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INVESTMENT BANKING

Macro-Economic & Human Capital Research

Q4 Results & ‘23 Outlook

Q4 RESULTS & '23 OUTLOOK

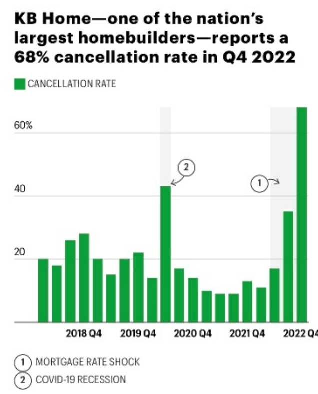
Banking - Earning season had several key factors that were expected, and some that were unpredicted. Bulge bracket banks had an increase in profits due to rising interest rates and their commercial business. With the increase of interest revenue, risk is an important factor to consider. Citi, Bank of America, Wells Fargo, and J.P. Morgan collectively have put aside $4 billion for projected allowances of doubtful accounts, thus creating a safety net with credit card debt at an all-time high among consumers.

Mergers & Acquisitions – Bulge bracket banks were able to soften the damage on earnings due to commercial banking; most if not all investment banking divisions had a significant decrease on M&A activity all across the board, with Goldman Sachs and Morgan Stanley among the ones that had their biggest decrease in years. Investment banks had an average of a 45% to 60% decrease on M&A deals towards the end of the 4th quarter. This was expected due to the changes in economic policy, the rising cost of borrowing, and the changes between deal making from a 10-90 stock/cash purchase with debt ratio to a more 50-50 ratio with debt. The rising cost of borrowing, economic uncertainty, the US Dollar getting stronger, and the current FED economic policy has had a direct impact on the M&A activity. For 2023, we expect that the M&A activity will slightly increase in the second quarter and start to revive by the second half of the year. The Fed will likely keep raising interest rates to trigger the soft landing, thus hoping to decrease inflation and brining stability to fixed income markets. Healthcare, Consumer, DCM, and Restructuring activity will most likely have the quickest rebound in the upcoming months.

Economic Policy – The year ended with a 7.1% inflation rate, and a yearly high of 9.1%. The Fed's current monetary tightening policy is slowly reducing their balance sheet. We expect the Fed to continue reducing its balance sheet all throughout 2023. We believe that the last stimulus package was not needed, and until the Fed reduces its balance sheet by that amount, they will not slow down on the economic tightening. There are signs that indicate a likely increase to M&A activity in 2023, and the decrease on a strong dollar is a key factor to lure investors to US Markets.

The DXY is currently sitting at a 101.89, a dive from 114.50 back in Q3 of 2022. This indicates that the current economic policy is working. A weaker dollar becomes more attractive to investors rather than looking for investment opportunities on emerging markets or alternate investments.

Gross Domestic Product – The US GPD continues to defy every forecast out there. The Bureau of Economics released on January 26, 2023 that the US grew an annualized rate of 2.9%, beating the expectation of 2.6%. Most economists would agree that while a recession is on the horizon, estimating the time and magnitude is more complex than the regular indicators would suggest. The inversion of the yield curve and the decrease of PMI are strong indicators to go by, but the return of a positive GDP growth makes the forecast harder to predict.



PMI and Real Estate – Overall, PMI has been on a decline every month for the last 12 periods. In December '21, we had a PMI of 58.8, meaning high growth in the housing markets. However, as of December '22, we are sitting at a 48.40. This is representative of a major decrease in Real Estate. In addition, one of the major players, KB Home, announced that its buyer cancellation rate was up 35% in Q4 of 22, with a total cancellation spike of 68% from the end of Q3.

Davos Economic Forum - The world economic forum came to an end last week. The three main concerns for the US in the short term are:

- Debt Crisis
- Rapid Inflation
- Geoeconomic Confrontation


United States of America

1 Debt crises
2 Rapid and/or sustained inflation
3 Geoeconomic confrontation
4 Cost-of-living crisis
5 Failure of climate-change adaptation

These factors represent the immediate concerns for the US economy as we approach Q2 and Q3. While China holds the total world's debt at a staggering 53%, the Paris 22 (comprised of 22 countries including the US) only holds 35%. China's commanding lead on international debt triggers concerns on the global economic impact with its foreign spheres of influences. The ability to pace and control economic supply chains will be a key factor in the second half of 2023. Rapid inflation and the decrease in fixed income sustainability will be crucial as the US comes to a key election year in 2024.

