Allison Nathan:  We're coming to the end of another volatile year for the economy and financial markets. How is that affecting the banking sector? And what can bank's balance sheets tell us about the health of the economy?

Richard Ramsden:  I think the overall message from the banks is that the economy is strong today. But there's a lot of uncertainty about what will happen.

Allison Nathan:  I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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Allison Nathan:  To help shed light on the sector, I'm
sitting down with Richard Ramsden, the business unit leader of the financials group in Goldman Sachs Research and Alex Blostein who covers the asset management industry for Goldman Sachs Research. Richard, Alex, welcome to the program.

**Richard Ramsden:** Thank you for having us.

**Alex Blostein:** Great to be here.

**Allison Nathan:** Richard, let's start with you. Banks are often seen as a bellwether or a leading indicator for the economy. Why is that?

**Richard Ramsden:** I think banks are the most macro of the micro sectors. And by that, what I mean is that the drivers of a bank's income statement are really macro variables. So, if you think about revenue, it's really a function of the level of interest rates, the trajectory of interest rates. It's driven by loan demand and changes in loan demand. Credit quality is a function of factors like unemployment, as well as expectations of changes in unemployment, as well as factors like corporate defaults.
So, I think a lot of investors often look at banks as a leading indicator of not just what is happening in the economy, but what could happen over the next six to 12 months. So, small changes in how banks are thinking about loan demand, thinking about changes in asset quality give you, in many ways, the best insight you're going to get from the micro sectors around what could happen to the economy over the next six to 12 months.

Obviously, this year it's become incredibly important. There's been a tremendous debate about the path for the economy heading into '23 and '24. But I do think that investors are trying to read the tea leaves from what banks are saying about the path for the economy.

**Allison Nathan:** Alex, I mention do you cover asset managers. So, what role do asset managers have in supporting economic growth?

**Alex Blostein:** Sure. Private markets is probably a better place to start here. And as Richard mentioned, banks generally facilitate the flow of funds in the economy. Provide capital to, whether it's consumers or corporations. Private markets, over time, have taken a bigger role here.
And I wouldn't say they provide the daily liquidity in a way. But they certainly provide more capital into the space.

So, over the last several years, private markets have grown to about 11 trillion dollars in totally global assets under management. The companies that we cover, the publicly traded alternative firms have about a third of that. So, speaking with them about where they're deploying capital and how they anticipate capital flows to come through over the next 12 months also tells you what kind of opportunities they see in this space. But it also tells you, perhaps, some of the areas of stress.

Like we saw earlier this year, when banks retrenched from some parts of the credit market and a lot of these private credit firms really stepped in.

**Allison Nathan:** Richard, if banks are a bellwether, what are they telling us now? So, in particular, if we think about the operating environment, the difficult operating environment we just discussed. How is, for example, the rise in interest rates affecting deposits on banks' balance sheets?
Richard Ramsden: I think the overall message from the banks is that the economy is strong today. But there's a lot of uncertainty about what will happen over the next 12 months, mainly because I think there's just a lot of uncertainty around how the tightening of financial conditions by the Federal Reserve is going to impact things like consumer spending and corporate confidence.

So far this year, the banks have had a very good year, partly because of the tremendous increase in interest rates that's led to this margin expansion that's been coupled with very strong levels of loan demand. So, if you look at the top line for the banking system, it's grown at high single digit, which is a reflection of both the change in interest rates and the change in loan demand.

I think there's just a lot of uncertainty though heading into next year around what will happen to loan demand. Are consumers going to start to retrench as a result of inflation and as a result of lower confidence? And are corporates going to carry on investing in capex projects which need to be funded, largely by the banking system? Which could result in weaker loan demand.
**Allison Nathan:** And are the banks seeing any signs of credit quality deterioration? I mean, something that could come along with this tougher economic environment?

**Richard Ramsden:** Credit quality is incredibly benign at the moment. So, if you look at loan losses, they are at the lowest level that they have been in 30 years. They're about half the level that they were at in 2019. So, really at this point in time, credit losses are really, as I said, at very low levels. And are likely to increase from here. So, there is an expectation that as interest rates go up and as economic growth slows, credit losses will normalize.

