MORNING BRIEFING
October 12, 2023

Banks, Biotech & Digital Money

Check out the accompanying chart collection.

Executive Summary: Bank stocks have tanked this ytd, and analysts are pessimistic on earnings prospects. Valuations are so depressed that both the S&P 500 Regional Banks and S&P 500 Diversified Banks industry indexes sport forward P/Es below 10. But Jackie sees signs that Q3 earnings may not be as bad as feared, including a recent pickup in capital markets activity and adequate protections against slowly rising loan losses. … Also underperforming this year has been the S&P 500 Biotech industry. But brisk M&A activity may underpin these stocks. … And: China has rolled out a digital currency; the government has been incenting its uptake in numerous ways.

Financials: Could They Surprise? The S&P 500 Financials sector has had a terrible year, especially considering that the US economy managed to avert recession. Worries about commercial real estate loans, underwater Treasury bonds, and fleeing deposits have cast a pall over the sector's stocks.

Here's the performance derby for the S&P 500 and its 11 sectors ytd through Tuesday's close: Communication Services (45.4%), Information Technology (38.5), Consumer Discretionary (27.0), S&P 500 (13.5), Industrials (4.8), Materials (1.5), Energy (1.1), Financials (-2.8), Health Care (-3.6), Real Estate (-7.9), Consumer Staples (-8.5), and Utilities (-17.0) (*Fig. 1*).

The S&P 500 Financials sector's -2.8% ytd return actually masks how awful the year has been for banks and brokers because insurance-related industries have had strong ytd performances: Reinsurance (16.3%), Insurance Brokers (12.4), and Financial Exchanges & Data (12.3). On the other side of the coin, the Financials industries with miserable ytd performances include: Regional Banks (-38.4%), Investment Banking & Brokerage (-17.4), Asset Management & Custody Banks (-8.8), and Diversified Banks (-4.7) (*Fig. 2*).

With Q3 earnings reports kicking off on Friday, we decided to look for what might go right for these beleaguered monetary giants. Here are a few of the optimistic nuggets that might offset some of the gloom:

(1) *Capital markets thawing.* Firms involved with capital markets activity may have

benefitted from the reopening of the IPO market and stabilization in the fixed-income markets. This week, deal flow included an IPO from comfy shoemaker Birkenstock and ExxonMobil's announcement that it has struck a deal to acquire Pioneer Natural Resources for $59.5 billion.

Improvement in the capital markets was evident in Jefferies Financial Group's Q3 *results* reported on September 27. Revenue in its Q3 debt and equity underwriting businesses jumped 16.2% y/y, and its equities and fixed-income capital markets business jumped 14.0% y/y. The only area still lagging was the firm's investment banking advisory business, due to a decline in global M&A volume. Revenue in this area dropped 30.4% y/y but rose 31.9% q/q.

(2) *Loan losses could rise slowly.* Most consumers are gainfully employed, with the unemployment rate remaining remarkably low at 3.8%. Those with a job should be able to make credit card and home mortgage payments, though banks have been slowly increasing their reserves. In Q2, even the impenetrable JPMorgan more than doubled its provision for credit losses in consumer lending to $1.9 billion due to a jump in provisions in the credit card area. As long as provisions can rise slowly, banks should be able to absorb them. Even after increasing provisions, JPMorgan earned $14.5 billion in Q2.

More concerning is the health of commercial real estate loans, particularly those involving office buildings given that many employees have been unwilling to return to the office more than three days a week. Tales of half-empty buildings in downtown areas have filled the headlines. And some small, less diversified banks may indeed have problems.

But PNC Financial Services Group's Q2 earnings report indicated that larger banks may be able to manage their way through whatever office real estate bankruptcies lie ahead. PNC's office real estate loans total $8.7 billion; that's 24% of its $35.9 billion commercial real estate loan portfolio but only 5.0% of the bank's $177.6 billion commercial and industrial loan portfolio and a mere 2.7% of its total loans.

Nonperforming office loans totaled 3.3% of the office loan portfolio, but that number is sure to increase, as 22.5% of the portfolio is criticized—i.e., the loans are still performing but exhibit some weakness in safety or soundness, perhaps due to high leverage or deteriorating collateral values. The bank's filing says it has established reserves that reflect expected losses in the office loan portfolio.

Loan losses and provisions for loan losses across the banking industry are rising, with the

best part of the credit cycle in the rear-view mirror. FDIC-insured institutions increased their provisions for loan and lease losses by $21.5 billion in Q2, compared to a much smaller increase of $11.1 billion in Q2-2022 and decrease of $10.8 billion in Q2-2021 (*Fig. 3*).

