



April 25, 2024

## Morning Briefing

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### Banks, Defense & AI Creep

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Check out the accompanying [chart collection](#).

**Executive Summary:** Two regional banks' Q1 earnings reports highlighted the drag higher interest rates are having on results and showed that office building real estate loan defaults may be manageable. Zions and Truist managements struck some optimistic notes about the future on their earnings calls, Jackie reports. And while the S&P 500 Regional Banks industry's fundamental metrics appear to be improving, its forward P/E remains lower than usual. ... Despite rampant geopolitical strife, the S&P 500 Aerospace & Defense industry's price index has barely risen ytd. Its diverse composition of companies explains why. ... And in our Disruptive Technologies segment, five novel ways AI is being employed (would you let ChatGPT plan your wedding?).

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**Financials: Rates Hurt Regionals.** This week, it was the regional banks' turn to face Wall Street, so we took a look at Zions Bancorporation's and Truist Financials' Q1 results. Investors have been wary about the quality of regional banks' commercial real estate portfolios. The greatest concern has revolved around commercial loans backing office buildings, some of which suffer from empty floors as workers continue to work from home a day or two a week. But last quarter, Zions and Truist appeared to be sailing through the rough waters.

All banks are suffering from slimmer net interest margins due to the higher-interest-rate environment that requires banks to boost the interest rate they pay on deposits. Another concern has been a lack of loan growth, but most bank CEOs appear hopeful that loan growth will pick up as more corporate CEOs grow confident that the economy isn't about to fall into a recession.

Here's a look at what Zions and Truist reported for Q1 as well as some of the S&P 500 Regional Bank industry's statistics:

(1) *Zions manages office loans.* Zions' Q1 revenue took a hit from more expensive deposits. Net interest income fell 13.7% y/y to \$586 million as the interest earned on loans and

investments climbed at a slower pace than the interest paid rose on deposits and borrowings. As a result, the bank's net interest margin fell to 2.9%, down from 3.3% a year ago.

The bank's deposits appear to have stabilized, with total deposits up 7.3% y/y to \$74.2 billion and short-term borrowings down to \$4.9 billion from \$12.1 billion a year earlier. The size of the bank's commercial loan book was largely unchanged y/y, but CEO Harris Simmons struck an optimistic note in the company's earnings [conference call](#), stating that: "Loan demand seems to have turned the corner this quarter with pipelines recovering somewhat from low levels late last year and improving customer sentiment." Loans and leases net of allowances—which include commercial, real estate, and consumer loans—was flat q/q and up 3.1% y/y.

The provision for credit losses fell to \$13 million, down from \$46 million in the year-ago quarter. That brought Zions' allowance for loan and lease losses up to \$699 million from \$618 million a year ago. Classified loans—often defined as "loans in danger of default"—rose to \$966 million, up from \$912 million a year ago. "We continue to expect that ultimate realized loan losses will be very manageable over the remainder of the year, as indicated by annualized net charge-offs for the quarter, which were a very low 0.04% of loans and leases," Simmons said in the company's earnings [press release](#).

Zions' loans for office buildings represent 14% of its total commercial real estate loans and 3% of its total loan balances. The bank experienced a jump in multifamily criticized loans, which it attributed to higher interest rates, construction delays, and longer times needed to lease the buildings. But bank officials didn't seem concerned about the development because the projects are supported by sponsors' contributions of additional equity, and the loans have strong covenants.

Simmons discussed the need to reform the deposit insurance system on the conference call. He noted that the \$250,000 maximum coverage per bank was last changed in 2011, and it's not indexed to inflation. So insured deposits have lost about a third of their purchasing power since the limit was last changed. He also noted that large banks are still perceived as too big to fail, so insured and uninsured deposits flowed to larger institutions regardless of their capital or credit quality.

(2) *Truist sells insurance division.* Formed through the 2019 merger of BB&T and SunTrust Banks, Truist Financial faces many of the same headwinds that Zions faces. Total deposits declined 4.7% y/y as the bank's non-interest-bearing deposits fell and its interest-bearing

deposits rose slightly.

Net interest income fell 12.5% y/y to \$3.4 billion, due to fewer earning assets and higher funding costs. The bank's net interest margin fell to 2.9% from 3.2% in the year-earlier quarter. "Loan demand was muted, and deposit costs continue to be under pressure," said CEO Bill Rogers in the company's earnings press release.

