January 16, 2025

Morning Briefing

California Insurance & Big Bank Earnings

Check out the accompanying chart collection .

Executive Summary: Southern California's devastating wildfires couldn't have hit at a worse time. The regional insurance market has been in a dysfunctional state of flux, as some insurers have fled the risky market, others have hiked premiums to account for the risk, and many homeowners have opted to go un- or under-insured as a result. Jackie surveys the damages and what they'll mean for insurers and residents. … She also recaps takeaways from the big banks' strong Q4 earnings reports yesterday—an auspicious start to what should be a great earnings season.

Financials I: California's Insurance Mess. The California wildfires torched modest neighborhoods as well as ritzy ones, damaging or destroying more than 12,000 structures. Homes and cars have been lost, as have art and wine collections. Smoke has damaged homes that survived the fires, and displaced homeowners will need to find rental properties.

While the wildfires aren't yet contained, there's speculation that insured damages could reach as high as $50 billion, and total damages, including economic loss, could amount to $150 billion. Pushing up the price tag are the high-net-worth residences in many fire-scorched areas. The destruction of the 18-bedroom, $125 million mansion used in the HBO TV series "Succession" is the biggest loss to date. Making matters worse, California's dysfunctional insurance market has left many homeowners with inadequate coverage or no coverage at all, as insurers have been pulling out of the state.

It's widely believed that insurance companies and reinsurers that do have exposure to California will be able to absorb the losses. And it's possible that the companies will use these fires to justify rate increases around the country in the future. But how insurers will fare if another large natural disaster strikes before this young year concludes is the big question.

Here are some details about California's dysfunctional insurance market at a time of flux:

(1) *Some insurers have fled the state.* Seven of the 12 biggest home insurers have limited their exposure to California over the past two years. Some did so because they weren't getting the rate increases they believed necessary to compensate for the potential risks. Others were spooked by the growing fire risk in the state. State Farm announced in March that it would not renew 72,000 home and apartment insurance policies in California, 69% of which were in Pacific Palisades, to reduce an overconcentration of risk in the area, a January 9 *Insurance Journal* *article* reported.

Nationwide, more frequent and larger catastrophes are becoming the norm. Last year, there were 27 disasters in the US that each cost more than $1 billion and had a total cost of $182.7 billion. That's up from yearly averages of 23 disasters costing an average of $149.3 billion annually over the prior five years, 13 costing $99.6 billion the prior decade, and just 3 costing $22.0 billion back in 1980-89 (all dollar amounts CPI-adjusted), according to a January 10 *report* by NOAA's National Centers for Environmental Information.

Prior to last year, California state regulators were requiring insurance companies to set their rates solely based on historical experiences and excluding reinsurance expenses. Late last year, they changed the rate-calculation formula to lure insurers back to the Golden State. Now forecasts of future damages and the costs of reinsurance may be built into rates. While the new state policy might have increased the insurance available for purchase, it may not have made insurance any more affordable.

(2) *Some homeowners have fled insurance.* Some homeowners reportedly do not have insurance or may be underinsured. For example, the *LA Times* *reported* that Francis Bischetti decided against getting homeowners' insurance from Farmers Insurance for his Pacific Palisades home when the price jumped from $4,500 to $18,000 last year. California's state-run Fair Access to Insurance Requirements (FAIR) Plan is an option for homeowners without commercial insurance. But a FAIR policy would have required Bischetti to cut down the 10 trees near his roof to lower the fire risk, also too expensive. The 55-year-old personal assistant lost his home to fire last week.

The number of policies issued by the FAIR Plan increased by 40.5% to more than 450,000 in the 12 months ended September 30, a January 9 *WSJ* *article* reported. In Pacific Palisades alone, the number of FAIR residential policies increased to 1,430 as of September 30, up from 773 a year earlier.

The FAIR Plan's exposure in the Palisades area is almost $6 billion, and it buys around $2.0 billion to $2.5 billion of reinsurance. If it doesn't have enough to cover losses, FAIR is able to assess the private insurance companies operating in California to raise the shortfall. Last year's rule changes allow companies to pass on some or all of that assessment to their customers, the *WSJ* *reported* yesterday. FAIR policy coverage is capped at $3 million, which given skyrocketing home prices in recent years, could be inadequate to cover replacement costs, a January 13 *report* from Fitch Ratings explained.

(3) *Looking back to Tubbs.* One of California's last large fires occurred in 2017 in northern California, near Calistoga. It lasted more than 23 days, claimed 22 lives, burned about 37,000 acres, and damaged or destroyed 6,000 structures, according to a CoreLogic *report*. The insured property losses from that fire were $5 billion to $7 billion according to CoreLogic or $11.1 billion according to an AON estimate.