(3) *Problematic Treasuries.* Banks that have been caught holding long-dated Treasuries and mortgage-backed securities in their held-to-maturity accounts, such as Bank of America, may underearn their peers for a few quarters. But those securities, if held to maturity, will be paid back in full and replaced with higher-earning investments. These are not the CDOs of 2008 that ended up being worth pennies on the dollar. And if we've seen the peak in interest rates for this cycle, worries about the banks' paper losses on these securities may have peaked as well.

(4) *Pessimism so bad it's good.* Perhaps most importantly, Wall Street's analysts are a relatively pessimistic bunch when it comes to banking-related financials. For the banks in the S&P 500 Regional Banks industry, they're forecasting a collective 7.9% drop in earnings this year and a 6.2% decline in 2024 (*Fig. 4*). The S&P Diversified Banks industry is expected to post solid earnings growth of 16.0% this year, but that disappears next year when earnings are forecast to drop 4.9% (*Fig. 5*). Only the S&P Investment Banking & Brokerage industry is expected to see earnings growth of 30.3% next year after a projected earnings decline of 11.9% this year (*Fig. 6*).

Forward P/Es for the Regional Banks and the Diversified Banks industries are both under 10, at 7.6 and 8.5, respectively (*Fig. 7* and *Fig. 8*). Only the Investment Banking & Brokerage industry's forward P/E has risen modestly from its June 23, 2022 low of 9.5 to a recent 10.8 (*Fig. 9*).

Health Care: M&A Biotech Boost. It hasn't been a great year for biotechnology stocks. The S&P 500 Biotechnology stock price index has fallen 3.8% ytd through Tuesday's close, and the iShares Biotechnology ETF, known by its ticker IBB, has declined 6.3% ytd (*Fig. 10*). That leaves these biotech stock indexes lagging the S&P 500 Health Care sector's ytd return of -3.6% and the S&P 500's 13.5% gain so far this year.

Biotech shares, many of which don't generate profits, have come under pressure from the jump in interest rates this year. But continued momentum in the M&A market may underpin stock prices. So far in 2023, there have been 28 biotech acquisitions valued at more than $500 million. That compares to the 43 deals of 2022, 35 in 2021, 28 in 2020, 29 in 2019, and 24 in 2018, according to *data* from BiopharmaDive in an October 8 article. Here's a quick look at what's driving the industry:

(1) *Lots of dry powder.* Global pharmaceutical companies have $700 billion in cash and leverage available to make acquisitions and bolster their research pipelines as patents expire, according to *calculations* by Goldman Sachs. "There's tremendous interest in M&A driven by the fact that pharmaceutical companies are facing big cliffs toward the end of the decade with roughly $200 billion in revenue that will erode as a result of patent expirations that will allow for competition from generic drugs," said Goldman healthcare analyst Asad Haider in July.

(2) *Bristol makes its move.* M&A deals are almost always good news for biotech targets. This week, Bristol-Myers Squibb announced it will acquire Mirati Therapeutics for up to $5.8 billion to gain access to Mirati's oncology drugs that target genetic drivers of specific cancers. Mirati's portfolio includes its lung cancer drug, Krazati, which was approved in December. The company's shareholders will receive $58 a share in cash and one non-tradeable contingent value right for each Mirati share. Mirati shares jumped to $56.60 as of Tuesday's close, up from a 2023 low of $28.06 in August and high of $54.26 in February.

This deal follows Bristol's acquisition of Turning Point Therapeutics for $4.1 billion last year, and it helps to boost Bristol's drug portfolio now that two of its largest drugs, Revlimid and Eliquis, face generic competition.

(3) *Modest earnings expectations.* Analysts are looking for companies in the S&P 500 Biotechnology index collectively to produce revenue that inches up by 1.6% in 2024 after decreasing by 8.2% this year (*Fig. 11*). Earnings for index members are forecast to fall 22.4% this year and improve by 3.4% in 2024 (*Fig. 12*).

Disruptive Technologies: China Pushes Digital Yuan. For years, the Federal Reserve and other federal agencies have been studying the viability of a digital dollar. Their job has gotten harder now that many mainstream Republicans, Silicon Valley libertarians, and anti-establishment leftists have opposed a digital US currency. Some opponents prefer bitcoin and/or oppose the control and information that a digital dollar would give the government.

