Trust Is Back in Vogue

"A man I do not trust could not get money from me on all the bonds in Christendom. I think that is the fundamental basis of business." (J.P. Morgan)

As the crisis in regional banks erodes trust in the financial sector, our Long Idea this week features a company that has embodied trust since 1799: JPMorgan Chase & Co (JPM: $129/share). We first made JPM a Long Idea and put it on the Focus List in May 2020. Since then, the stock is up 42% while the S&P 500 is up 35%.

The current panic in the banking sector points to a flight to safety and confirms our long-term thesis on the stock. Even after outperforming the market since our original report, JPM still offers attractive risk/reward and could be worth at least $157/share today, or 22% higher than the current price.

JPM Offers Favorable Risk/Reward Based on the company's:

- position to gain market share in the wake of the regional banks crisis
- impeccable standing with a strong CET1 ratio
- position to grow profits in a rising interest rate environment
- undervalued stock price

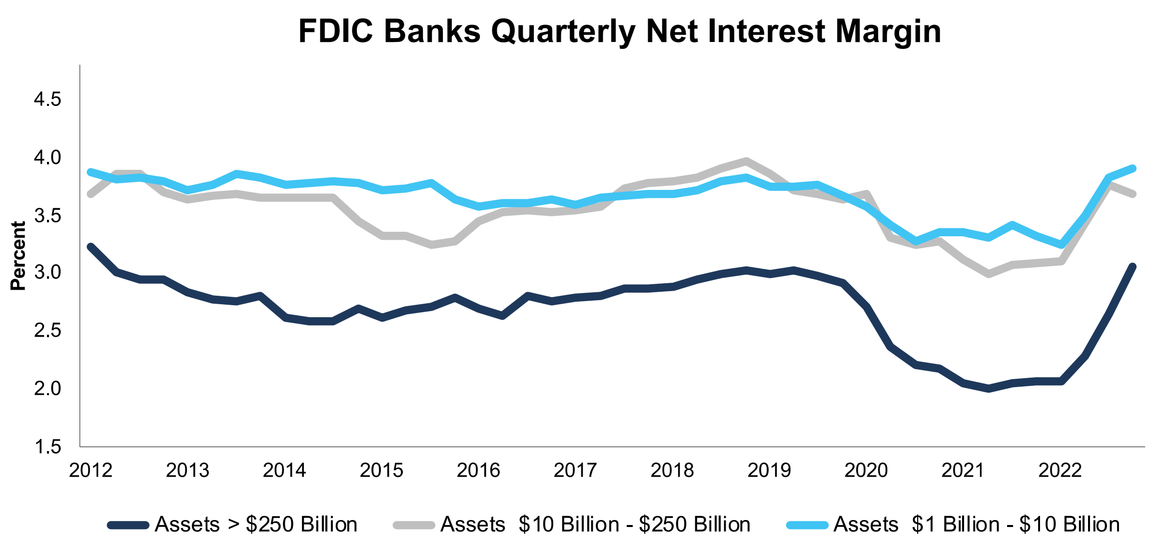
What's Working:

Banks Are Strong, JPMorgan Is Even Stronger

Despite the crisis of confidence unleashed by the collapse of Silicon Valley Bank, the banking sector is well-prepared to weather a recession and actually thrive on the back of higher interest rates. The net interest margin of 4,706 banks insured by the FDIC widened for the third consecutive quarter in 4Q22 when it rose 82 basis points year-over-year (YoY) to 3.37%.

For reference, the FDIC notes the current net interest margin is "above the pre-pandemic average of 3.25%". The YoY growth in net interest margin was the largest reported increase in the history of the FDIC's Quarterly Banking Profile. See Figure 1. JPMorgan specifically reported $20+ billion in net interest income in 4Q22 alone, which represents 48% YoY growth.