Even though banks allowed affected homeowners to postpone mortgage payments, default rates rose, and the price to rent or buy a home in the area rose far faster than the statewide average. Still, rebuilding did occur. Of the 3,043 residential units destroyed in Santa Rosa, 2,176 were rebuilt as of October 2022, another 440 are under construction, and 288 are in the permit review process.

(4) *What's next for affected residents*? Already there are reports that landlords in the LA area are jacking up rents, even though there are California laws that restrict price increases to 10% or less during a declared emergency, a January 14 *New York Post* *article* reported. Among many examples, the article cited a five-bedroom property in Santa Monica that listed at $12,500 per month in February and was recently relisted at $28,000 per month.

Banks already have started to offer forbearance to mortgage holders affected by the latest fires. Chase Home Lending, Bank of Montreal, and others have announced they'll be offering affected homeowners with mortgages the ability to temporarily pause their mortgage repayments, a January 13 Reuters *article* reported. Homeowners are on the hook for their mortgage regardless of whether they have homeowners' insurance and regardless of whether the insurance entirely covers the cost of rebuilding the home.

Rising insurance costs didn't stop people from buying expensive homes in California's inventory-constrained market before the fire. Our guess: It won't stop them in the future either, even though doing so might get even pricier.

(5) *Companies to watch.* State Farm had the largest exposure to California's homeowners insurance market in 2023 ($2.7 billion in written premiums), followed by Farmers insurance (more than $2 billion), Liberty Mutual ($908 million), CSAA Insurance Exchange ($895

million), and Mercury Insurance ($839 million). Allstate, USAA, and Auto Club each had more than $700 million in exposure, a January 14 Fox Business *article* reported.

Insurance companies may be able to recoup some of their losses if they can successfully sue SoCal Edison and prove that its electrical equipment contributed to starting the fires. A number of insurers reportedly have requested that the utility preserve any evidence related to the Eaton fire, a January 14 *article* in Program Manager reported. A case may also be brought against the Los Angeles Department of Water and Power for failing to properly manage water supplies to fight the fire. A suit has been brought on behalf of Pacific Palisades residents and others affected by the fire.

The S&P Property & Casualty Insurance industry's stock price index has risen 2.5% since last Friday, when it bottomed at 12.0% below its record high hit on November 27 (*Fig. 1*). It is a small reversal compared to the 13% annual gains the index has enjoyed over the past decade, supported by both revenue and earnings growth (*Fig. 2* and *Fig. 3*).

Analysts have been expecting earnings to grow more modestly this year, as pricing in the insurance market was expected to soften after several years of sharp price increases. That may change in the wake of the California fires. Earnings grew 33.6% in 2023 and 49.6% last year but have been expected only to rise 9.4% this year and 7.1% in 2026 (*Fig. 4*). For now, the industry's forward P/E, 12.4, is at the lower end of its decade-long range of 9-16 (*Fig. 5*).

Financials II: Banks Are Looking Good. Some of the nation's largest banks, including JPMorgan Chase, Wells Fargo, and Citigroup, delivered largely positive Q4 earnings news yesterday. Bank managements painted a rosy picture of the quarter's operating environment on their earnings conference calls: With unemployment low, consumers continue to borrow money and repay it on time for the most part. Investment banking and markets activities picked up steam, helped by the stock market's gain last year.

Banks are paying slightly more for deposits, as consumers have higher-yielding alternatives, but they didn't have to pay a Federal Deposit Insurance Corporation (FDIC) assessment last quarter, as they did in Q4-2023 to help the FDIC recover from losses on the failures of Silicon Valley Bank and Signature Bank.

Here's a deeper look:

(1) *Investment banking gets a win.* Investment banking and markets activity picked up in Q4

as the election receded into history, business confidence improved with the election of Donald Trump, and the stock market continued hitting record highs.

At JPMorgan, Q4 investment banking revenue rose 46% y/y to $2.6 billion, and Markets & Securities Services revenue was $8.3 billion, up 20%. Fixed-income markets revenue also jumped 20%, to $5.0 billion, and equity markets revenue surged 22% to $2.0 billion. The bank's asset management arm benefitted from an 18% increase in assets under management to $4.0 trillion, helped by inflows and higher market levels.

At Wells Fargo, investment banking revenue surged 28% to $491 million, somewhat offset by the 5% decline in markets revenues. Rounding out the big three, Citigroup's investment banking revenues gained 35% to $925 million.

