Yardeni Research

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Morning Briefing

Defense, Auto Loans & Local LLMs

Check out the accompanying chart collection.

Executive Summary: With wars ongoing, the federal government's weapons purchases haven't let up during the government shutdown. Investors have been bidding up the stocks of US defense contractors as a result, and the S&P 500 Aerospace and Defense industry has impressively outperformed the broader market. But investors liked what they heard in the earnings reports of just two out of four recently reporting companies. … Also: Jackie shares trends in consumer and auto finance after the recent bankruptcies of two subprime lenders. … And: Will the massive buildouts of AI infrastructure be rendered unnecessary if AI systems reside not in the cloud but locally on users' equipment?

Industrials: Defense Stocks Shrug off Shutdown. The US government may be closed for business, but that hasn't stopped the stocks of the government's defense contractors from continuing their sharp rally this year. The S&P 500 Aerospace and Defense industry's stock price index has gained 39.4% ytd through Tuesday's close (*Fig. 1*).

It is the top-performing industry in the S&P 500 Industrials sector, which has risen 17.5% ytd, making it the fourth best performing sector in the S&P 500 (*Fig. 2* and *Fig. 3*). Driving the Aerospace & Defense industry's stock price index higher are GE Aerospace (up 83.8% ytd), Howmet Aerospace (80.3%), RTX (49.5%), Northrop Grumman (27.7%), and Boeing (22.8%). They're far outpacing the S&P 500's 14.5% ytd performance. Even more eye-popping: the 140.1% ytd performance of defense newcomer Palantir Technologies. While not in the S&P 500 Aerospace and Defense industry's index, residing instead in Information Technology's Application Software industry, Palantir is the fifth best performing stock in the S&P 500 ytd.

Why such share-price resilience amid the government shutdown? With wars brewing around the world, the US and European governments' weapon purchases have continued unabated. It also doesn't hurt that President Trump has requested a defense budget that would include almost $1 trillion of spending in fiscal 2026.

If there's a potential cloud on defense investors' horizon, it's the Trump administration's proclivity to micromanage its critically important contractors. Defense stocks flinched when Treasury Secretary Scott Bessent *said* last week: "I do think our defense companies are woefully behind in terms of deliveries, so we may have to, as their biggest customer ... prod them to do a little more research, a little fewer stock buybacks, which is really what got Boeing into trouble."

GE, RTX, Northrop, and Lockheed each reported earnings on Tuesday. Their share prices reacted favorably to the reports in two cases, negatively in two. Let's take a look.

(1) *GE & RTX rocket ahead.* GE Aerospace and RTX managements both raised their full-year earnings outlooks and posted extremely strong Q3 results.

GE has been benefitting from the strength of airline travel and the defense industry. Management increased its adjusted EPS guidance for the full year to $6.00-$6.20 from $5.60-$5.80 previously. The company reported impressive Q3 sales gains of 27% y/y in its commercial engines division and 26% y/y in its defense-and-propulsion technologies unit. GE shares popped 1.3% on Tuesday to a new record high.

RTX management *raised* its adjusted EPS guidance for full-year 2025 to $6.10-$6.20 from $5.80-$5.95. The company's munitions and integrated air and missile defense systems are in high demand by both domestic and international buyers. RTX enjoyed Q3 sales increases across each of its segments: Collins Aerospace (8% y/y), Pratt and Whitney (16%), and Raytheon (10%). RTX shares gained 7.7% Tuesday, also closing at a record.

(2) *Northrop & Lockheed disappoint.* Northrop Grumman cut its *full-year sales guidance*, blaming its aeronautics segment. Full-year 2025 revenue is now expected to fall in the $41.7 billion-$41.9 billion range, down from $42.1 billion-$42.3 billion previously.

Northrop's Q3 aeronautics sales rose 6% y/y but fell short of analysts' estimates due to decreased revenue from the F/A-18 fighter jet as its production neared completion. Likewise, Q3 space systems revenue fell 6% y/y as work wound down in the restricted space and next-generation interceptor programs. Northrop shares dipped 0.4% Tuesday.

Conversely, Lockheed *boosted* its full-year 2025 EPS forecast range to $22.15-$22.35 from $21.70-$22.00. The company enjoyed Q3 sales gains in its aeronautics segment (up 12% y/y), missiles and fire control (14%), and space division (9.1%). Nonetheless, Lockheed shares fell 3.2% on Tuesday, with some analysts apparently disappointed by the company's

2025 free cash flow guidance.