So far, we really haven't seen much. The only area that we've seen some normalization in terms of losses is in credit card portfolios. But it tends to be in the lower FICO bands where, I think, inflation is having the biggest impact.

Really, the biggest driver for credit losses is going to be a pickup in unemployment. And, obviously, at this point, we're just not seeing that. So, until the employment picture in the United States changes, until unemployment rates start to go up, we're not really expecting to see much. So, that's going to be clearly the most important variable to
watch over the next six to 12 months.

**Allison Nathan:** And is it right to assume that things haven't begun to reduce availability of credit to the real economy at this point? Or have they begun to get more cautious?

**Richard Ramsden:** I do think at the margin, banks are starting to tighten underwriting standards. And I think they're doing it for a few reasons. The first is that some of the largest banks are capital constrained at the moment. But secondly, I do think that some of the banks are worried around what could happen to asset prices.

So, for example, if you look at the housing market in the US, house prices are up 40 percent over the last few years. There is a clear expectation that house prices decline as much as 5 to 10 percent. As a result, I do think they are thinking about lending into the mortgage market in a slightly different way than a year ago.

I do think banks are concerned around pockets of commercial real estate, especially office. There is clearly a very active debate about what the long-term picture for
office space is going to look like. So, I do think at the margin they are showing some caution there. But broadly, I don't think the banks have really changed their appetite to lend that much.

Keep in mind, most of these banks will lend through an economic cycle. What they are looking for is ensuring that they are adequately compensated for the risk that they're taking on. So, rather than pulling back in terms of availability of credit, I think what most banks are doing is adjusting the price of that credit or the price of that loan to really compensate them for what they perceive the economic risk to be.

**Allison Nathan:** And everyone, of course, is very focused on the problem of inflation. Beyond the higher interest rates that have clearly been a response to this higher inflation, is it impacting the sector?

**Richard Ramsden:** It is. I think it's impacting the sector in several ways. I think the most obvious way has actually been through loan demand. Very simply, inflation has resulted in more loan demand over the last few years. So, as an example, if you go out and buy a used car today, it's
probably going to cost 20 to 30 percent more than three years ago. Which means that the size of the loan is 20 to 30 percent larger than a few years ago. You know? If you go out and buy a house, it's going to cost more than a few years ago. Which means the size of the loan is going to be bigger.

The second thing that inflation has done, I think, is resulted in a pickup in corporate loan demand. And I think what's happened, especially over the last six months, is that inflation has started to feed on itself.

So, if you're a corporate and you're looking to buy raw materials, if your expectation is that the cost of those raw materials is going to rise, you're going to go out and try and buy more of them at today's prices rather than wait. Again, a lot of that inventory build is financed by the banking system.

I think on the negative side, there's a lot of focus around how inflation could impact credit quality, especially at the lower income cohorts for households. So, clearly, inflation will have an impact in terms of consumers' overall disposable income levels. And I do think that will have an
impact in terms of their ability to service some forms of
debt, especially if we go into an economic downturn.

**Allison Nathan:** And Alex, how has the macro landscape
shifts that Richard and I have been discussing affected
allocations and product development for the asset
managers and the investor side of the community?

**Alex Blostein:** Yeah, this was really an unprecedented
year in many ways. You've had the typical 60/40
investment portfolio. So, 60 percent equity, 40 percent
fixed income, is down something in the mid teens. And if
you look at parts of the fixed income market, they're down
as much as 20 percent, especially at the longer end of the
curve on the duration side. So, this is really not something
that we've seen in a long time. And that's clearly impacting
both institutional and retail investors in a really broad way.

Having a lot of the CEOs at our conference here over the
last couple days, a couple themes really stood out. First, we
think there's going to be a lot more focus on portfolio
construction. If you look back over the last decade, the very
easy Fed policy, a significant amount of liquidity just made
it a very easy decision just to be long beta. Equity markets
have been rising very steadily. You've seen that in the most pronounced way in growth. But frankly, in fixed income as well.