While we study and bicker over the possibility of a digital dollar, the Chinese government has already rolled out its digital currency, the e-CNY, with mixed success. The digital yuan was available in 26 cities, and 5.6 million merchants have registered to use it as of last year. There have been 120 million wallets opened to hold e-CNY, and 950 million transactions valued at 1.8 trillion yuan ($249.9 billion) have occurred as of July, according to an October 10 *article* in the *South China Morning Post* (*SCMP).*

Those figures, while large, have much room left to grow if the digital currency is broadly adopted by China's massive population. The government appears to be finding ways to encourage (dare we say "push"?) its citizens and others to use the digital currency. Here's a look at some of them:

(1) *Tourists using e-CNY.* Starting last month, foreigners in China are allowed to sign up for an e-CNY wallet using their international phone number and their Visa or Mastercard. The wallet can be used to make purchases at stores that display the e-yuan acceptance sign and on online platforms, like Meituan and Ctrip.

The e-CNY wallets are also linked to the Faster Payments System of the Hong Kong Monetary Authority. Tourists from Hong Kong can open an e-wallet, use e-CNY for purchases, and pay lower transaction costs. This feature was introduced in advance of the Asian Games, held recently and used by attending athletes, an October 9 *article* on Bitcoin.com reported.

In September at the China-Asean expo, a large trade show held in Nanning, many banks set up e-CNY experience zones at their booths, the *SCMP* article reported.

(2) *E-CNY for bus fare.* Some Chinese provincial and city governments have begun to pay their employees in e-CNY, including Jiangsu province and the city of Changshu.

Meanwhile, the city of Suqian plans to adopt digital yuan wallets for government budget units. In the city of Jinan, citizens will use digital wallets to pay for bus rides. And the e-CNY can be used for subway tickets in the city of Ningbo.

(3) *WeChat and Alipay onboard.* One reason why the adoption of the e-CNY has been slow is because most Chinese citizens already use digital wallets from WeChat and Alipay for their transactions. "The payment market structure formed by cash, bank cards, and third-party payment platforms are currently satisfying the needs for daily consumption in China," a former director-general of research at the People's Bank of China (PBOC) said at a conference, according to a December 31 *article* on Bitcoin.com.

With this in mind, the PBOC has worked to improve the compatibility and the integration of the e-CNY with the WeChat and Alipay wallets, a July 5 Bitcoin.com *article* reported. WeChat announced in March that the e-CNY would be integrated into its system, and Alipay did the same in December.

(4) *Bridging countries.* The PBOC joined the central banks of the United Arab Emirates, Thailand, and Hong Kong and the BIS Innovation Hub Hong Kong Center in 2021 to develop the mBridge. It uses digital currencies and blockchain to facilitate cross-border payments.

The organization's stated goal is to allow cross-border payments to be immediate, cheap, and universally accessible with secure settlement. In September, Tencent became one of the first organizations chosen to participate in the project's pilot. And presumably from China's government's perspective, if the program happens to help the yuan replace the dollar, all the better.

Calendars

US: **Thurs:** Headline & Core CPI 0.3%m/m/3.6%y/y & 0.3%m/m/4.1%y/y; Initial Unemployment Claims 210k; Natural Gas Storage; Crude Oil Inventories & Gasoline Production; Federal Budget Balance; IEA Monthly Report; OPEC Monthly Report; IMF Meeting. **Fri:** Import & Export Prices 0.5%/0.5%; Consumer Sentiment Index Headline, Current Conditions, and Expectations 67.4/70.4/65.5; Baker-Hughes Rig Count; IMF Meetings; Harker. (FXStreet estimates)

Global: **Thurs:** UK GDP 0.2%m/m/0,5%y/y; UK Headline & Manufacturing Industrial Production -0.2%m/m/1.7%y/y & -0.4%m/m/3.4%y/y; UK Trade Balance –£15.2b; UK BoE Credit Conditions; China CPI 0.3%m/m/0.2%y/y; China PPI -24%y/y; China Trade Balance ¥510b; ECB Publishes Account of Monetary Policy Meeting; Woods; Pill; Elderson; Panetta. **Fri:** Eurozone Industrial Production 0.1%m/m/-3.5%y/y; Lagarde; Nagel; Buch; Cunliffe. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* moved back above 2.00 this month, to 2.13, after falling the prior three weeks from 2.25 to 1.77; it was at 3.07 10 weeks ago. *Bullish* sentiment rebounded 6.3ppts this week to 48.6%, after falling the prior three weeks by 8.4ppts (to 42.3% from 50.7). It was at 57.1% during the August 1 week—which was the most bulls since November 2021, when the reading reached a danger level of 57.2%. Meanwhile, *bearish* sentiment fell 1.1ppts to 22.8%, after being unchanged at

