its peak during mid-2021, based on the 12-month sum (*Fig. 1*). Rail loadings have been dropping since the middle of last year (*Fig.*

2). The ATA Tonnage index has dropped 3.3% from its September peak (*Fig. 3*). And intermodal rail traffic has fallen as business inventories have risen to create the glut that companies are currently working down (*Fig. 4*).

"The freight recession that we see right now is largely inventory driven," said J.B. Hunt President Shelley Simpson on the company's January 18 Q4 earnings *conference call*. But there's an end in sight, as the data customers have shared with the company suggest that shipping volumes may start to normalize in Q2: "We have had good signals from our customers about … a more normal environment [in Q2]. We're not sure at what point that is in Q2, but we do feel [confidence about orders during] the back half of the year."

Some Union Pacific customers tell the company that their inventory issues may not get resolved until the back half of Q3, reported EVP of Marketing and Sales Kenny Rocker on the company's January 24 earnings *conference call*. But executives at both companies noted the advantage of transporting lower volumes: increased fluidity and fewer traffic snarls throughout the system.

(2) *Declining earnings all around.* Both J.B. Hunt and Union Pacific reported y/y declines in their Q4 earnings.

The trucking company's revenue rose 4% to $3.7 billion due to fuel surcharges, and net income fell to $201.3 million from $242.2 million a year earlier. The bottom line was hurt by a $64 million pre-tax casualty claim expense and helped by a $149.1 million decline in the cost for rents and purchased transportation.

Union Pacific's Q4 revenue *rose* 8% to $6.2 billion, also boosted by fuel surcharges and price increases. But net income fell to $1.6 billion from $1.7 billion a year earlier, as a number of key costs jumped faster than revenue increased. Compensation and benefits rose 10%, fuel soared 43%, and purchased services and materials rose 18%. Results were also hurt by operating inefficiencies. While revenue carloads were up 1%, the railroad's velocity was down 3%, and its average maximum train length decreased 1%. The company blamed poor weather during the quarter and lack of crew availability but noted that it's training 600 new employees.

Looking out into 2023, Union Pacific forecasts improved efficiency and the ability to raise prices faster than inflation. This year, the company expects its all-in inflation to be around 4%, with mid-single-digit employee cost increases partially offset by productivity gains.

Norfolk Southern also reported on Wednesday Q4 expenses that rose faster than revenue. Its Q4 operating revenue rose 13% y/y, but operating expenses jumped 19%, leading to a 5% increase in operating income. The railroad operator's $3.42 earnings per share were up 10% y/y but missed analysts' consensus forecast of $3.44.

(3) *Trucking industry stats.* The drop in trucking volumes has helped freight prices decelerate. Truck freight prices increased by 8.2% y/y in December, down from the peak 25.0% increase last May (*Fig. 5*). But the number of employees in the industry and the wages they're getting continue to climb (*Fig. 6*).

Analysts are expecting revenue growth for the S&P 500 Trucking industry to drop sharply from a 21.0% gain last year to a 1.8% decline this year and a small increase of 5.9% in 2024 (*Fig. 7*). Their earnings expectations follow a similar pattern: 32.0% in 2022, -1.1% in 2023, and 9.0% in 2024 (*Fig. 8*). The industry's forward P/E has fallen along with earnings expectations. It's now 23.9, down from its peak of 31.2 in November 2021 (*Fig. 9*).

(4) *Rail industry stats.* Railroads faced a number of headwinds that may dissipate as the year progresses. First, the price of fuel was higher for much of last quarter than it is currently (*Fig. 10*). Second, rail customers have been working through excess inventory (*Fig. 11*). And lastly, rail workers were threatening to strike late last year, and proactive customers may have found other ways to ship goods before Congress moved on December 1 to impose an agreement between workers and the rail operators.

This traffic slowdown has been a blow to the rail industry. The S&P 500 Railroads industry is expected to post revenue growth that slows sharply from the 15.6% increase in 2022 to only a slight increase of 0.4% this year and a muted gain of 2.7% in 2024 (*Fig. 12*). Analysts forecast a strong increase of 16.7% in 2022, followed by tepid growth this year, 2.2%, and improvement in 2024, 7.9% (*Fig. 13*). The industry's forward P/E has come down sharply to 17.5 from its recent peak of 23.3 in April 2021 (*Fig. 14*).

