JPM Morningstar

**Analyst Note** 11/09/2016

Donald Trump's unexpected presidential victory in the U.S. has certainly surprised the global financial markets, and we expect a fair amount of volatility in stock, bond, and currency markets (particularly the Mexican peso). While Trump's campaign rhetoric has lacked detail, some common themes provide insight into what kind of financial and economic policies his administration might pursue. Broadly, the potential for both short- and long-term stock, bond, and currency market volatility should be viewed as a negative for traditional asset managers like Blackrock and T. Rowe Price, but the potential for the Department of Labor's fiduciary rule to be watered down in a Trump presidency should be seen as a positive for active managers (which is already being reflected in the Nov. 9 stock prices). This same volatility should be a positive for investment banks and exchanges such as Goldman Sachs, Intercontinental Exchange, and CME Group, because they benefit from higher trading levels. From a banking system perspective, we rate the U.S. banking system as fair, one step above poor, and that political stability is a key supporting pillar for our fair rating. While Trump's victory may have been a surprise to the markets, we do not expect the transition from an Obama administration to a Trump administration to be particularly difficult, as our political assessment of the U.S. from a banking system perspective is based on the quality of its institutions, its ability to obtain a fair election result, and its respect for the rule of law versus the divisiveness of the campaign. There is also the potential for regulation of the banking system to be lessened, reducing regulatory compliance costs as well as easing future bank capital rules. We expect to be taking a hard look at our coverage over the next couple of days to ensure that our long-term assumptions reflect any potential changes to the operating and competitive dynamics of the financial services industries.

**Investment Thesis** 11/01/2016

Jamie Dimon, Morningstar's 2002 CEO of the Year, earned his reputation as one of the best bankers in the business, but it's difficult to captain the massive ship that JPMorgan Chase has become. Investors often forget that JPMorgan recorded billions in legal expenses in the years leading up to the financial crisis, and we see no reason to believe that it will suddenly begin to operate impeccably. However, its conservative management and growing scale advantages should produce fair returns--and reasonable cash capital returns--for shareholders.

Customers are still flocking to the bank, and it is quickly generating capital. Its massive branch and ATM network, combined with exceptional customer service, draws deposits and contributes to economies of scale, while its topnotch investment bank and asset management operations boost revenue and increase customer switching costs. Though some have called for the bank to be broken up, we think there are clear benefits to customers stemming from size. The needs of complex, global corporations simply cannot be met to the same extent by a smattering of smaller institutions. Retail customers will benefit as well as technological costs, including new mobile and payment technologies, and investments in customer security, are spread across a massive base.

However, investors should not expect the firm to consistently fire on all cylinders. Capital-markets-driven business, including trading, investment banking, and asset management, is cyclical, as is the firm's core lending business, so there are limits to the benefits of diversification. In our view, JPMorgan should generally command a valuation consistent with its position in a cyclical, slow-growing, heavily regulated industry. That said, the firm finally seems set to benefit from moderate loan growth, higher interest rates and margin, an improving housing market, and minimal loan losses after several years of industrywide conservatism. Even in the event of a global market downturn, the long-term outlook for JPMorgan looks fairly bright.

**Economic Moat** 11/01/2016

We assign a narrow moat rating to JPMorgan Chase. We expect the company to handily achieve returns on tangible common equity exceeding our assigned 11% cost of equity over our five-year forecast period.

JPMorgan's commercial and investment banking businesses are fairly resistant to disruption, in our view. Multiple products per customer and an exceptionally strong branch network also protect the large bank against share loss to low-cost online competitors.

From a systemic standpoint, we believe the U.S. offers a fair banking environment. Though the quality of regulatory monitoring has become considerably stronger in the past several years, the country still uses a complex and somewhat archaic system of regulation. Furthermore, the company's banking market is quite fragmented--JPMorgan must compete with a variety of regional and community banks as well as large money center institutions. Over the past 50 years, the banking system has achieved returns roughly in line with its cost of capital, which supports our view of the environment as intensely competitive. Our outlook is more positive from a macroeconomic and political standpoint. The U.S. is still the world's leading democracy and maintains the world's reserve currency. However, its military involvement around the globe potentially detracts from its economic and political stability, and the country has experienced a number of financial crises during its history.