23.9% last week—which was the highest percentage since the end of May. The *correction count* dropped 5.2ppts to 28.6% after rising the prior three weeks by 7.0ppts (to 33.8% from 26.8%); it was 24.3% 10 weeks ago, which was the lowest since the start of the year. Turning to the *AAII Sentiment Survey* (as of October 5), pessimism rose for the third successive month, while optimism rose for the first time in four weeks. The *percentage expecting stock prices to rise over the next six months* rose to 30.1%, after falling the prior three weeks, by 14.4ppts (to 27.8% from 42.2%); the prior week's 27.8% reading was the lowest since May 25. Even with the increase, optimism was below its historical average of 37.5% for the seventh time in eight weeks. The *percentage expecting stocks to fall over the next six months* rose for the third week, by 12.4ppts (to 41.6% from 29.2%), with the latest week contributing only 0.6ppt. The latest move up put pessimism at its highest level since May 4 (44.9%)—above its historical average of 31.0% for the fifth time in seven weeks. The *percentage expecting stock prices will stay essentially unchanged over the next six months* pulled back by 8.1ppts (to 28.3% from 36.4%) the past three weeks. It was below its historical average of 31.5% for just the second time in eight weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose 0.1pt w/w to 12.7% during the October 5 week, but remains 0.1pt below its 11-month high of 12.8% during the September 21 week. That's up from a 24-month low of 12.3% during the March 30 week, but is down 0.7pt from its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.4pts above its seven-year low of 10.3% during April 2020. Forward revenues rose 0.3% w/w to a new record high. Forward earnings gained 0.8% w/w to 0.9% below its record high during the September 21 week, which had been its first since the June 16, 2022 week nine months ago. Both had been steadily making new highs from the beginning of March 2021 to June 2022; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth rose 0.1pt w/w to an 11-month high of 4.5% and is now up 2.2pts from its 33-month low of 2.3% during the February 23 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth jumped 0.6pts higher w/w to a 23-month high of 10.4%, and is now 6.9pts above its 31-month low of 3.5% in mid-February. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 2.3% in 2023 (unchanged w/w) and 4.8% in 2024 (down 0.1pt w/w) compared to a revenues gain of 12.4% in 2022. They expect an earnings gain of 1.0% in 2023 (down 0.1pt w/w) and an 11.6% rise in 2024 (down 0.1pt w/w) compared to an earnings gain of 7.2% in 2022. Analysts now expect the profit margin to fall 0.1ppt y/y to 12.0% in 2023 (unchanged w/w), compared to 12.1% in 2022, and to rise

0.7ppt y/y to 12.7% in 2024 (down 0.1pt w/w). The S&P 500's weekly reading of its forward P/E fell 0.2pt w/w to a 29-week low of 17.8 and is down from a 17-month high of 19.8 during the July 20 week. That's still up from a 30-month low of 15.3 in mid-October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio was down 0.01pt w/w to an 18-week low of 2.26 and compares to a 15-month high of 2.46 during the July 27 week. That's up from a 31-month low of 1.98 in mid-October and compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Looking at the S&P 500 sectors, the October 5 week saw consensus forward revenues rise for 10 of the 11 sectors and forward earnings rise for 10 sectors. The forward profit margin also moved higher for 10 sectors. Four sectors have forward revenues at post-pandemic or record highs this week: Communication Services, Health Care, Industrials, and Utilities. Among the remaining seven sectors, only Energy and Financials have forward revenues more than 5.0% below their post-pandemic highs, while Materials is rising now after nearly falling into that doghouse. Utilities is the only sector with forward earnings at a record high this week as these four sectors have eased from that mark several weeks earlier: Communication Services, Consumer Discretionary, Industrials, and Information Technology. Among the remaining six sectors, only Energy and Materials have forward earnings down more than 10.0% from their post-pandemic highs, while Financials exited that club in the latest week. Among the 11 sectors, only Industrials weathered the broad retreat in the forward profit margins from their post-pandemic or record highs. Now, nearly all of the sectors are showing signs of recovering from their early 2023 lows. None of the sectors had a forward profit margin at a record high this week. That's down from these three sectors in that club several weeks earlier: Consumer Discretionary, Industrials, and Information Technology. The margins of Communication Services, Financials, and Real Estate remain close to their post-pandemic highs. Those of Energy and Materials are surging higher now off their lows in July, but Consumer Staples and Health Care margins remain at or close to their record lows. Energy and Industrials were the only two sectors to have their profit margins improve y/y for full-year 2022, and these five sectors are expected to see them improve y/y in 2023: Communication Services, Consumer Discretionary, Industrials, Information Technology, and Utilities. Here's how the sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.2%, down from its 25.7 record high a week earlier), Financials (18.2, down from its 19.8 record high in August 2021), Real Estate (17.2, down from its 19.2 record high in 2016), Communication Services (16.5, down from its 17.0 record high in October 2021), Utilities (13.1, down from its 14.8 record high in