Average loans and leases decreased 5.5% y/y and 1.4% q/q to \$309.4 billion. Loans and leases declined q/q in every commercial and consumer loan segment except for commercial construction, where they jumped 9.5% q/q. The bank expects average loan balances to "decline modestly" in Q2, though more slowly than they declined in Q1.

Truist expects net revenue will decline about 2% in Q2 compared to Q1, due to a drop in net interest income. The forecast assumes three cuts in the federal funds rate this year, the first one in June. It also assumes that net interest income will trough in Q2 and modestly improve during the second half of the year.

The provision for credit losses declined q/q by \$72 million to \$500 million and was relatively flat y/y. Commercial Real Estate loans make up about 7.2% of the bank's total loans and leases. The bank increased its reserve on the office loan portfolio to 9.3% from 8.5% during the quarter to reflect the sector's stress. "We expect stress to remain in the office sector but believe that the size of our office portfolio is manageable and well reserved. Approximately 5.5% of our office portfolio is currently classified as non-performing, but 89% of these loan balances are paying in accordance with the original terms of the loan," said CFO Mike Maguire on the company's [conference call](#).

Truist is in the process of selling Truist Insurance Holdings, with the deal scheduled to close in Q2. The sale is expected to generate \$10 billion of after-tax cash proceeds, which aren't factored into management's forward guidance but should improve the bank's capital position, raise net interest income, and potentially give the bank the flexibility to buy back shares.

Truist benefits from its wealth management business, which grew income 5.0% y/y to \$356 million during Q1, and its investment banking and trading operation, where income jumped 23.8% y/y to \$323 million. However, those gains were largely offset by a 31.7% decline in mortgage banking income to \$97 million, due to a gain on the sale of a servicing portfolio a year ago. Overall, the bank's net income from continuing operations, excluding a FDIC assessment, fell 17.1% y/y to \$1.1 billion.

(3) *Regional banks stocks turning the corner?* The S&P 500 Regional Banks industry has had a tough year, hurt by concerns about office real estate loan exposure and worries about fleeing deposits. The industry's price index fell 64.3% from its peak on January 13, 2022 to its low on May 4, 2023 ([Fig. 1](#)). The index also hit similar lows in October 2023 and in March 2020. Since October 27, 2023, the index has rebounded 41.3% through Tuesday's close.

The industry's collective forward revenues per share and forward operating earnings per share tumbled sharply over the past year. (FYI: "Forward" revenues and earnings per share are the time-weighted average of analysts' consensus estimates for the current and following years and represent the future periods on which investors focus.) But in recent weeks, these forward looking financial metrics have stopped declining and—dare we say it?—appear to be inching higher ([Fig. 2](#) and [Fig. 3](#)).

While earnings are forecast to decline 11.0% this year, analysts expect 16.0% growth in 2025 ([Fig. 4](#)). Joe's Net Earnings Revisions Index (a.k.a. NERI)—a measure of the net percentage of forward earnings estimates being raised or lowered by industry analysts—while still negative, is decidedly less so than it recently had been, at -3.9% in April ([Fig. 5](#)).

As for valuation, the industry's forward P/E (i.e., the multiple based on forward earnings) has come off its low of 6.2 last year. At a recent 10.4, the forward multiple remains below its more usual level around 12.0 ([Fig. 6](#)).

**Industrials: Defense Revenues Pop.** Uncertainty around the world has grown recently, with Iran and Israel firing missiles at each other, Russia and Ukraine still locked in war, and China making threatening comments about Taiwan. Munitions are being consumed at a rapid pace, and the US Congress just approved a \$95.3 billion foreign aid package that will provide military equipment to Ukraine and bolster Israel's air defense system. Despite what should be boom times for defense contractors, the S&P 500 Aerospace & Defense industry's stock price index has risen only 4.4% ytd through Tuesday's close ([Fig. 7](#)).

Here's a quick look at what's holding the index back and why stock selection has been so important in this industry:

(1) *Choosing wisely.* The companies composing the S&P 500 Aerospace & Defense industry are a diverse bunch, and that shows in their ytd results. TransDigm Group (with shares up 22.8% ytd through Tuesday's close) and Howmet Aerospace (19.7%), make aircraft components; Axon Enterprises (16.7%) makes tasers; and Huntington Ingalls

Industries builds ships (only 5.7%).