Semiconductors: Bad News from Microsoft. The correction in computer sales continued through Q4. The latest datapoint comes from Microsoft, which reported on Tuesday that sales in its personal computing segment fell 19% to $14.2 billion, and sales directly related to its Windows operating system tumbled 39%. This follows news that worldwide PC shipments were down 28.5% in Q4, according to a January 11 Gartner *press release*.

Texas Instruments *added* to the gloom on Tuesday by reporting Q4 revenue fell 3% y/y and 11% q/q. It also forecast Q1 earnings of $1.64-$1.90 a share, the midpoint of which is below analysts' expectations of $1.87, a January 24 Reuters *article* reported. None of this is good news for semiconductors, the brains that make computers and video game consuls run.

Analysts estimate that S&P 500 Semiconductor earnings fell 1.2% last year and will fall another 13.4% this year before bouncing sharply higher, by 24.0%, in 2024 (*Fig. 15*). But investors aren't waiting for the good times to return before buying semiconductor shares. Despite the doom and gloom, the S&P 500 Semiconductors stock price index has risen 34.9% since the market's October 12 low, trouncing the S&P 500's 12.3% gain. The S&P 500 Semiconductors index is also up 16.4% ytd through Tuesday's close, again beating the broader index's 4.6% increase (*Fig. 16*). The S&P 500 Semiconductors index remains 30.8% off its November 29, 2021 high, leaving plenty of room for the rebound to continue, though perhaps at a slower pace.

Certain semiconductor companies have rallied on company-specific news. Investors are betting that Nvidia will benefit from the growing use of artificial intelligence programs like ChatGPT because its graphics chips are designed for complex computing tasks, a January 23 Bloomberg *article* reported. Nvidia shares are up 31.8% ytd through Tuesday's close, but down 42.3% from their 2021 high. Privately held ARM has been taking market share away from Intel in PCs and data centers, a January 23 *WSJ* *article* noted. It's reportedly teeing up an IPO for later this year.

Disruptive Technologies: The Wallet Wars. They're more than a little late to the game, but big US banks have decided to create their own digital wallet to compete with the likes of Apple Pay, Google Pay, and PayPal. Already, 62% of Gen Z and Millennials, 50% of Gen X, and 32% of Baby Boomers are making digital payments or transfers, according to research by Cornerstone Advisors cited in a January 25 *Computerworld* article.

Bank of America, JP Morgan Chase, Wells Fargo, and four other banks collectively are developing a digital wallet that will be managed by Early Warning Services, the bank-owned company that operates Zelle, a January 23 *WSJ* *article* reported. The banks will have to lure early adopters from their competitors' offerings. Most consumers aged 21-42 who make digital payments use PayPal (74%), followed by Cash App (49), Venmo (39), Zelle (34), Apple Pay (32), Goggle Pay (24), and Facebook Pay (16). The banks may need to offer incentives—like cash back or rebated credit card fees—to entice consumers to try the new wallet. The articles about the new offering didn't state how much capital the banks were putting up to fund the new venture.

The banks also will have to convince merchants to adopt the software in their point-of-sale and online systems. Chase Pay was closed in 2021 after just one year of operation because it was unable to get enough merchants on board, the *Computerworld* article noted.

Doing nothing may not be an option for banks. Digital payments and account-to-account money transfers will put up to $34 billion of revenue at risk for North American banks between 2022 and 2026, a December 12 Accenture *report* states. At risk are revenues generated from credit card transaction interchange fees, interest income from credit cards, and fees attributable to banks from alternative payments. Disruption is never painless.