JPMorgan's competitive advantage stems from cost advantages and customer switching costs in its core banking operations and switching costs and intangible assets in wealth management and investment banking. Of more than $1 trillion in deposits, about one third cost the bank nothing in interest expenses. We think JPMorgan's low-cost deposit base is partly attributable to its ability to create high switching costs among its customers. The company generates a wide range of noninterest income from mortgage banking, interchange fees, asset management, investment banking, and other sources. Switching costs also play a role in the bank’s asset management and custody operations.

Noninterest expenses--including the costs of litigation--averaged 2.7% of assets over the past five years, resulting in efficiency ratios ranging from 63% to 72%. We expect this figure to improve significantly over our five-year forecast period due to a normalization of the interest rate environment and reductions in expenses related to the financial crisis, and we believe the bank can achieve sub-55% efficiency ratios as we calculate over the next five years, thanks to economies of scale and the revenue synergies associated with its diversified business model. Scale is particularly important in mortgage and credit card lending, investment banking, and trust banking--areas where JPMorgan is a massive player.

JPMorgan successfully navigated the financial crisis with nary a losing quarter, experiencing manageable losses in mortgage and credit card loans. Though the company experienced massive losses related to the London Whale, we have no reason to believe aggressive risk-taking is widespread at the firm, giving us confidence that credit losses are likely to remain under control in the coming years.

JPMorgan's complexity produces additional capital costs for the systemically important institution.

[**Valuation**](http://quicktake.morningstar.com/StockNet/StockValuation.aspx?Country=USA&Symbol=JPM&culture=en-US) 11/01/2016

Our fair value estimate is $72. Our fair value estimate represents 1.4 times reported tangible book value as of Sept. 30, 2016, reflecting our belief that the company will be able to moderately outearn its cost of capital on a tangible basis--in line with management's goals. It also represents 10 times our 2018 earnings per share estimate. In our base-case scenario, we expect the net interest margin, as we calculate it, to increase from 2% in 2015 to 2.6% by 2020. We expect noninterest income to increase from $50 billion in 2015 to $53 billion by 2020 as the company benefits from economies of scale and scope, as well as superior management. On the expense front, we expect gradual improvement as litigation and foreclosed property expenses slowly decline. We expect JPMorgan to achieve a 54% efficiency ratio by the end of our five-year forecast. We forecast net charge-offs to average of 0.75% of gross loans over the long run.

**Risk** 11/01/2016

An investment in JPMorgan entails a large amount of regulatory and macroeconomic risk. On the regulatory front, costs of compliance are clearly increasing, while several sources of revenue--proprietary trading, interchange fees, and overdraft fees, to name a few--have been curtailed since the financial crisis began. The company is now clearly a prime target of regulators seeking fines and litigants seeking compensation for alleged misdeeds. Centralized clearing could reduce the profitability of the bank's over-the-counter derivatives business. It's even possible, though unlikely, that large, systemically important institutions eventually could be broken up.

At the same time, revenue could suffer from the combined effects of a low, flat yield curve, minimal economic growth, and weak loan demand. Trading, investment banking, and asset management revenue would also suffer from extended economic weakness.

**Management** 11/01/2016

JPMorgan Chase's management team, led by CEO Jamie Dimon, is Standard, in our view. While the company was not damaged by the financial crisis to the extent that some peers were, the company's modest returns on total shareholder equity, the rising burden of its size and complexity, increasing management turnover, and a handful of high-profile allegations of wrongdoing have tarnished our view of the firm in recent years.

We further caution that JPMorgan, like several of its large peers, was assembled through acquisition and has not existed for long in its current form. It's therefore possible that the conservative philosophy espoused by Dimon may not fully penetrate the entire company. JPMorgan Chase and Wells Fargo once provided evidence that large financial institutions could be successfully managed, but the London Whale incident at JPMorgan and fraudulent account openings at Wells now cast doubt on that claim.

**Overview**

**Profile:**

JPMorgan Chase is one of the largest financial institutions in the United States, with more than $2 trillion in assets and operations in dozens of countries. The company is organized into several business segments: investment banking, commercial banking, treasury and securities services, asset management, retail financial services, and credit card businesses. JPMorgan Chase is a major player in the derivatives markets.