The ability to successfully manage supply chains and fixed-price contracts while building without errors often separates the winners from the losers. The shares of Textron—which builds small commercial planes and commercial and military helicopters—have risen 18.5% ytd, while the shares of Boeing, which has consistently needed to repair faulty planes, have fallen 35.1% ytd. General Dynamics and RTX shares have climbed 12.7% and 20.5% ytd, respectively, while the shares of Lockheed Martin and Northrop Grumman are barely in positive territory ytd, up 1.5% and 1.4%, and the shares of L3Harris Technologies have slid 1.4% ytd.

Lockheed reported Q1 earnings earlier this week that continued to be weighed down by problems with the F-35 fighter jet and a charge in its missiles unit. The defense company's revenue jumped 13.9% to \$17.2 billion, but its net earnings for the period fell to \$1.5 billion, down from \$1.7 billion a year ago. Q1 free cash flow was flat y/y at \$1.3 billion.

The company has struggled with a technology upgrade to the F-35 fighter, which would allow it “to carry more weapons, better recognize targets and improve its electronic warfare capabilities,” an April 18 [blogpost](#) on The National Interest explained. The upgrade, which is behind schedule, could take another 12-16 months to implement.

Q1 revenue in Lockheed's missiles and fire control segment jumped 25.3% y/y, bolstered by demand for missiles, as wars have been eating through existing stockpiles. Nonetheless, operating profit fell 17.5% y/y to \$311 million due to a charge on a classified program.

(2) *Governments are spending.* Those companies that can avoid pitfalls should benefit from robust spending on defense by governments at home and abroad. US real national defense spending was up 3.3% y/y in November to \$837.8 billion, and industrial production of defense and space equipment rose 11.2% y/y in March ([Fig. 8](#)). Recent reports don't imply that a slowdown is in the offing. New orders of defense aircraft and parts climbed 11.8% ytd in March to \$4.7 billion ([Fig. 9](#)).

Analysts expect revenue for the S&P 500 Aerospace & Defense industry's companies collectively will decline 2.4% this year but rise 7.8% in 2025 ([Fig. 10](#)). More impressively, earnings are expected to grow 23.2% this year and 26.9% in 2025 ([Fig. 11](#)). The industry's growth potential isn't a secret, however. Its stock price index appears to have broken out of a range that has held since 2018, and its forward P/E has jumped to a record 24.5 ([Fig. 12](#)).

**Disruptive Technologies: AI Spreading.** What makes artificial intelligence (AI) so powerful is its ability to complete so many different tasks faster and more efficiently than a human. From drug design to wedding planning, here are some of the recent ways AI is being used that caught our eye:

(1) *Drug developer.* Moderna plans to use ChatGPT Enterprise throughout its organization to transform every business process, an April 24 *WSJ* [article](#) reported. The Covid vaccine maker's employees have created more than 750 versions of ChatGPT to facilitate specific tasks or processes. It can determine the best drug dosages to be used in clinical trials or it can draft responses to regulators' questions. Moderna employees are also using ChatGPT "to help predict the structure of new enzymes that will enable manufacturing processes with better yield and reduced waste," the article stated.

(2) *Wedding planner.* Couples are using ChatGPT to help plan their weddings instead of spending thousands of dollars to hire a wedding planner. ChatGPT can help create wedding websites, write vows, and manage budgets, an April 24 *New York Post* [article](#) reported. One bride used ChatGPT to teach her how to arrange floral bouquets instead of hiring a florist, and another bride used it to help design the invitation. ChatGPT can come up with a list of to-dos and split them between the future bride and groom. And it can come up with an itinerary for the honeymoon.

(3) *Meter maid.* Los Angeles plans to test this summer the installation of AI-powered cameras on its Metro buses to ticket drivers of cars parked in bus lanes. It's hoped that drivers won't park in bus lanes if they know they'll be receiving tickets, which should improve bus times and increase ridership, an April 24 *LA Times* [article](#) reported. When the camera identifies an illegally parked car, it will take a video of the car and submit it to the LA Department of Transportation, where a human will determine whether a ticket should be issued. The person who is ticketed will be able to review the recording. Similar programs are being used in Washington DC and New York City.

(4) *Waste eliminator.* Two companies have developed AI programs aimed at reducing food waste, an April 4 *NYT* [article](#) reported. Winnow has developed an AI program that uses a camera perched atop trash bins to monitor what food is thrown away. Hotels using the system can assess what guests are tossing, investigate why, and adjust their offerings accordingly. In one example, a hotel learned that its breakfast croissants were too big, and the excess was being scrapped.