(3) *Aerospace & Defense numbers.* The S&P 500 Aerospace and Defense industry analysts have been sharply increasing their earnings estimates over the past year, thanks in large part to Boeing's renaissance and the continued strength in defense spending. The industry's 2024 earnings were depressed by Boeing's problems. As its fortunes improved, the Aerospace and Defense industry's earnings benefitted from easy comparisons and are expected to jump 79.0% this year.

Strong growth is expected to continue into 2026, with earnings forecast to increase 34.9% compared with only 20% expected at this year's start (*Fig. 4*). The industry's success has definitely been recognized by investors: The index sports a forward P/E of 32.1 (*Fig. 5*).

Keep in mind that Boeing's stock has an outsized impact on this industry, as it represents 11.7% of the S&P 500 Aerospace and Defense industry's market capitalization (*Fig. 6*). The company's per-share results are expected to swing from a loss of $18.36 in 2024 to a loss of $0.54 this year, to earnings of $4.40 in 2026; the outlook has brightened now that the company has fixed its 737 Max problems and increased its production levels.

Financials: Another Cockroach Spotted. PrimaLend Capital Partners, a lender to used car dealerships that make subprime loans, *filed for bankruptcy* protection yesterday.

PrimaLend does not provide loans to consumers. Instead, the Dallas-based company provides financing—including for receivables, real estate, and auto inventory—to BHPH (buy here, pay here) car dealerships. These are dealerships that act both as the car seller and the lender, typically to individuals with poor or no credit history. PrimaLend, which has a $75 million *bond due* in 2028, says it is pursuing a sale.

PrimaLend's bankruptcy follows in the wake of Tricolor Holdings' bankruptcy, which we discussed *last week*. The financial troubles of these two relatively small companies that catered to the subprime community won't bring down the financial markets. But they are providing a roadmap of where problems lie if the economy ever enters a recession.

Let's see where current trends in the auto industry and consumer finance appear to be heading:

(1) *Auto loans up.* The dollar amount of auto loans outstanding has increased sharply since the pandemic. As of Q2 there were $1.6 trillion of auto loans outstanding, up 33% from $1.2

trillion in 2020 (*Fig. 7*). It's notable that far fewer auto loans are held by banks, only $500 billion.

(2) *Consumer credit growth slows.* Consumer credit has continued on its upward March but the pace of growth has slowed in recent years. Consumer credit outstanding stood at $5.1 trillion in August, consistent with the level a year prior (*Fig. 8*). Meanwhile, consumer incomes have continued to climb. As a result, consumer credit as a percentage of disposable personal income has remained relatively steady over the past 20 years, at 22.0% (*Fig. 9*).

(3) *Delinquencies worth watching.* Consumer loan delinquencies aren't at record levels, but they are trending upwards. Auto loans that are delinquent by 90 days or more have climbed to 2.9% of auto loan balances, up from below 2% at the start of 2022. The biggest jumps in delinquency rates are in student loans (12.9%) and credit card loans (6.9%), while mortgage delinquencies remain minimal (1.3%) (*Fig. 10*).

Disruptive Technologies: AI Locally. We are used to using artificial intelligence (AI) that's based in the cloud. It's the whole reason that ChatGPT and others are spending billions of dollars to build data centers filled with super-powerful, expensive semiconductors. There may be an alternative, however.

Some large language models (LLMs) have been adapted to run locally, on powerful laptop computers, instead of in the cloud. A locally run LLM offers users increased speed, more privacy and security, improved energy efficiency, and eliminates subscription or usage limits.

Last week, Apple introduced a new chip, the M5, that some believe will allow users to tap into the power of AI on their laptops. Nvidia has a powerful chip in this race as well. And new developers have created software to run LLMs locally, including Ollama (unrelated to Llama or Obama).

Here's a look local LLMs, which threaten to leave many data centers dark:

(1) *Apple's M5 chip & local LLMs.* Apple appears to be positioning itself as Switzerland, agnostic to what LLMs run on its powerful laptops. Notably, Apple is neither creating its own LLM nor investing in those of others.

Instead, it has developed the M5, which includes a 10-core GPU with a neural accelerator in each core. Neural accelerators are designed to speed up AI and machine learning tasks. The chip also boasts increased memory, which allows Apple devices to run larger AI models locally.

“With the introduction of neural accelerators in the GPU, M5 delivers a huge boost to AI workloads. Combined with a big increase in graphics performance, the world’s fastest CPU core, a faster neural engine, and even higher unified memory bandwidth, M5 brings far more performance and capabilities to MacBook Pro, iPad Pro, and Apple Vision Pro,” *said Johnny Srouji*, Apple’s senior vice president of hardware technologies.