Calendars

US: Thurs: Real GDP & Price Index 2.6% & 3.3%; Durable Goods Orders Total & Core 2.5%/-0.2%; Nondefense Capital Goods Orders ex Aircraft -0.2%; Initial & Continuous Jobless Claims 205k/1.659m; Goods Trade Balance Advance Estimate; New Home Sales 617k; Kansas City Manufacturing Index; Chicago Fed Manufacturing Index; Natural Gas Storage. **Fri:** Core PCED 0.3%m/m/4.4%y/y; Personal Income & Spending 0.2% & -0.1%; Consumer Sentiment Headline, Current Conditions & Expectations 64.6/68.6/62.0; Pending Home Sales -0.9%; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: Italy Business & Consumer Confidence 101.8/102.7; Spain Unemployment Rate 12.5%; UK Labor Productivity; UK CBI Distributive Trades Survey -5; Australia PPI 1.7%. **Fri:** France Consumer Confidence 83; Spain GDP 0.1%q/q/2.2%y/y; Lagarde; Balz. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull-Bear Ratio climbed for the third week this week to 1.60—the highest since mid-August 2022—after falling the prior three weeks from 1.37 to 1.08. *Bullish sentiment* slipped to 45.1% this week, after jumping the prior two weeks from 36.6% to 46.5% (which was the highest the start of 2022), outnumbering bears for the 10th consecutive week. Meanwhile, *bearish sentiment* retreated for the third week to 28.2%, the lowest since mid-September and far below the 44.1% reading in early October last year. The *correction count* jumped to 26.7% after slipping the prior two weeks from 29.6% to 23.9%, remaining well below its late September peak of 40.3%. Turning to the AAII Sentiment Survey (as of January 19), optimism about the short-term direction of the stock market rose to a nine-week high, while pessimism was the lowest in 11 weeks, with neutral sentiment unchanged. The *percentage expecting stock prices to rise* over the next six months rebounded the past two weeks by 10.5ppts (to 31.0% from 20.5%) to its highest percentage since November 17, 2022's 33.5%. It remained below its historical average of 37.5% for the 55th consecutive week, but is no longer at an unusually low level. The *percentage expecting stocks to fall* over the next six months fell for the fourth week from 52.3% to 33.1%—the first time it's been below 40% on consecutive weeks since August 2022 and the lowest since early November. Pessimism remained above its historical average of 31.0% for 58 of the past 61 weeks. The *percentage expecting stock prices will stay essentially unchanged* over the next six months was unchanged at 36.0%. It was above its historical average of 31.5% for the third straight week.

S&P 500 Q4 Earnings Season Monitor (*link*): The Q4-2022 earnings season is off to a poor start, assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With 19% of S&P 500 companies finished reporting revenues and earnings for Q4, revenues are ahead of the consensus forecast by just 0.5%, and earnings have exceeded estimates by 1.7%. At the same point during the Q3 season, revenues were 1.3% above forecast and earnings had beaten estimates by 5.4%. For the 95 companies that have reported Q4 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings from Q2-2021 to Q3-2022. The collective y/y revenue gain for the 95 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.4%, and earnings have declined 3.3% y/y as higher costs and increased loan loss provisions continue to pressure profit margins. Just 67% of the Q4 reporters so far has reported a positive revenue surprise, and 66% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (59%) than positive y/y revenue growth (78%). These figures will change markedly as more Q4-2022 results are reported in the coming weeks, particularly from non-Financial firms with greater exposure to the strong dollar. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "The German economy is starting the new year with more confidence," noted Clemens Fuest, president of Ifo Institute, after the release of Ifo's business survey. The overall index increased for the fourth successive month, by 1.6 points in January and 5.9 points over the period, to 90.2, from last September's 84.3—which was the lowest reading since May 2020. It was as high as 101.4 in June 2021. The *expectations* component accounts for the upswing, also climbing for the fourth month, by a total of 11.3 points to 86.4, after plunging 23.5 points—from 98.6 in February to 75.1 in September—which was the lowest since April 2020. Meanwhile, *current conditions* has remained at recent lows, at 94.1 this month, after dropping 6.8 points during the six months through November to a 21-month low of 93.2. There were some signs of hope in three of the four sectors of the German economy: The *manufacturing sector* saw its business climate index continue to improve, jumping 14.7 points the past three months, from a 28-month low of -15.4 in October to -0.7 this month, as companies were less pessimistic about the future (to -16.9 from -40.1 in October) over the period, with the current assessment component making its move up the past two months, climbing 6.8 points to 17.0. The *service sector* followed a similar pattern, with its business climate index moving up from -8.8 last September to +0.2 this month as its expectations (-15.0 from -36.0 in September) measure was less negative, though businesses were less satisfied with their current conditions, which continued its decline. Sentiment in the *trade sector* (-15.4 from -32.3 in September) was less negative for the fourth month, posting its highest reading since last June, as expectations (-33.8 from -57.6) moved away from historical lows, and current conditions (to 5.0 from -2.5) moved back into positive territory after three months of negative readings. The *construction sector* remained entrenched in negative territory, though improved a bit to -21.6, as expectations improved for the third month, to -43.9 from -46.8 in October, though remained extremely pessimistic, while businesses were less satisfied with their current situation, which fell to 3.9 this month; it peaked at 33.4 last February.

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