Yardeni Research

MORNING BRIEFING
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Banks, Drugs & CES

Check out the accompanying chart collection.

Executive Summary: Bank stocks have been rallying, with investors shrugging off concerns about commercial real estate loans and net interest margin pressures even as bank analysts cut 2024 revenue and earnings estimates. Will big banks' Q4 earnings reports Friday change the narrative? … Also: Several forces look poised to disrupt pharmaceutical pricing. Besides Medicare's newly bestowed negotiation powers, Florida plans to save big bucks by importing drugs from Canada and innovative new business models cut out the middle man to lower the drug prices offered to consumers. … And: Jackie highlights intriguing new technologies unveiled at this year's CES convention.

Financials: Looking Ahead. Santa Claus was kind to bank stocks, which have rallied sharply over the past three months. The shares benefited from decelerating inflation and falling interest rates, which likely boosted the value of bank bond investment portfolios. A robust Q3 GDP report, which indicated that a recession wasn't in the cards, also lit a fire under bank stocks and led to a friendly trading environment along with more bond and equity underwriting.

Going forward, whether the rally continues may depend on whether banks can show that they've adequately increased reserves against souring commercial real estate loans. The commercial real estate market hasn't worsened, but it hasn't improved much either, with roughly a fifth of commercial buildings vacant, according to a January 8 *WSJ* article. Banks' net interest income may also come under pressure now that Treasury bond yields have fallen at the same time that banks are paying higher interest rates on deposits to attract customers.

So far, investors have shrugged off credit and net interest margin concerns. The S&P Financials sector stock price index has risen 20.1% since the S&P 500 bottomed on October 27, outpacing all other sectors except for Real Estate. Here's the performance derby for the S&P 500 and its 11 sectors from October 27 through Tuesday's close: Real Estate (22.5%), Financials (20.1), Information Technology (17.7), Consumer Discretionary (17.6), Communication Services (16.3), Industrials (16.1), S&P 500 (15.5), Health Care (14.2), Materials (12.0), Utilities (9.9), Consumer Staples (9.4), and Energy (-3.0) (*Fig. 1*).

The S&P 500 Diversified Banks and the S&P 500 Regional Banks stock price indexes have risen 31.0% and 36.0% since October 27, and the S&P 500 Investment Banking & Brokerage stock price index has gained 31.1%. All three are among the top 15 performing industries we track along with Consumer Finance, up 34.3%, and Asset Management & Custody Banks, up 29.7% (*Table 1*).

Here are some of the items we'll be watching as the big banks report earnings on Friday:

(1) *Keeping tabs on real estate.* Banks have actively been increasing their allowances for loan and lease losses since June 2022. Large banks have increased their collective allowance by $24.6 billion to $127.1 billion, which isn't as high as it was during the pandemic but is much higher than it was in 2019. Small banks have increased their allowance for losses to a new record of $68.1 billion, slightly higher than the previous post-Covid peak (*Fig. 2*).

Smaller banks have needed to increase their reserves more aggressively because they were large lenders to the commercial real estate market in recent years. Small banks' commercial real estate loans jumped 66.5% from the start of 2018 through the end of 2023 to $2.0 trillion (*Fig. 3*). Small banks' commercial real estate loans even eclipse the $0.9 trillion of outstanding commercial real estate loans at large banks, which has risen only 5.7% over the same period (*Fig. 4*).

(2) *Net interest income.* The net interest income banks report for Q4 will be the outcome of a tug of war between loan balance growth and falling interest rates. Total loans and leases at all banks increased 3.2% in Q4-2023 compared to Q4-2022 (*Fig. 5*). Total loan growth would have been faster were it not for the largely unchanged levels of commercial and industrial loans outstanding at both large and small banks (*Fig. 6*). The lack of growth may be attributable to the inventory destocking that has occurred at retailers and other companies over the past year. As companies need to replenish their inventories, loan growth may resume (*Fig. 7*).

During the quarter, banks increased their borrowings to offset modest deposit losses, which is typically a more expensive mix than increasing funds by raising deposits alone (*Fig. 8* and *Fig. 9*). They also let some of their securities mature to provide funds for lending.

(3) *Trading good, M&A bad.* With the S&P 500 up 24.2% last year and Treasury bond yields off their highs, Q4 trading should have been profitable for those banks positioned correctly. Jefferies Financial Group reported that its equities capital markets revenue rose 8.9% y/y

and its fixed-income capital markets revenue fell 12.9% y/y in its quarter ending November 30. Revenue from debt and equity underwriting jumped 52.8% y/y in the quarter.