Of course, Nvidia also has its *own offering*, the RTX GPU for the RTX AI PC.

(2) *New software makes it possible.* Ollama is open-source software designed to simplify downloading, running, and managing LLMs locally on a computer. Launched in 2023, the company was co-founded by Jeffrey Morgan and Michael Chiang to dismantle the complexity and cost that made it prohibitive for developers to access LLMs.

Ollama makes it possible to run LLMs locally due to “quantization.” For the geeks in our crowd, here’s how quantization is described in a BytePlus *article*: “*Quantization* is a technique that reduces the size and computational cost of LLMs by lowering the *precision* of their weights, significantly shrinking their memory footprint without a drastic loss in performance. This advancement allows powerful models that would typically require enterprise-grade servers to run efficiently on everyday laptops and PCs.”

Ollama doesn’t have the market to itself. Lama.cpp is another open-source program developed by Georgi Gerganov, to run LLMs locally. Other players are GPT4All, developed by startup Nomic AI, and LM Studio, founded by Yagil Burowski.

(3) *OpenAI blinks?* An LLM does not have to be open source to run locally, but most are because open-source programs have fewer restrictions than proprietary or licensed models and don’t require permission from the vendor.

Meta’s Llama, Mistral AI, and Alibaba’s Qwen are open-source programs, often referred to as LLMs that are adapted for local use. Notably, OpenAI joined the party in August, when it released an open-source offering, gpt-oss. It’s the *first open-source offering* OpenAI has released since GPT-2’s launch in 2019 and it was available on Ollama and LM Studio.

(4) *What can local LLMs do?* Local LLMs are being used by developers, but in the future

they might also be used by *students and researchers*. A student could upload into a local LLM all of the materials accumulated during a semester, including lecture recordings, textbooks, handwritten notes, and labs. The local LLM could use the information to develop a personalized study guide, flash cards, quizzes, and detailed explanations of problems. Importantly, the uploaded information would remain on the student's computer, ensuring its privacy and protecting the copyright of the textbook.

Apple says its M5 chip users will be able to use AI to transform 2D photos into spatial scenes in the Photos app or generate a persona (i.e., a digital avatar representing the Apple VisionPro headset user) with greater speed and efficiency due to the chip's improved performance and energy efficiency.

Calendars

US: Thurs: Existing Home Sales 4.06mu; Chicago Fed National Activity Index; KC Fed Manufacturing Index; Barr; Bowman. **Fri:** Headline & Core CPI 0.4%m/m, 3.1%y/y & 0.3%m/m, 3.1%y/y; University of Michigan Headline, Current Conditions & Expectations 52.0, 61.0 & 51.2; University of Michigan 1-Year & 5-Year Inflation Expectations 4.6% & 3.7%; S&P Global M-PMI & NM-PMI 52.0 & 53.5. (Source: FX Street)

Global: Thurs: Eurozone Consumer Confidence -15.0; France Business Confidence 96; UK Gfk Consumer Confidence -20; UK CB Industrial Trends Orders -30; Japan M-PMI 48.6; Lane; Hall; Bullock. **Fri:** Eurozone, Germany & France M-PMI Flash Estimates 49.5, 49.5 & 48.3; Eurozone, Germany & France NM-PMI Flash Estimates 51.1, 51.0 & 48.4; UK Retail Sales -0.2%m/m, 0.6%y/y; UK C-PMI, M-PMI & NM-PMI Flash Estimates 50.6, 46.6 & 51.0; Japan Leading Indicators 1.3%; Nagel; Woods. (Source: FX Street)