(2) *Sluggish loan growth.* Given the economy's strength, commercial loan growth has been relatively tepid and outpaced by slightly stronger consumer loan growth. Commercial banks' total loans and leases grew 2.7% y/y for the week ending December 30 (*Fig. 6*). But commercial & industrial loans edged up only 0.7% y/y, while consumer loans jumped 2.0% (*Fig. 7*). Within consumer loans, credit cards increased a hearty 4.9% y/y, while auto loans continued to slide, down 2.4% (*Fig. 8*).

At JPM, global corporate and investment banking loans and middle-market loans each dipped 2% q/q. CEO Jamie Dimon on the *conference call* attributed the declines in loan growth despite general business optimism to factors that he doesn't view as negatives: "wide-open capital markets," small businesses' healthy balance sheets, and perhaps continued caution.

(3) *NII down, but credit improved.* Now that interest rates have climbed, banks can no longer expect depositors to earn nothing on their money in the bank. At JPMorgan, net interest income (NII) dipped 3% y/y to $23.5 billion in Q4. The bank attributed the decline to lower rates, deposit margin compression, and lower deposit balances in its Consumer & Community Banking (CCB) division. Average deposits in CCB were down 4% y/y and flat q/q.

At Wells Fargo, NII income declined 7% y/y in Q4 to $11.8 billion. The bank's earnings *press release* attributed the decline to "deposit mix and pricing changes, the impact of lower rates on floating rate assets, and lower loan balances, partially offset by lower market funding."

Conversely, the bank benefited from a decline in provisions for credit losses. Provisions shrank to $1.1 billion in Q4 from $1.3 billion a year prior. The drop reflected a decline in allowances "across most loan portfolios," partially offset by a higher allowance for credit card loans due to an increase in balances.

Banks are still returning to post-pandemic normalcy. The federal government gave out cash to help consumers during the pandemic. In many cases, that cash found its way into banks and cash balances have been coming down for the most part ever since (*Fig. 9*). Likewise, allowances spiked shortly after the pandemic began, and then they dropped sharply, as the government gave many consumers funding. Since 2022, allowances have crept back up, but the increases seem to be leveling off as the new year begins (*Fig. 10*).

(4) *Banks hit new heights.* JPMorgan, Citigroup, and Wells Fargo all are members of the S&P 500 Diversified Banks stock price index, which climbed 35.3% last year, outpacing the S&P 500's 23.3% gain (*Fig. 11*). The industry's revenue and earnings growth is expected to slow this year but remain positive. Revenue is forecast to grow 1.2% this year and 4.4% in 2026, while earnings are expected to increase by 3.4% this year and 14.4% in 2026 (*Fig. 12* and *Fig. 13*). The industry's forward P/E, 12.7, is near the top of its historical 8-14 range (*Fig. 14*).