Figure 1: Quarterly Banking Profile FDIC Banks Net Interest Margin 2012 – 2022

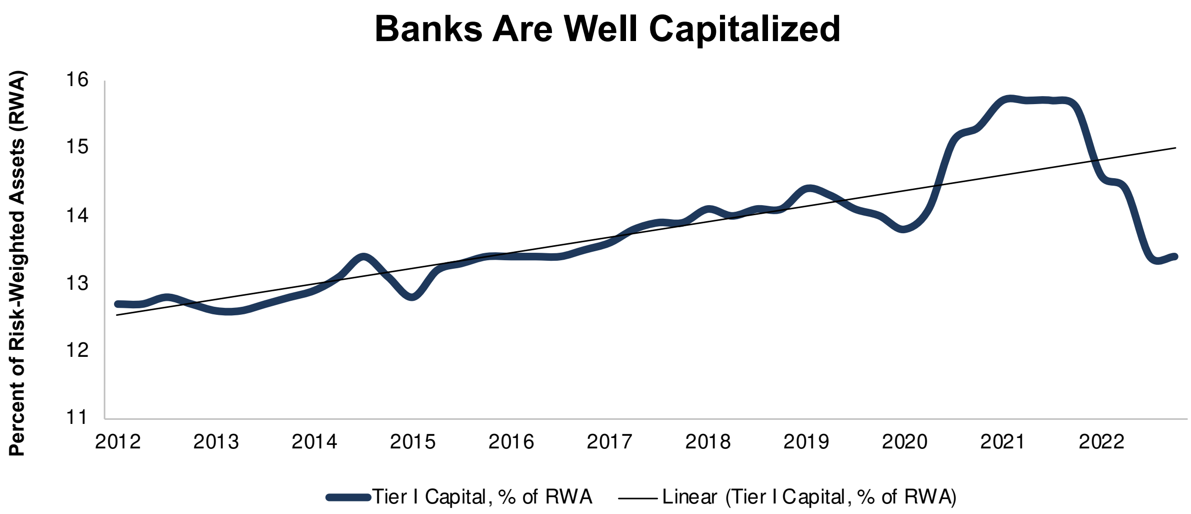


Source: New Constructs, LLC and FDIC

The [Financial Soundness] Indicator, monitored by the St. Louis Federal Reserve, has been trending up for the past decade. The indicator tracks Regulatory Tier I Capital as a percentage of risk-weighted assets (RWA), which is a measure of capital requirements established by Dodd-Frank and Basel II post-2008. See Figure 2. Though the percentage of Tier I Capital has fallen in the last year, it still stands at over twice the 6% required under the Basel III accord.

JPMorgan's [Common Equity Tier I] Capital Ratio (CET1), the equity portion of its Tier I Capital, stands at 13.4% in 4Q22, which is well above the 4.5% required by the Federal Reserve.

Figure 2: Tier I Capital as a % of Risk-Weighted Assets: 2012 – 2022



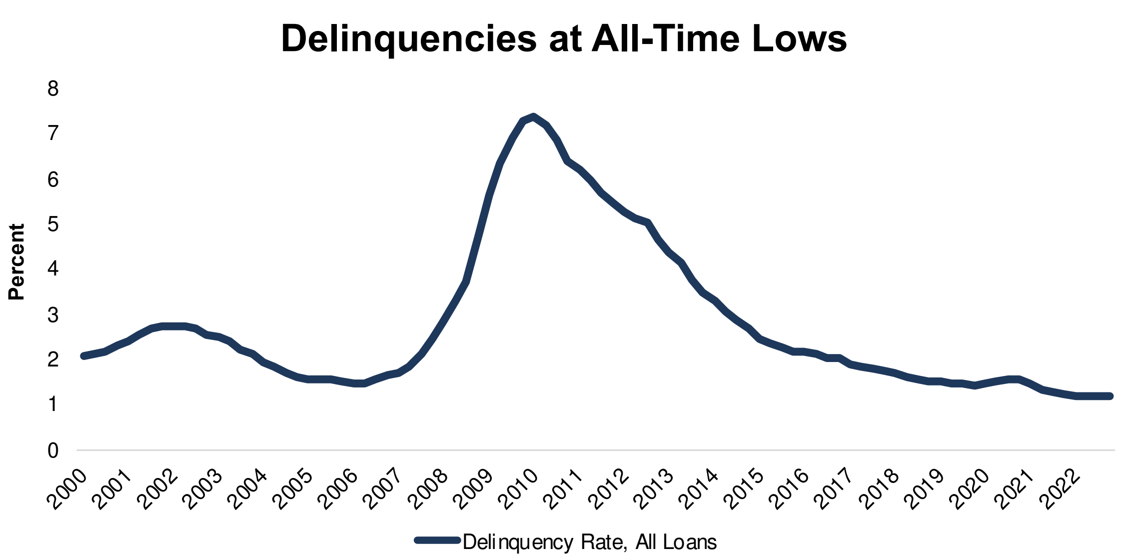
Source: New Constructs, LLC and FRED

It's Not 2008 Again

While recession fears persist, the labor market is still charging forward with low unemployment and healthy wage growth. In fact, the unemployment rate of 3.6% in February 2023 remains near record lows.