Energy cost is another factor that will have a direct effect in the US economy. The cost of energy is a key reason why the EU has failed to tame inflation.

The Fed will continue to reduce its balance sheet, slowing down economic growth in an attempt to slow down GPD growth and regain its grip on inflation.

Q4 & End of Year Earnings Reports

- Even as inflation and geopolitical jitters affect the big U.S. banks, they still manage to beat earnings targets.
- Investment Banking M&A activity severely decreased. For example, Citi Group (58%), Bank of America (58%), J.P. Morgan (54%), Goldman Sachs (48%), and Morgan Stanley (49%) all show a negative revenue on M&A advisory and deal revenue. The current sentiment was across all industry sectors.
- JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc., and Wells Fargo & Co. managed to beat Wall Street's reduced expectations for their Q4 profits as higher interest rates boosted income from loans.
- The banks turned in stronger-than-expected results despite a slowdown in overall deal activity such as home mortgage loans and initial public offerings.
- Given the global geopolitical environment, *"We don't know the future,"* Dimon said.
- Shepardson praised J.P. Morgan's efforts to beef up its Q4 provision for credit losses to $2.3 billion from $1.54 billion in the previous quarter to protect its balance sheet against potential higher loan defaults.
- *"If there are any more hiccups with inflation or fears around moves by the Fed, they have the flexibility to come out of [it] really well,"* Shepardson said.
- Overall, US unemployment numbers remain relatively low, despite an increase in layoffs of late.
- *"There is still significant desire from both corporate and financial sponsors to transact,"* Gary Posternack, co-head of global M&A at Barclays, was quoted as saying. "*All dealmakers need now is the right economic conditions*," he said.
- Tech has laid off numerous workers as the economy began overheating. Companies tend to over-hire in attempts to aggressively grow. However, unsustainable growth is one of the results of an overconfident market. This will be the new topic as the Fed is trying to use not only higher interest rates, but higher unemployment to tackle inflation. This will likely will have trickledown effect to other industries.

Q2 and Q3 2023 Speculations: Economy and Human Capital

- Banks and major businesses have seen layoffs based on bad year-end numbers in comparison to 2021. This adjustment was expected to show investors that corrective measures were taken.

- With a new year, Human Resource departments will be given a new budget that will allocate hiring for the future.
- Upon receiving lackluster bonuses, bankers will be on the lookout for new ventures and opportunities as they will have no current attachment to their current employment.
- Powell stated that his target remains the same: 2% inflation, and a GDP growth of 0.05%. This shows a very slow year.
- Creditors want defaults to go through to make aggressive moves and capitalize on the markets, and continue their cycle.
- GDP growth and "soft landing" will continue to create opportunities in many markets as some developed nations have already signaled a mild recession or the slowing down on Federal Reserve interest hike.
- "*ECM are on bearish trend and DCM will be bullish*," said Brice Richards, Marathon Asset Management Chairman & CEO.
- "*As long as the SP500 does not reach a 3600 level, there should be no concern on a harsh recession in the United States,"* said Madison Faller, J.P. Morgan Chase Global Market Strategist.
- Investment Banks have seen one of the worst quarters since the great recession back in 2008; there will be a clean slate coming into 2023, thus creating new opportunities the second half of 2023.
- "*I remain quite bullish, maybe not on the first quarter, but certainly as we go forward*," said Stephan Feldgoise, global co-head of M&A (GS). Still, there are "*clear headwinds in the first part*" of 2023.
- Geoeconomic Confrontation will be a key factor to tame inflation and sustainability among international markets. This will create a unique scenario which ventures whether investors decide to shift to emerging markets or stay local and re-invest in the US as the decrease on the US Dollar makes it more appealing.
- Bill Adams, chief economist for Comerica Bank, noted jobs data, paired with other recent indicators, appeared to suggest the economy was on the cusp of contracting at year's end.
- *"A slowing trend in real GDP — and more importantly, slowing inflation — is enough for the Fed to reduce the size of their rate hike at next Wednesday's decision,"* Adams said.
- *"The Fed is nearing the end of its rate hike cycle, which we forecast will conclude with a final quarter percentage point increase at the March decision,"* Adams said.