HUMAN CAPITAL ANALYTICS

Q4 | 2023 Macroeconomics & Banking

Human Capital Market Points

Prepared by EMM Research

Macroeconomics

In an attempt to tame inflation, The Federal Reserve started raising interest rates in 2022. Now, the Fed has started to slow its rate hikes, deciding to hold rates at their current level at the last FOMC meeting.

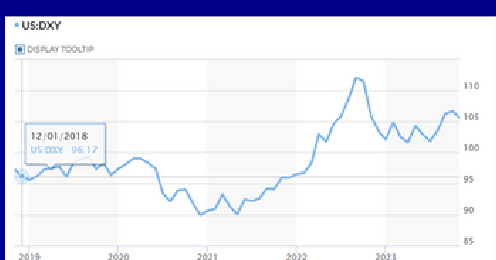
Cautiously pursuing an economic soft-landing, Fed Chair Jerome Powell must slow growth without causing a recession. Powell stated that he may leave higher rates in place for longer to ensure his target for 2% inflation is met successfully, but it remains unclear exactly how long this period will be.

The current monetary policy stands as such: at the current economic growth rate, we are currently pricing in that the Fed Funds Rate will be around 5.25% to 5.5% by the end of 2023, and in turn there is a 34% chance for rates to remain at this level until after Q2 of 2024.

It is important to note that although inflation has gone down overall, Core CPI has remained high. Core CPI numbers persist above the Fed's 2% target, which suggests we are in for a longer period of increased interest rates punctuated by the occasional minor increase. In addition to CPI, PPI and PMI are useful indicators of the current health of the economy.

Geopolitical conflict and uncertainty complicate the macroeconomic situation, impacting global supply chains and creating disruptions and delays. For example, the war in Ukraine and ongoing tensions in the Middle East create the potential for heightened fuel costs and greater volatility in the oil market. The US is largely dependent on manufactured goods from China and Asia, but Chinese production has slowed, and the lack of explanation or transparency regarding this slowdown will have a direct impact on the US economy as we approach 2024.

GDP is forecasted to increase modestly this next year, with the Federal Reserve watching closely. There is the potential for rates to remain steady during the upcoming year, as well as the possibility of a slight rate cut in the second half of 2024.



The US dollar has remained strong compared to other currencies. With the ability to decrease its purchasing power every year, there is in turn decreased inflation and increased tentative investment opportunity in the US. The Fed was successfully able to lower the DXY index to 105.58, back from its high of 113.31, when inflation peaked.

Banking & M&A

Deal-making in 2023 has plummeted from its high back in 2021, with deal flow decreasing 14% quarter-to-quarter and a staggering 41% year-over-year. Bankers with high risk tolerance have been on the lookout for companies that may have sat out during the overheating M&A market of the last 2 years. In general, bankers have also been more selective with deals, and risk appetite has begun to increase.

Revenue from increased credit card debt has given banks the ability to offset their slow M&A activity, which has steadily decreased over the past 12 months.

The M&A market has started to see some "window shopping" activity, yet many sellers persistently believe that overinflated valuations from 2 years ago are still on the table. We anticipate there will be some necessary compromise between buyers and sellers as the realities of the current economy become clearer. VC and PE firms remain on the sidelines with high levels of dry powder, as they struggle to justify high seller valuations. Their approach has largely shifted toward opportunistic deals, value add investments, and predatory LBOs.

The cost of borrowing will be a key factor for upcoming deals, with Instacart's IPO serving as an excellent example. The dramatic pricing change is a reflection of the harsh reality companies face in the current economic climate.

Deal Flow was very slow throughout Q3 of 2023; however, we have seen a drastic increase in activity in the first few weeks of Q4, which could signal that companies are reaching common ground and that there may be a spark in M&A activity.

Fed rates have become one of the biggest concerns for business. The cost of borrowing has increased drastically over the last 18 months. This has decreased many companies' bottom lines and resulted in significantly depressed valuations compared to pre pandemic and pandemic era valuations. This will also have a direct effect on the cost of borrowing going forward, as well as the discrepancies between real rates and the internal rate of return (IRR) or the modified internal rate of return (MIRR) depending on preferred metrics.

Banking & M&A (Cont.)

The upcoming election year and potential new leadership of federal/state asset allocators will impact overall asset allocation, and traditionally there is an uptick in markets after elections.

Some sectors are slowing down, which is to be expected following the post-pandemic business boom. Business activity has largely returned to normal levels, or even lower than in the pre-Pandemic era. As companies continue to adjust, some fully returning back to the office and others embracing hybrid models. Software and IT companies have experienced more traction and stability than most; however, top industries like real estate, REITS, and commercial services have all seen a drastic drop in their M&A activity.

Distressed companies will be at the forefront of the ReFi business. If the companies are healthy and able to pay for services and goods, they will be able to navigate and wait out the current cost-prohibitive debt market. Many distressed companies and commercial real estate firms will have challenges as maturity dates on loans are coming, and the lack of cash flow might force them to liquidate or use assets for collateral to navigate and survive the current interest rate.

For 2024, as the DXY decreases, US currency will lose purchasing power and create a window of opportunity for foreign investors. We expect to see an increase in deal making due to the overwhelming amount of cash reserves of banks, hedge funds, and private equity firms. As prices come back down, current valuations and high costs of borrowing will create new dynamics between the buy and sell sides. This will generate more deals and compromise between the parties.

Geopolitical, geographic, and supply chain disruptions in a weakened Middle East and East Asia should also generate interest for companies willing to negotiate.

Investment Banking Labor Market

US consumer activity remains resilient despite the Fed's best efforts, which fuels banking deal activity in the Consumer & Retail space. Retail activity within Luxury brands and franchising have also continued to see relative activity. Healthcare banking remains strong, and we anticipate seeing continued M&A activity and a rebound of IPO activity within the Life Sciences, BioTech, and Pharma Services space in 2024. The broader geo-political landscape is also starting to yield increased banking activity in the Aerospace & Defense, Industrials, and Industrial Tech sectors.

Regarding compensation, the consensus within the investment banking community is that total compensation will be down anywhere from 20 – 35%, depending on the sector and product. We do not, however, anticipate a broader culling effort in banking. The banks have been "right-sizing" throughout 2023 and will most likely continue to make modest cuts through the first half of the year. Additionally, as banks continue with selective cuts, we will also see selective hiring. This trend is a continuation of what we have seen in 2023. Almost all universal banks hired senior originators while cutting others.

In short, we will continue to see human capital movement in 2024. At the senior and autonomous execution levels, however, movement continues to be born out of market dislocation and a push for "upgrading" talent rather than new hires. Professional movement between firms will be driven by poor bonuses as competitors take advantage of candidate frustration and dislocation in the market.

Additional Thoughts

With the way the market is trending, downstream or less prestigious banks will be the ultimate winners.

Increasingly, recent top tier graduates will go to middle market or boutique market firms, having been crowded out of opportunities at larger firms, which have dramatically decreased hiring quotas. Managing directors will come to the middle market and smaller firms where higher guarantees err more in their favor. A period of economic downturn or turmoil can be an opportunity to grasp top tier talent that other years might have not been available to them. This will resonate through all the sectors.

Traditionally, we see advisory firms take advantage of this dislocated market – the elite boutiques, in particular, are hiring aggressively.

Balance sheet banks will post potential gains due to increased rates on lending and deposits. This will dismay advisory bankers who are going to see firm profits increase while their bonuses decline.

2023 was a slow year. Banking bonuses, across multiple products areas, will be down as a result. In turn, bankers will look to see what external opportunities exist. Their willingness to leave will increase competition in the larger hiring market.

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