As a result of low unemployment and wage growth, loan delinquencies are at all-time lows, per Figure 3.

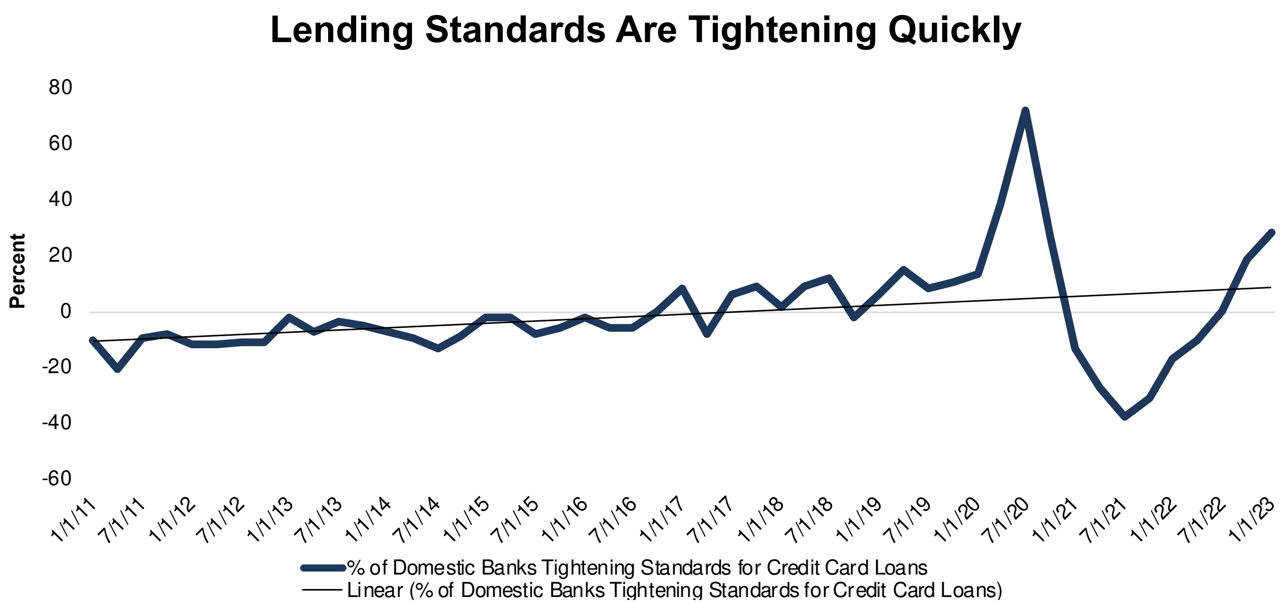
Figure 3: Delinquency Rate, All Loans 2000 – 2022



Source: New Constructs, LLC and FRED

Better yet, banks have been signaling tighter lending standards since 3Q21, per Figure 4. Tougher underwriting coupled with higher interest rates will work to preserve profits for U.S. banks, especially those with the reach and scale of JPMorgan.

Figure 4: Percentage of Domestic Banks Tightening Lending Standards, 2011 – 2023



Source: New Constructs, LLC and FRED

Financials Are Stronger Than You May Realize

In our latest analysis of GAAP vs. Economic Earnings for the S&P 500, we've observed a number of discrepancies between the GAAP earnings of S&P 500 constituents and Economic Earnings, the true profits of a business. Perhaps, the most noteworthy discrepancy is in the Financials sector: TTM 4Q22 GAAP earnings **fell** $61 billion over the TTM ended 3Q22 while Economic Earnings **rose** by $25 billion over the same time.

This $86 billion discrepancy supports DataTrek Research's observation that the contribution of the Financials sector to S&P 500 4Q22 earnings stands at 18%, second only to the Technology sector's 21%. Despite this comparable contribution to total S&P 500 earnings, the Financials sector holds just half of the Technology sector's weight in the S&P 500 index. In short, the Financials sector is quite undervalued.