When we pivot to '23 and perhaps longer, with a less accommodate Fed policy, you could see much more focus on downside protection. I think probably more search for alternatives. And more ways to look for uncorrelated assets.

And when it comes to the more traditional asset classes, 2022 saw a record amount of outflows from traditional fixed income funds. Now, when you look at the available yields today, you could actually earn, for the first time in probably more than a decade, a pretty reasonable return both on cash, as well as things like liquid investment grade, probably north of 5 percent. High yield, closer to high single digits. So, we think there's going to be a massive amount of inflows back into fixed income because you can actually earn pretty reasonable returns. And that will benefit a lot of players across the board, both on the private credit side, because those are typically floating rate loans that they're making, ETFs, for sure. We're starting to see some of that already come back. And some of the
traditional fixed income managers. But the dispersion is going to be really wide, based, again, on their underperformance that some of the managers have seen.

But I guess the last theme I would point to is energy transition as far as where capital's going. If anything, the events of 2022 really have shown the focus on alternative energy sources, one. And two, just the need to transition faster. And the amount of capital that's required to do that is in trillions of dollars. So, we think there's going to be a lot of capital coming into this part of the market to solve this void.

**Allison Nathan:** Let's talk about the banks' and asset managers' roles in the capital markets. M&A, and IPO activity were notably more muted this year coming off of the record activity levels we saw in 2021. Richard, what do you expect in terms of capital market activity in 2023?

**Richard Ramsden:** Yeah, so this year, obviously, as you mentioned, has been a much weaker year for capital markets. So, if you look at M&A activity, it's down 35 percent. If you look at IPO activity or equity capital markets activity more broadly, it's down north of 70 percent
compared to last year. And that's obviously been driven by a combination of factors including weak performance of equity markets, very high levels of volatility, as well as the market, I think, just resetting to a new valuation paradigm as a result of structurally higher interest rates.

Our expectation is that activity will start to pick up next year, but probably not until the second half of the year. So, there are some signs that the M&A market is starting to stabilize. We do think that financial sponsors are going to start becoming at the margin a little bit more active at redeploying capital. And we do think corporates are also going to start thinking about how best to capitalize on some of the lower valuations that exist in today's market.

On the IPO side, I think we do need to see a few things before activity picks up. The first is we need to see lower levels of volatility so that bid offer spreads narrow. And secondly, I do think investors really take a view on what they think structurally higher interest rates mean in terms of what they're willing to pay for some of the longer duration growth companies that historically attracted very, very high multiples.
Alex Blostein: Yeah. If I could maybe just add to that. Alternative managers, private equity firms, private credit firms, obviously, are huge consumers and customers of capital market businesses. 20 - 25 percent, at least, probably of the revenue pool, right? So, they've been generally sidelined this year for many of the reasons that Richard talked about.

So, as you think about next year, one of the themes we've heard loud and clear from a number of large private equity firms is that the appetite for public to private transactions is definitely starting to pick up for the first time in quite a long period of time. It takes some period of time for the sort of bid ask to narrow and for seller expectations to become a little bit more grounded. But we're likely to see more public to private transactions. So, that will help the M&A backdrop.

And as far as the IPO activity goes, these sponsors are still sitting on, effectively, a record amount of embedded gains. Even [UNINTL] marking down over the course of 2022, we think there's going to be greater emphasis on seeking ways to realize some of these investments. That's probably second half of 2023 story. But that will help as well.
**Allison Nathan:**  And Richard, Alex mentioned your financials conference that you just held and some of the key themes coming out of that from the asset manager side of things. But from your perspective, what was the tone of the conference? And any key takeaways you would get about the banking sector more broadly?

**Richard Ramsden:**  I think the tone overall was cautious. I still think there's a lot of uncertainty around what will happen to the economy next year. There's still a lot of uncertainty around where interest rates are going to end up. Is the Fed going to have to go materially above 5 percent? How long are interest rates going to remain structurally higher?

And I think the banks themselves are also trying to figure out for themselves what higher interest rates are going to mean in terms of long-term consumer spending patterns and longer-term corporate spending and investment patterns. I think that is something where there's still a lot of uncertainty.