The biggest area of disappointment was the M&A business, which was practically dormant in Q4 but appears to have revived in early 2024. At Jefferies, Q4 revenue from the advisory business dropped 18.1% y/y. In the earnings *press release*, Jefferies management stated: "2023 was a transition year in the economy, in capital markets in our industry and at Jefferies. … Jefferies performed reasonably well and eked out a modest return on equity during what we believe to be the bottom of the current cycle."

(4) *A look at industry numbers.* Analysts have been aggressively cutting 2024 revenue and earnings estimates for companies in the S&P 500 Diversified Banks industry for much of the past year. The industry's revenue is expected to fall by 0.7% this year, and earnings are forecast to drop by 5.1% (*Fig. 10* and *Fig. 11*). The industry's forward P/E stands at 10.5, off its recent low of 8.0 on October 27 but still far from the 13-14 range during more attractive market environments (*Fig. 12*).

Earnings estimates for the S&P 500 Regional Banks industry also have been chopped throughout the past year. Currently, analysts expect the industry's 2024 revenue to fall 2.7% while its earnings drop 8.8% (*Fig. 13* and *Fig. 14*). At a recent 10.2, the Regional Banks industry's forward P/E is off its low of 6.2 hit on March 23, 2023 and below its high of 15.4 in January 2022 (*Fig. 15*).

Health Care: Disruption Arrives. Drug manufacturers and pharmacy benefit managers often are villainized for selling lifesaving drugs at outrageous prices. But a number of players have come up with new models for drug pricing and delivery that they hope will drive down drug prices. Interestingly, the share prices of entrenched players in the pharmaceutical market don't seem to reflect concern about any challenges to the status quo. Let's take a look at recent news in the industry and the stock market's reaction to it.

(1) *Government got the ball rolling.* President Biden's Inflation Reduction Act of 2022 gave Medicare the power to negotiate some drug prices with manufacturers for the first time. The first 10 drugs to subject to haggling are Eliquis, Jardiance, Xarelto, Januvia, Farxiga, Entresto, Enbrel, Imbruvica, Stelera, Flasp, and Novolog, an August 29 CNBC *article* reported. They're among the drugs that Medicare Part D spends the most on, and all have been on the market for at least seven years.

Price negotiations will continue through August; the agreed upon prices will be published on

September 1, and the new prices will go into effect in January 2026. Companies that refuse to negotiate will either pay a hefty tax or pull its products from the Medicare and Medicaid markets. Fifteen additional drugs will face price negotiations in 2027, followed by another 15 in 2028. Merck, Bristol Myers Squibb, and the US Chamber of Commerce each separately have filed lawsuits claiming that the price negotiations are unconstitutional.

(2) *Mark Cuban jumps in.* The owner of the Dallas Mavericks basketball team launched the Mark Cuban Cost Plus Drug Company to offer drug pricing transparency and lower prices. The company buys drugs directly from manufacturers, offers them to customers at cost plus 15% to cover the expense of running the company, a $5 fee to cover the cost of pharmacy partners, and shipping costs. The company's *website* lists more than 2,000 drugs for 85 ailments, showing their retail prices and the Cost Plus prices.

The Cost Plus model eliminates the portion of a drug's price that's added by pharmacy benefit managers and pharmacies. The pricing transparency may also shame some drug manufacturers into lowering their wholesale prices. But Cost Plus doesn't directly address the problem of drug makers selling their products at exorbitant wholesale prices. However, Cuban does plan to build a fill-and-finish factory to produce low priced generic versions of some drugs, specifically those that are on the Food and Drug Administration's (FDA) list of products facing shortages.

(3) *O Canada.* The FDA recently granted Florida the ability to directly import prescription drugs from Canada to lower drug prices. Canada has lower drug prices than the US, in part because its national health system negotiates the prices for prescription drugs, a January 9 Ars Technica *article* reported. Florida Governor Ron DeSantis says the imports will save the state up to $180 million in the first year. Florida will have to submit additional information about the drugs to the FDA, test the drugs for authenticity, and relabel them to meet US rules.

Many Canadians aren't happy about this news. Our northern neighbor worries that a new large US buyer will lead to shortages for Canada's residents and possibly to price spikes. PhRMA, the US pharma industry's trade association, has come out against the development and is "considering all options" to block it, the Ars article reported.

(4) *Some industry response.* Last month, CVS announced that starting this year its "pharmacies will get reimbursed by pharmacy-benefit managers and other payers based on the amount that CVS paid for the drugs, in addition to a limited markup and a flat fee to cover the services involved in handling and dispensing the prescriptions," a December 5

WSJ *article* reported. While CVS's plan is structured similarly to Cuban's model, it lacks the transparency of his offering, and time will tell what its impact on prices will be.