Calendars

US: Thurs: Retail Sales Headline & Ex Autos 0.6%/0.4%; Jobless Claims 210k; Import & Export Price Index 0.1%/0.2%; Philadelphia Fed Manufacturing Index -5. **Fri:** Housing Starts & Building Permits 1.32mu/1.46mu; Headline & Manufacturing Industrial Production 0.3%/0.2%; Capacity Utilization 77.0%; Baker Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Germany CPI 0.4%m/m/2.6%y/y; Italy CPI 0.1%m/m/1.4%y.y; UK GDP 0.2%m/m; UK Total & Manufacturing Industrial Production 0.1%m/m/-1.0%y/y & 0.0%m/m/-0.4%y/y; ECB Monetary Policy Meeting Accounts. **Fri:** Eurozone Headline & Core CPI 2.4%/2.8%y/y; UK Retail Sales 0.4%m/m/4.2%y/y; Nagel; Cipollone. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* dipped to 1.32 during the latest week, the lowest in a year. *Bullish sentiment* fell to 42.4% this week from 62.9% during the first week of December—which was the most bulls since late July, when the report noted seven consecutive weeks with bulls over 60%, ending at 64.2%. *Bearish sentiment* has increased over the same period from 16.1% to 32.2%, while the correction count has also increased from 21.0% to 25.4% over the same time span, though ticked down from 27.9% to 25.4% during the latest week. In the *AAII Sentiment Survey* (as of January 9), bearish sentiment about the short-term outlook for stocks rose, while bullish sentiment and neutral sentiment fell. *Bullish sentiment* fell 0.8ppts to 34.7%, below its historical average of 37.5% for the second time in six weeks, while *neutral sentiment* dropped 2.4ppts to 28.0%, below its historical average of 31.5% for the 26th time in 27 weeks. Meanwhile, *bearish sentiment* climbed 3.2ppts to 37.4%, above its historical average of 31.0% for the seventh time in eight weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at a record high of 13.6% during the January 9 week. It is now 3.3ppts above its seven-year low of 10.3% during April 2020. Forward revenues and earnings both rose w/w to new record highs too. The consensus expectations for forward revenues growth was unchanged w/w at 5.7%, and is just 0.1ppt below its 23-month high of 5.8% during the August 1 week. It has gained 3.4ppts 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 was steady w/w at 14.2%, just 0.1ppt below its 38-month high of 14.3% during the December 12 week. It's now 10.9ppts 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 boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.6% in 2024 (unchanged w/w) and 5.5% in 2025 (unchanged w/w) compared to a revenues gain of 2.2% in 2023. They expect an earnings gain of 9.9% in 2024 (unchanged w/w) and a 14.2% rise in 2025 (unchanged w/w) compared to an earnings gain of 2.5% in 2023. Analysts expect the profit margin to rise 0.5ppt y/y to 12.4% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.0ppts y/y to 13.4% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E edged up 0.1pt w/w to 21.6 from a 13-week low of 21.5, and is now 0.8pt below its 43-month high of 22.4 during the December 12 week. It's up 1.9pts from a 14-week low of 19.7 during the August 8 week and 6.3pts 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 rose 0.02pt w/w to 2.93 from a 10-week low of 2.91 and is now 0.09pt below its December 12 record high. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): During the January 9 week, forward revenues rose for six of the 11 S&P 500 sectors, and forward earnings rose for four. This led to rising forward profit margins for three of the 11 sectors too. These five sectors posted record-high forward revenues this week: Communication Services, Consumer Discretionary, Financials, Health Care, and Utilities. These three sectors are just a hair below their record-high forward revenues last week: Consumer Staples, Information Technology, and Real Estate. Industrials' forward revenues remains 2.9% below its early September record. Materials and Energy have ticked higher recently but remain the biggest laggards at 5.6% and 14.3% below, respectively. These three sectors had record-high forward earnings this week: Communication Services, Financials, and Utilities. These six sectors are less than 0.5% below their recent record-high forward earnings: Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, and Real Estate. Among the remaining two sectors, forward earnings remains depressed for Energy and Materials, which are stabilizing in recent weeks at 32.7% and 22.2% below their respective post-pandemic highs. Looking at the record-high forward profit margin club, Financials became the newest entrant this week, joining the Communication Services and Industrials sectors. In recent weeks, the Consumer Discretionary and Information Technology sectors were in that club. Among the laggards, Energy's forward margin was steady w/w at 9.4%, up 0.1pt from a 34-month low of 9.3% the week before that and down 1.5ppts since its six-month high of 10.9% in mid-June; Consumer Staples' 6.9% is just 0.2ppt above its seven-year low in March 2023; Health Care's 8.7% is only 0.2ppt above its record low in April; and Real Estate's 17.2% is up from a low of 12.4% in December 2020. 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 (26.9%, down 0.1ppt w/w and from its 27.6% record high in September), Financials (19.8, up 0.1ppt w/w to match its prior 19.8 record high in August 2021), Communication Services (18.6, a record high this week), Real Estate (17.2, down from its 19.2 record high in 2016), Utilities (14.4, down from its 14.8 record high in April 2021), S&P 500 (13.6, a record high this week and in 18 of the past 19 weeks), Materials (11.1, down 0.1ppt w/w and from a 20-month high of 11.6 in July and a 13.6 record high in June 2022), Energy (9.4, up 0.1ppt from a 34-month low in late December and down from its 12.8 record high in November 2022), Industrials (11.3, a record high this week), Consumer Discretionary (9.3, down from its 9.4 record high in early December), Health Care (8.7, 0.2ppt above its 8.5 record low at the end of April 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).