JPMorgan Could Benefit from the Banking Crisis

Regardless of banking sector fundamentals, we cannot ignore the fact that the market's reaction to SVB has been both intense and sustained. First Republic Bank, collectively chosen as the next domino to fall, has fallen 87% since March 10, 2023 despite a $30 billion injection by major U.S. banks (JPMorgan included) coordinated by the Department of Treasury, the Federal Reserve and the FDIC. The market did not buy the dip.

A continuation of the trend is possible. Sound fundamentals cannot prevent or supersede the loss of confidence that causes a bank run, but as we'll show below, JPMorgan stands to gain from an extended regional bank crisis or a reversion to normality.

Bank deposits have fallen at the highest rate in nearly a year according to data released by the Federal Reserve on March 17, 2023. Deposits fell $98 billion for the week ended March 15, 2023. However, the decline is not equal across the industry. Over the measured time period, small banks lost $120 billion in deposits while the largest 25 banks gained almost $67 billion.

A consolidation is taking place: the crisis in regional banks is likely to direct deposits and assets destined to money market funds from small banks to market leaders. JPMorgan's brand and track record positions it to continue to take market share in the current environment.

In addition, should the regional bank crisis continue and other banks fail, the company is well-positioned to acquire distressed assets at attractive valuations as it did with the Bear Stearns acquisition for $2/share, and, more recently, as First Citizens Bank did with Silicon Valley Bank and New York Community Bank did with Signature Bank.

JPMorgan's Fundamentals Continue to Improve

Despite operating in an increasingly challenging environment, JPMorgan's fundamentals continue to break records.

2022 saw both net revenue and net operating profit after tax (NOPAT) reach all-time highs. Additionally, return on invested capital (ROIC) and free cash flow (FCF) both improved YoY. In fact, the company generated $137 billion in cumulative FCF in the last five years (33% of enterprise value) and improved ROIC from 9% in 2016 to 12% in 2022. With a 10-year average NOPAT margin at 25%, it is no surprise JPMorgan leads in profitability compared to its Wall Street peers. See Figure 5.

Figure 5: Superior Profitability Vs. Competitors

Company	Ticker	NOPAT Margin	Invested Capital Turns	ROIC
JPMorgan Chase & Company	**JPM**	**27%**	**0.5**	**12%**
Goldman Sachs Group, Inc.	GS	19%	0.6	11%
Morgan Stanley	MS	17%	0.6	10%
Bank of America Corp	BAC	24%	0.3	8%
Wells Fargo & Company	WFC	15%	0.4	5%
Citigroup Inc.	C	19%	0.3	5%

Source: New Constructs, LLC and company filings

Higher for Longer

While the Federal Reserve stood the course with a 25 basis point hike last week, the market is now pricing a dovish pivot with interest rate cuts through the end of 2023. However, it seems more likely the Federal Reserve will continue to fight inflation in a 'higher for longer' regime. This regime is likely to gradually put pressure on profitless businesses that were only viable during periods of easy money (many of which are on our Zombie Stocks list) and the poorly managed banks that funded them, i.e. not JPMorgan.

The combination of higher interest rates, an ample capital cushion, and tighter lending standards positions JPMorgan to continue to grow profits and cement its position as a market leader.

What's Not Working:

Deal Drought: Noninterest revenue was down 11% YoY in 2022, driven primarily by the 49% YoY decline in Investment Banking fees. In JPMorgan's 2022 10-K, the company attributed the decline in fees to lower issuance and volume of announced deals. This trend may persist as companies hold off on IPOs and debt issuance while they wait for more favorable market conditions. Similarly, M&A activity is likely to be lower and not driven by the 'fear of missing out'. In contrast, average loans rose by 6% from 2021, average deposits rose 5%, and net interest income grew by 28%.

Tougher Regulation May Be Coming: Regulators from the Federal Reserve, FDIC and Treasury Department faced an unfriendly Senate Banking Committee on March 28, 2023 to answer questions about their role in the collapse of Silicon Valley Bank and Signature Bank earlier this month. All three officials came out in favor of tougher regulations for banks with more than $100 billion in assets. The call for tighter reins on banks matriculated from the grassroots level of Occupy Wall Street and is now part of the public discourse. As the average citizen learns that banks tend to capture the upside of their bets while calling on the U.S. Government (and, thus, the taxpayer) when things go sideways, pressure for tighter regulation is likely to mount.