April 2021), S&P 500 (12.7, down from its record high of 13.4 achieved intermittently in 2022 from March to June), Energy (11.3, down from its 12.8 record high in November), Materials (11.1, down from its 13.6 record high in June 2022), Industrials (10.7, down from its record-high 10.8 a week earlier), Health Care (9.2, a record low and down from its 11.5 record high in February 2022), Consumer Discretionary (8.2, down from its 8.4 record high a week earlier), and Consumer Staples (6.8, down from its 7.7 record high in June 2020).

S&P 500 Sectors & Industries Forward Profit Margin Since March 30 Bottom (*link*): The S&P 500's forward profit margin rose 0.1pt w/w to 12.7% during the October 5 week, but remains just shy of its 11-month high during the September 21 week. It's now up 0.4ppt from a two-year low of 12.3% during the March 30 week. Seven of the 11 sectors' margins have improved since then, with the S&P 500's gain paced by five sectors. It's still down 5.6%, or 0.7ppt, from its record-high 13.4% during the June 9, 2022 week, as seven of the 11 sectors' margins are down since then, with the S&P 500's drop paced by three of the 11 sectors. Here's the sector performance since the S&P 500's forward profit margin bottom on March 30: Communication Services (up 13.5% to 16.5%), Consumer Discretionary (up 11.9% to 8.2%), Information Technology (up 7.9% to 25.2%), Industrials (up 4.4% to 10.7%), Real Estate (up 3.5% to 17.2%), S&P 500 (up 3.1% to 12.7%), Consumer Staples (up 1.6% to 6.8%), Materials (up 0.2% to 11.1%), Utilities (down 0.5% to 13.1%), Financials (down 1.3% to 18.2%), Health Care (down 3.7% to 9.2%), and Energy (down 4.1% to 11.3%). These are the best performing industries since the March 30, 2023 bottom: Casinos & Gaming (up 91.0% to 7.3%), Publishing (up 25.0% to 3.0%), Wireless Telecommunication Services (up 19.3% to 13.7%), Personal Care Products (up 18.9% to 10.1%), Homebuilding (up 18.8% to 12.7%), Interactive Media & Services (up 17.0% to 23.4%), Semiconductors (up 16.7% to 31.1%), Brewers (up 16.1% to 9.2%), and Home Furnishings (up 15.7% to 6.3%).

US Economic Indicators

Producer Price Index (*link*): The PPI for September came in hotter than expected. *Final demand* advanced 0.5% (vs 0.3% expected) last month and 1.9% during the three months through September, averaging monthly gains of 0.6% during Q3. Prices were basically flat the first half of the year, ticking down 0.1% during the six months through June. September's yearly inflation rate was 2.2%, accelerating for the third successive month from June's 0.2%. *Core prices*—which excludes food, energy, and trade services—advanced 0.2% for the second month in September, following a 0.3% increase in July; it averaged monthly gains of 0.2% the first half of the year. September's yearly rate was little changed

at 2.8%—fluctuating between 2.8% and 2.9% the past few months. *Final demand goods* increased 0.9% in September, building on August's 2.0% jump—which was the biggest monthly gain since mid-2022, as prices for final demand energy continued their recent month up. The yearly rate increased to 0.8% in September, up from June's bottom of -4.3%; it was at a record high of 17.6% last June. *Final demand services* rose 0.3%, after increasing 0.2% and 0.8% the prior two months, with the yearly rate little changed at 2.9%. The yearly rate has been hovering just below 3.0% the past seven months; it peaked at a record-high 9.4% last March. The PPI for *personal consumption* rose 0.5% in September, averaging monthly gains of 0.6% during Q3, following a six-month gain of only 0.1% the first half of the year. The yearly rate moved up for the third month to 2.4%, after slowing from a record high last March of 10.4% to a 34-month low of 0.4% this June. The yearly rate for *personal consumption excluding food & energy* was at 2.7% during September, down from its record high of 8.1% during March 2022. Looking at *pipeline prices*, the yearly rate for intermediate goods prices remained below zero for the seventh month, though ticked up from a low of -9.2% in June to -3.7% in September. It fell below zero in March for the first time November 2020; it was at a cyclical high of 26.6% during November 2021. The yearly crude goods rate was in negative territory for the eighth successive month, falling 20.7% y/y in September. However, it narrowed from June's decline of 32.5%—which was the steepest yearly decline since summer 2009; the rate was at a recent peak of 50.7% last June.

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