US Economic Indicators

Regional M-PMI (*link*): The New York Fed was the first regional Fed bank to report on manufacturing activity for January and posted a contraction in activity during the month. The *headline general business conditions* sank 14.7 points (to -12.6 from 2.1), well below the consensus forecast of 12.0. Both the *new orders* (-8.6 from 4.3) and *shipments* (-1.7 from 9.1) measures moved from expansion to contraction during the month. *Delivery times* (3.5 from -7.4) were slightly longer, while *supplier availability* (0.0 from 1.1) was unchanged changed. Meanwhile, *inventories* (5.8 from 10.5) rose slightly. Turning to the *labor market*, conditions showed steady *employment* (1.2 from -6.6) levels, but a shorter workweek (-15.1 from -2.3). *As for pricing*, both the prices-paid (29.1 from 21.1) and prices-received (9.3 from 4.2) measures picked up during the month. *Looking ahead*, firms were more optimistic that conditions would improve over the next six months, with the index of *future business activity* (36.7 from 26.9) climbing 9.8 points—with 53.3% of the respondents expect conditions to improve and only 16.7% expecting them to deteriorate over the period.

CPI (*link*): The headline CPI was a tick more than expected in December, while the core CPI was in line with expectations. *Headline* CPI rose 0.4% last month, slightly above the consensus of a 0.3% increase, while the core rate matched the consensus estimate of 0.2%. On a *year-over-year basis*, the *headline* rate climbed to 2.9% from 2.7% in November and recent low of 2.4% in September—which was the lowest rate since February 2021; it peaked at 9.1% in June 2022. Meanwhile, the core rate was at 3.2% in December, a tick down from the 3.3% rate in each of the prior three months. It's down from September 2022's 6.6%. The *goods inflation* rate rose 0.3% y/y, moving above zero for the first time since May, up from September's -1.3%, with the durable goods rate at -1.9% y/y, narrowing from August's -4.2%; the rate peaked at 18.7% in February 2022. The rate for nondurable goods (1.1% y/y) moved further above zero, after moving above in November (0.4) for the first time in four months—up from a recent low of -0.7% in September; it peaked at 16.2% in June 2022. *Services excluding energy services* is drifting lower, though remains relatively high at 4.4%, well above rates a couple of years ago. Looking at *durable goods prices*, there's lots of red in the yearly percent changes, though they are up from recent lows: used cars & trucks (-3.3), furniture & bedding (-1.5), and new vehicles (-0.4), while major appliances (-3.5) are also up from recent low, though showed a deeper decline than in November. Motor vehicle parts & equipment moved back above zero this August (1.9) for the first time since last August, though eased to 1.3% in December. Here's a snapshot of yearly rates for some key *nondurable goods* prices from highest to lowest: recreational commodities (7.3), food (2.5), apparel (1.2), housekeeping supplies (1.2), medical care commodities (0.5), and energy (-0.5). The rate for recreational commodities is down from its recent high of 11.2% in April, while energy prices fell back below zero in August (-4.0) and fell deeper into negative territory in September (-6.8), though the decline narrowed to -0.5 by December. It posted a recent peak of 3.7% in May. The rate for medical care commodities drifted down toward zero from its recent peak of 3.1% in June. Turning to services inflation, *rent of shelter* remains high, though the yearly rates are easing from their recent highs in April 2023: rent of primary residence (to 4.3% from 8.8%) and owners' equivalent rent (4.8 from 8.1). Turning to *non-housing-related services*, the yearly rate for transportation service (7.3) remains high, though is down from recent highs, while the rate for recreation services (2.7) is up from September's 2.2%—which was the lowest since mid-2021. Meanwhile, the yearly rate for education & communication services is hovering just below 2.0%, while the medical services (3.4) rate has been on an accelerating trend, up from its recent bottom of -2.6% in September 2023, though hovering below 4.0% recently. The rate for other personal services (3.7) has been easing steadily recently.

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production edged higher again in November, with all categories showing increases during the month. *Headline* production, which excludes construction, rose 0.2% in November following an upwardly revised 0.2% gain in October (from unchanged) and September's 1.6% shortfall. Among the *main industrial groups*, *consumer durable goods* (1.5%) production posted the largest gain, after a two-month drop of 2.0%, while *energy* output followed suit, rebounding 1.1% in December following a two-month slide of 2.3%. *Capital goods* production increased for the third time in four months, by 0.5% m/m and 1.4% over the period, while *intermediate goods* production also rose three of the past four months, by 0.5% m/m, but fell 0.6% over the period. *Consumer nondurable goods* output continued its up-and-down pattern, edging up 0.1% in November after a 2.4% drop and a 2.2% gain the prior two months. *Energy* output rebounded 1.1% in November following two-month drop of 2.3%. Looking at the *largest Eurozone economies*, production fell on both a monthly and a yearly basis in November in Spain (-1.5% m/m & -0.8% y/y), while Germany (1.3 & -3.3), Italy (0.3 & -1.5), and France (0.2 & -1.1%) posted monthly gains, though remained below a year ago.

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