Strategy Indicators

S&P 500 Q3 Earnings Season Monitor (*link*): With 99 companies having reported Q3 results through mid-day Wednesday, the Q3-2025 earnings season is now kicking into high gear. Among the 99 companies, Q3 revenues are ahead of the consensus forecast by 2.0%, and earnings have exceeded estimates by 7.4%. That's a weaker revenue and earnings surprise than in Q2-2025, but that's because company guidance has improved vastly q/q compared to Q2. On a positive note, we expect aggregate y/y revenue and earnings growth will be ahead of Q2's positive rates and that more companies will beat their Q2 growth rates. So far, 85% have higher revenues and 80% have higher earnings, up from 81% and 69% rising y/y in Q2. Financials are knocking out of the park so far, with double-digit percentage growth on both the top and bottom lines.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): During the October 16 week, the S&P 500's forward revenues rose 0.1% w/w to a record high. Forward earnings gained 0.2% w/w to another new record high as the forward profit margin remained steady at a record high of 14.0%. The forward profit margin is now 3.7ppts above its seven-year low of 10.3% during April 2020. The consensus expectations for forward revenues growth remained steady w/w at a 38-month high of 6.3%. From a longer-term perspective, that's well above its 20-year average of 5.2%. It has gained 4.0ppts 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 0.1ppt w/w to a 37-week high of 13.5%, up 2.6ppts from its 15-month low of 10.9% during the May 29 week. That's a bit stronger than its 20-year average of 11.4%, and is just 0.8 ppts below its 38-month high of 14.3% during the December 12 week. That's also 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 5.8% in 2025 (up 0.1ppt w/w) and 6.4% in 2026 (up 0.1ppt w/w), compared to a 5.0% rise in 2024. They expect an earnings gain of 11.5% in 2025 (up 0.1ppt w/w) and a 14.0% rise in 2025 (up 0.2ppt w/w) compared to 2024's earnings gain of 11.6%. Analysts expect the profit margin to rise 0.7ppt y/y to 13.2% in 2025 (unchanged w/w) and 0.9ppt y/y in 2026 to 14.1% (unchanged w/w), compared to 2024's 12.5%. Looking at valuation data as of October 16, the S&P 500's weekly forward P/E dropped 0.3pt w/w to 22.7 from a five-year high of 23.0. It's now up 3.5pts from its 16-month low of 19.2 during the April 17 week. 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 0.04pt w/w to 3.18 from a record high of 3.22. 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 Revenues, Earnings, & Margins (*link*): During the October 16 week, ten of the 11 S&P 500 sectors posted gains in their forward revenues; five posted gains in their forward earnings; and the forward profit margin rose for three sectors. These four sectors had post pandemic- or record-high forward revenues this week: Financials, Health Care, Information Technology, and Utilities. These four are less than 0.2% from their very recent record high revenues: Communication Services, Consumer Discretionary, Industrials, and Real Estate. Consumer Staples' would be near a record high too, but is instead 5.8% below due to Drug Retail's exit in late August. Energy's is improving now from its three-year low in May, but remains depressed at 29.1% below its September 2008 record and 16.4% below its cyclical high in October 2022. Materials' has improved to a 26-month high to 3.9% below its June 2022 record high. These four sectors had record-high forward earnings this week: Communication Services, Financials, Information Technology, and Utilities. These five are less than 1.2% from their record highs: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Real Estate. Forward earnings remains depressed for the last two sectors, Energy and Materials, despite improving in recent months to 38.7% and 21.9% below their respective highs during 2022. Looking at the forward profit margin, three sectors rose w/w and three fell. Financials rose to a new record high again. These five sectors remain close: Communication Services, Consumer Discretionary, Financials, Industrials, and Utilities. The margins of Consumer Staples, Energy, Materials, and Real Estate have improved somewhat from their recent multi-year lows, but Health Care's is still at a record low. 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 (28.3%, at a ninth straight record high and for the first time since September 2024 when low-margin Dell's addition to the index lowered the margin 1.3ppts then to 26.3%), Financials (21.0, up 0.1ppt w/w to a record high), Communication Services (19.6, up 0.1ppt w/w and down from its 19.8 record high during the August 7 week), Real Estate (16.7, down 0.1ppt w/w from a 32-week high and down from its 19.2 record high in 2016), Utilities (14.8, at a 43-month high and 0.3ppt below its 15.1 record high in April 2021), S&P 500 (14.0, at a record high), Materials (11.0, up 0.1ppt w/w to a 38-week high and 0.5ppt from 51-month low in late February and down from a 20-month high of 11.6 in July 2023 and a 13.6 record high in June 2022), Consumer Discretionary (9.4, at a record high for three weeks for the first time since April), Energy (8.8, down 0.1ppt w/w and up from a 55-month low of 8.5 during the during the May 15 week and down from its 12.8 record high in November 2022), Industrials (11.2, 0.1ppt below its 11.3 record high in early January), Health Care (8.1, at a record low and down from its 11.5 record high in February 2022), and Consumer Staples (7.1, down 0.1ppt w/w and up 0.4ppt from a 21-month low of 6.7 during the 9/4 week just before Drug Retail's exit from the sector, and down from its 7.7 record high in June 2020).

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