CVS is a member of the S&P 500 Health Care Services industry; its share price index has risen 12.7% since October 27, only modestly trailing the S&P 500's 15.5% performance over the same period (*Fig. 16*). The industry also includes insurer Cigna Group, Quest Diagnostics, DaVita, and Laboratory Corp. of America Holdings. Despite the upheaval in drug pricing, analysts are calling for the industry to grow revenue 7.2% this year and increase earnings 5.1% (*Fig. 17* and *Fig. 18*). The industry's forward profit margins have narrowed sharply from over 5% in 2019 to 3.6% currently (*Fig. 19*).

Disruptive Technologies: CES Stimulates the Imagination. The annual CES convention in Las Vegas is always a great place to learn about things you never knew you needed or wanted but actually do. News reports have already identified some of the most interesting products being offered at this year's confab. Here are some of our favorites:

(1) *Pretty solar panels.* Instead of ugly black panels, Japanese company inQs has developed a pane of glass that can generate electricity using the sun's rays. SQPV glass uses transparent silicon quartz to capture ultraviolet and infrared light, while letting the visible light spectrum pass through the window, a January 8 CNET *article* reported. The company manufactures the glass in Tokyo and sells it only in Japan.

(2) *Robotic shoes.* Strap a pair of Moonwalkers on your feet, and you'll be able to walk up to 250% faster, bounding up staircases and strolling up hills. Moonwalkers are a platform attached to eight wheels with two straps that keep them on your feet (they resemble those old-fashioned roller skates that strap on over shoes—yes, we're dating ourselves!). The company that makes them, Shift Robotics, says Moonwalkers can roll over cracks in sidewalks and rough surfaces and can save time and energy for workers in large warehouses, retail stores, and airports, a January 8 *USA Today* *article* reported. Ikea currently is testing them in its Sweden stores. Here's a *video* from the company.

(3) *AI in everything.* We're not sure the AI label is being accurately applied, but it seems to be on all manner of products. Ever wanted to be in two places at the same time? It's almost possible using Hollo AI to create a digital twin of yourself by uploading a selfie and voice recordings. An Internet content creator plans to use her digital twin to communicate with her followers 24 hours a day, a January 9 *AP* *article* reported.

The Motion Pillow uses AI to detect a sleeper's snoring and then inflates airbags to lift the sleeper's head. The Bmind Smart Mirror uses AI to monitor mental wellness and recommends steps to improve mood. Minitailz is a collar that tracks a dog's steps, location, heart rate, and breathing. It claims to detect heart failure before the onset of symptoms and earned the CES Best innovation award in the AI category, a January 9 ZDNet *article* reported.

(4) *Committing to hydrogen.* Hyundai reports that it's working on various ways to produce hydrogen and use it in transportation and as an energy source. The company has developed a way to turn organic waste and plastic into clean hydrogen. Food waste, sewage sludge, and livestock manure are examples of organic waste that throw off large quantities of methane. Hyundai can take that waste and break it down using microorganisms in anerobic digestion to create a biogas that's refined into biomethane and ultimately into hydrogen. The process is being used in Korea.

"It is the world's first facility to produce 500kg of hydrogen per day using 60 tons of food waste and to operate hydrogen cars in an integrated commercial manner. The greatest advantage of waste-to-hydrogen is the ability to establish mini hydrogen production hubs at the regional level," the company's *website* states.

Hyundai is also turning plastic that has been thrown out into hydrogen. It melts the plastic and after a number of steps, the melted plastic turns into hydrogen. The company states it can turn 130,000 tons of waste plastic into 24,000 tons of hydrogen in an "environmentally friendly" fashion.

(5) *Hello, Clarice.* Skyted's voice frequency absorber looks far too much like Hannibal Lecter's mask to pass up the "Silence of the Lambs" reference. Consumers can use the mask to hold private conversations on planes, trains or in noisy environments, a January 4 TechCrunch *article* reported.

Imagine people walking around wearing both the voice frequency absorber and Apple's new Vision Pro virtual reality headset, their faces completely obscured by tech. Put them in a room with humanoid robots, and it might be tough to tell the people from the machines!

Calendars

US: Thurs: Headline & Core CPI 0.2%m/m/3.2%y/y & 0.2%m/m/3.8%y/y; Initial & Continuous Jobless Claims 210k/1.875m; Fed Budget Balance -$53.5b; Natural Gas

Storage. **Fri:** Headline & Core PPI 0.1%m/m/1.3%y/y & 0.2%m/m/1.9%y/y; Baker-Hughes Oil Rig Count; Kashkari. (FXStreet estimates)