Another company, Afresh, scans supermarket data to identify areas that are overstocked,

also in an effort to minimize food waste. “If Easter egg painting season traditionally brings more egg sales, it can calculate how many more cases of eggs the store should order, and also, how many more bell peppers because shoppers usually make omelets with the extra eggs at home,” the article explains. While an experienced store manager will know these trends exist, the AI program’s predictions are more precise and accurate.

(5) *Psychologist*. AI-powered chatbots are offering help with mental health, but they can’t officially be considered therapy or medical advice because they’re not regulated by the Food and Drug Administration, a March 25 *Fast Company* [article](#) reported. Nonetheless, these chatbots are being used to help with anxiety and depression, particularly by teens and young adults, who are more comfortable using technology. Proponents believe these therapy apps are needed because there’s a shortage of human therapists; moreover, the apps eliminate the stigma that some feel going to visit a human therapist. That said, because these apps aren’t regulated, their results aren’t being tracked, and there’s no way to know whether they’re effective. They’ve also been known to hallucinate.

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## Calendars

**US: Thurs:** GDP & GDP Price Index 2.5%/3.0%; Real Consumer Spending 2.8%; Kansas City Manufacturing Index; Initial Claims 215k; Goods Trade Balance -\$92.1b; Pending Home Sales 0.9%; Wholesale Inventories 0.2%; Fed’s Balance Sheet; Natural Gas Storage. **Fri:** Personal Income & Consumption 0.5%/0.6%; Headline & Core PCE 0.3%/0.3% & 0.3%/m/m/2.6%/y/y; University of Michigan Consumer Sentiment, Total, Current Conditions, and Expectations 77.8/79.3/77.0; Inflation Expectations 1-Year & 5-Year 3.1%/3.0%; Baker-Hughes Rig Count. (FXStreet estimates)

**Global: Thurs:** Gfk German Consumer Climate -25.9; France Business Survey; UK Distributive Trade Surveys; UK Gfk Consumer Confidence -20; Japan Headline & Core CPI 2.6% & 2.2%/y/y; BOJ Interest Rate Decision; Japan Leading Index 2.3%; ECB Economic Bulletin; Schnabel; Nagel; Mauderer. **Fri:** France Consumer Confidence; Spain Unemployment Rate 11.7%; De Guindos. (FXStreet estimates)

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## Strategy Indicators

**Stock Market Sentiment Indicators** ([link](#)): The *Bull-Bear Ratio* fell for the third week to 2.15 this week after climbing to 4.43 three weeks ago—which was the highest reading since



February 5, 2018. Bullish sentiment retreated for the third week to 46.2% this week, the lowest since late October, after climbing the prior two weeks from 60.3% to 62.5%—which was the most bulls since summer 2021. Meanwhile, bearish sentiment climbed to 21.5% from 14.5% the prior two weeks, and 14.1% three weeks ago—which was the fewest bears since 12.6% in late January 2018. The correction count rose for the third week to 32.3% this week, the highest since mid-January, from 23.4% three weeks ago. Turning to the AII Sentiment Survey (as of April 18), pessimism surged among individual investors about the short-term outlook for stocks, while optimism and neutral sentiment both decreased. The percentage expecting stocks to fall over the next six months jumped 9.9pts to 34.0%, moving above its historical average of 31.0% for the first time in 24 weeks. The percentage expecting stock prices to rise over the next six months fell 5.2ppts to 38.3%—exceeding its historical average of 37.5% for the 24th straight week. The percentage expecting stock prices will stay essentially unchanged over the next six months declined 4.8ppts to 27.8%, putting it below its historical average of 31.5% for the fourth time in five weeks.

**S&P 500 Earnings, Revenues, Valuation & Margins** ([link](#)): The S&P 500's forward profit margin remained steady w/w at 12.9% during the April 18 week, down 0.1pt from an 18-month high of 13.0% several weeks earlier. That's up from a 24-month low of 12.3% during the March 30, 2023 week, and is just 0.5pt below its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.6pts above its seven-year low of 10.3% during April 2020. Forward revenues ticked up less than 0.1% w/w to a record high. Forward earnings rose 0.2% w/w to 0.1% below its record high several weeks earlier. 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 w/w to an 18-month high of 5.3%. It has gained 3.0pts 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 0.2pt w/w to a 29-month high of 11.6%. It's now 8.3pts above its 31-month low of 3.3% during the February 16, 2023 week. 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 4.5% in 2024 (unchanged w/w) and 5.8% in 2025 (unchanged w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 9.5% in 2024 (up 0.2pt w/w) and a 14.3% rise in 2025 (down 0.1pt w/w) compared to an earnings gain of 2.3% in 2023. Analysts expect the profit margin to rise 0.6ppt y/y to 12.5% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise



1.0ppt y/y to 13.5% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E dropped 0.6pt w/w to an 11-week low of 20.0 from 20.6 a week earlier and is down from a 26-month high of 21.1 at the end of March. That's 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 fell 0.07pt to an 11-week low of 2.59 from 2.66 a week earlier and is down from a 25-month high of 2.71 at the end of March. That's up from a six-month low of 2.22 during the October 26 week and 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** ([link](#)): Looking at the 11 S&P 500 sectors during the April 18 week, five had their forward revenues rise w/w, and four had forward earnings move higher. The forward profit margin moved higher w/w for seven of the 11 sectors. Three sectors have forward revenues at post-pandemic or record highs this week: Health Care, Industrials, and Real Estate. Among the remaining eight sectors, five are less than 1.2% from their recent record highs and only three have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. Communication Services is the only sector with record-high forward earnings this week. These five sectors were in that camp in very recent weeks: Consumer Discretionary, Consumer Staples, Industrials, Information Technology, and Utilities. Among the remaining five sectors, only Energy and Materials have forward earnings down more than 10.0% from their post-pandemic highs, while Health Care and Real Estate are nearly in that club. Looking at the forward profit margin, only the Industrials sector 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 forward profit margin lows. Communication Services, Consumer Discretionary, and Information Technology are the only sectors with their forward profit margin at a record high this week. In recent weeks, Industrials was in that camp as well. Energy's forward margin is edging up now from its 23-month low in February, while those of Consumer Staples and Health Care remain at or close to their record lows. The annual profit margin is expected to fall y/y in 2024 for Energy, Materials, and Real Estate and improve for the other eight sectors. 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 (26.6%, a record high this week), Financials (18.7, 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 (17.0, a new record high this week), Utilities (13.6, down from its 14.8 record high in April 2021), S&P 500 (12.9, down from its record high of 13.4 achieved intermittently in 2022 from March to June), Energy

(10.8, down from its 12.8 record high in November 2022), Materials (10.8, down from its 13.6 record high in June 2022), Industrials (10.6, down from its 10.8 record high in early April), Consumer Discretionary (8.8, a new record high this week), Health Care (8.6, a new record low this week and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

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## US Economic Indicators

**Durable Goods Orders & Shipments** ([link](#)): Durable goods orders posted a sizeable increase in March, led by a big jump in transportation orders. Durable goods orders increased 2.6% (vs 2.3% expected), following a downwardly revised 0.7% in February (vs 1.3% preliminary estimate). Transportation orders shot up 7.7%, as orders for non-defense aircraft and parts soared 30.6%, while orders for motor vehicles & parts jumped 2.1% in March and 4.0% during the two months through March. Excluding transportation, orders ticked up 0.2% last month, after ticking up only 0.1% in February. Meanwhile, nondefense capital goods orders excluding aircraft (a proxy for future business investment) rose 0.6% during the two months through March, continuing to bounce around record highs, while nondefense capital goods shipments excluding aircraft (used in calculating GDP) is within 0.5% of January's record high.

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## Global Economic Indicators

**Germany Ifo Business Climate Index** ([link](#)): German business confidence increased notably in April, with both current conditions and expectations beating estimates, led by service providers. The business climate index climbed for the third month by 4.3 points to 89.4 (vs 88.8 expected) this month, from January's 85.1—which was the lowest level since May 2020. The expectations component (to 89.9 from 83.4 in January) brightened, climbing for the third month to a 12-month high, while the current situation (88.9 from 86.9 in February) component bounced off February's level, which was the lowest since July 2020. In manufacturing, the business climate index rose, reflecting much less pessimistic expectations, while companies assessed their current situation as worse. Meanwhile, the service sector was a bright spot, led by a marked improvement in the current situation, while expectations held steady—with companies skeptical about the months ahead. Trade's business sentiment also rose this month, led by a big move up in expectations, though it still remains pessimistic overall, while companies were less satisfied with their current

conditions—with wholesalers pessimistic. Business, however, improved sharply for retailers. Construction's business climate saw progress for the third straight month, with expectations considerably less pessimistic, though companies' assessment of their current situation was somewhat worse, with many reporting a lack of orders.

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