Shares Have Upside at Current Levels

Below, we use our reverse discounted cash flow (DCF) model to analyze expectations for different stock price scenarios for JPMorgan.

In the first scenario, we quantify the expectations baked into the current price. If we assume:

- NOPAT margin immediately falls to 18.5% (vs. 25% ten-year average NOPAT margin) through 2032 and

- revenue grows 3% compounded annually (vs. 6% compounded annually since 2017) through 2032, then

the stock would be worth $129/share today – equal to the current stock price. In this scenario, JPMorgan's NOPAT declines 1% compounded annually from 2023 – 2032 and its NOPAT in 2031 is 6% below its 2022 NOPAT. For reference, JPMorgan has grown NOPAT by 8% compounded annually over the last ten years.

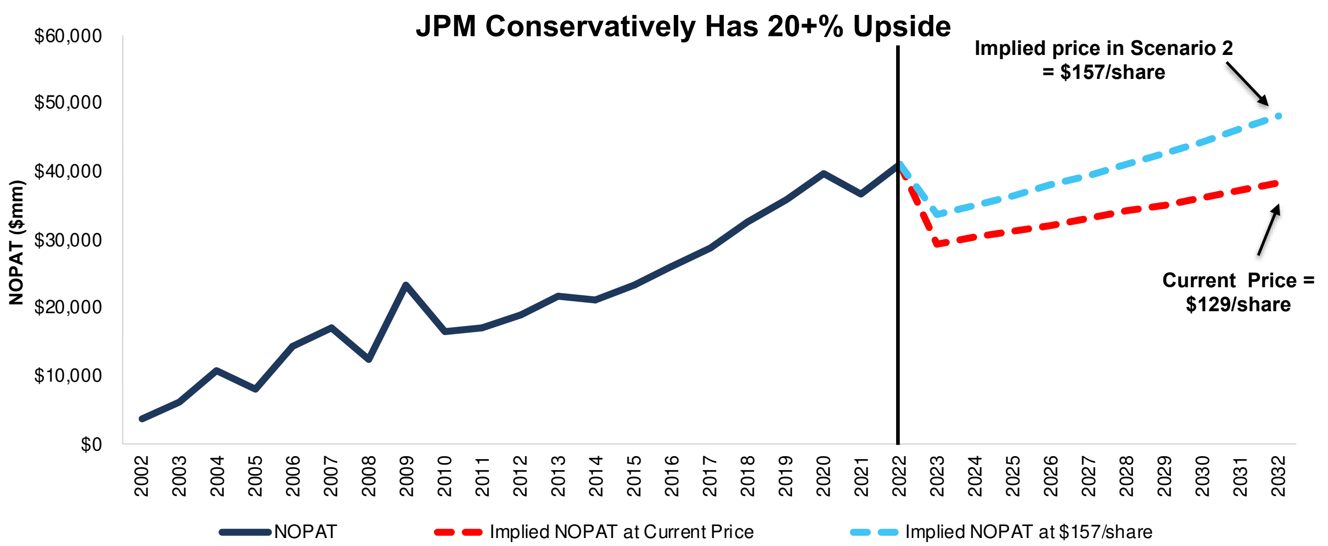
Shares Could Go 22%+ Higher

If we instead assume:

- NOPAT margin falls to 21% (vs. 27% in 2022) from 2023 through 2032,
- revenue grows 4% compounded annually from 2023 through 2032, then

the stock would be worth $157/share today – a 22% upside to the current price. In this scenario, JPMorgan's NOPAT grows 2% compounded annually from 2023 – 2032 (vs. 8% compounded annually for the last ten years). Should the company's NOPAT grow more in line with historical levels, the stock has even more upside.

Figure 6: JPMorgan Historical and Implied NOPAT: DCF Valuation Scenarios



Source: New Constructs, LLC and company filings

This article was originally published on March 29, 2023.

Disclosure: David Trainer, Kyle Guske II, and Italo Mendonça receive no compensation to write about any specific stock, sector, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
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Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.

- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.

- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.

- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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