Global: Thurs: Italy Industrial Production -02%; Japan Leading & Coincident Indicators; China CPI & PPI -0.4%y/y & -2.6%y/y; China Trade Balance 76.2b; ECB Bulletin. **Fri:** Eurozone CPI; UK GDP 0.2%m/m/-0.1%3m/3m/0.1%y/y; UK Headline & Manufacturing Industrial Production 0.1%/0.3%; China New Loans & Total Social Financing 1.4t/2.2t; Lane. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (***link***): The *Bull-Bear Ratio* slipped to 3.07 this week from 3.32 last week—which was the highest since early August 2021. *Bullish* sentiment fell to 54.4% this week, after climbing 2ppts (to 57.1 to 55.1%) the prior three weeks, matching its late July peak. Meanwhile, *bearish* sentiment edged up to 17.7% this week, after slipping 4.5ppts the previous three weeks, to 17.2% (lowest since summer 2021) from 21.7%. The *correction count* climbed for the second week to 27.9% from 25.0% two weeks ago. Turning to the *AAII Sentiment Survey* (as of January 4), the short-term outlook for stocks increased in the latest survey, while pessimism declined and neutral sentiment was roughly flat. The *percentage expecting stock prices to rise over the next six months* climbed 2.2ppts to 48.6%, above its historical average of 37.5% for the ninth successive week, and the 10th time in 13 weeks. The *percentage expecting stocks to fall over the next six months* slipped 1.6ppts to 23.5%, below its historical average of 31.0% for the ninth straight week. The *percentage expecting stock prices will stay essentially unchanged over the next six months* edged down 0.7ppts to 27.9%, remaining below its historical average of 31.5% for the fifth successive week and the 13th time in the past 14 weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin improved 0.1pt w/w to 12.7% during the January 4 week, and is now just 0.1pt below its 11-month high of 12.8% during the September 21, 2023 week. That's up from a 24-month low of 12.3% during the March 30, 2023 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 0.5% w/w to its third straight weekly record high. Forward earnings surged 1.1% w/w to its first record high in four weeks. It had hit that mark during the September 21 week for the first time since the June 16, 2022 week. Revenues and earnings 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 to a 15-month high of 5.1% and is now up 2.8pts from its 33-month low of 2.3% during the February 23, 2023 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. The forward earnings growth forecast rose 0.3pt w/w to a 26-month high of 11.5%, and is now 8.0pts 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 2.0% in 2023 (unchanged w/w) and 4.9% in 2024 (unchanged w/w) compared to a revenues gain of 12.5% in 2022. They expect an earnings gain of 1.5% in 2023 (unchanged w/w) and a 10.9% rise in 2024 (up 0.1pt w/w) compared to an earnings gain of 6.8% in 2022. Analysts expect the profit margin to fall 0.1ppt y/y to 11.9% in 2023 (unchanged w/w), compared to 12.0% in 2022, and to rise 0.7ppt y/y to 12.6% in 2024 (unchanged w/w). The S&P 500's weekly reading of its forward P/E dropped 0.2pt w/w to 18.7, 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 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 dropped 0.05pt w/w to 2.46 from a 20-month high of 2.51 and is up from a six-month low of 2.22 during the October 26 week. That compares to a 31-month low of 1.98 in October 2022. That also 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: Looking at the S&P 500 sectors, the January 4 week saw consensus forward earnings rise for all 11 sectors and forward revenues rise for all but the Energy sector. The forward profit margin moved higher for all 11 sectors. Three of the 11 sectors have forward revenues at post-pandemic or record highs this week: Communication Services, Health Care, and Information Technology. Among the remaining eight sectors, just three have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. These four sectors have forward earnings at a record high this week: Communication Services, Consumer Staples, Information Technology, and Utilities. Among the remaining seven sectors, only Energy and Materials have forward earnings down more than 10.0% from their post-pandemic highs, while Financials exited that club in early October. Among the 11 sectors, only Industrials has weathered a broad margin retreat from post-pandemic or record highs. Now nearly all of the sectors are showing signs of recovering from their early 2023 lows, and their recent stalling appears to be ending. Consumer Discretionary is the only sector with their forward profit margin at a record high this week. That compares to three sectors in that club during the past three months, which also included Industrials and Information Technology at that time. The forward profit margin of Communication Services also remains close to its post-pandemic high. Energy's is deteriorating again while those of Consumer Staples and Health Care 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. The annual profit margin is expected to be flat y/y in 2023 for Consumer Staples, but these six sectors are expected to see their margins improve: Communication Services, Consumer Discretionary, Financials, Industrials, Information Technology, and Utilities. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.8%, down from its 26.0% record high in December 2023), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (16.5, down from its 19.2 record high in 2016), Communication Services (16.6, down from its 17.0 record high in October 2021), Utilities (13.4, 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 (10.9, down from its 12.8 record high in November 2022), Materials (10.9, down from its 13.6 record high in June 2022), Industrials (10.6, down from its record high 10.8 in September 2023), Health Care (8.9, a record low and down from its 11.5 record high in February 2022), Consumer Discretionary (8.4, a record high this week), and Consumer Staples (6.8, down from its 7.7 record high in June 2020).

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