I think where the banks feel confident is just in their own
capital illiquidity [PH] positions. The banking system in the US has seen a considerable increase in the amount of capital that they're required to hold. They're still sitting on very high levels of liquidity as a result of the expansion of the Fed's own balance sheet. So, even though I think there's a lot of macroeconomic uncertainty, I think they feel very confident about their own ability to weather an economic downturn, but also serve the needs of their clients in terms of continuing to originate loans through an economic downturn.

And I think that's actually very important because if you think about macroeconomic cycles, often what you see is banks start to contract their balance sheets at a time that their clients need it the most because financial markets have closed down. I don't think we're going to see that this time round. I think banks will adjust the price of credit to reflect the economic uncertainty. But I don't think you're going to see a broad withdraw of credit provision to the economy. Which means that whatever downturn we have is likely to be more shallow than in some of the prior cycles where you have seen this contraction of credit availability.

**Allison Nathan:** So, even if the banks are relatively
optimistic and you seem relatively optimistic on this sector, bank stocks are down 24 percent this year, even though they've had considerable earnings upgrades. So, what concerns are being reflected in that valuation?

**Richard Ramsden:** I think bank stocks are very simply reflecting a very high probability of a recession. So, on our numbers, I think bank valuations are building in something close to a 50 to 60 percent probability of a recession over the next 12 to 18 months. That is much higher than the probability that our economists have. But I think it does speak to just the overall level of uncertainty around what could happen.

**Allison Nathan:** And we've talked a lot about credit quality deterioration. Systemic risk always comes up in the conversations about recession risk and market volatility. Are we seeing any signs of systemic risk at all from either of your universes?

**Richard Ramsden:** The key place to look for systemic risk is really in funding markets. So, when banks are worried about systemic risk or when investors are worried about systemic risk, you typically see breads [PH] on
funding move very rapidly. We're not seeing really any indication of that at all.

I think most banks are focused on risks outside of the banking system. So, there are two I would point to. The first is that market liquidity has deteriorated considerably over the course of this year across a broad range of assets, including equities, corporate credit, as well as treasuries. And I do think banks are worried about the liquidity dynamic in financial markets heading into next year. I think they're worried that if something happens, they may not be able to sell positions in a way that they historically could.

And secondly, I think they're worried about some of the risks that exist in non-bank lenders. So, over the last ten or 12 years, you have seen this significant shift in terms of lending from the banking system to the non-banks. And I do think there are concerns that some of those non-bank lenders could have problems if we do go through a deeper economic downturn than we currently anticipate.

Alex Blostein: And maybe just to piggyback on that, we get a lot of questions around systemic risk when it comes
to private markets just by the fact that they've grown so much. Right? This is the space that has growing at a 15 to 20 percent [UNINTEL] for the last several years. And to Richard's point, some of the lending that used to take place in the banking system now is done by a number of funds.

But I go back to one of the key pillars of the causes stressing the system, which really starts with liquidity and funding. And most of these firms, actually all of these firms, have incredibly long structural funding where clients give them money, sometimes into perpetuity, but the typical duration is somewhere between five to ten years. So, these firms are never really forced sellers because they have funding locked in place. And that also gives them more time to work through credit troubles of some of their portfolio companies if that becomes a real issue.

**Allison Nathan:** And finally, our conversation has focused primarily on cyclical risks. But how are banks thinking about investments in strategic priorities in the coming year and over, let's say, the next several years?

**Richard Ramsden:** Clearly, there is a very significant shift in the way in which people consume banking services.
The banking industry is digitizing in a very rapid way. So, if you think about how consumer payments are made, increasingly they're made over your iPhone. If you look at the corporate payments, obviously they're migrating towards, again, digital forms of payments versus things like checks. And I think there's a view that regardless of the economic cycle, this is a trend that is just not going to change. And there is a lot of competition from non-banks. Increasingly, technology companies are investing in their payment capabilities. We have seen a number of tech companies expand the type of banking products that they offer.

And I think when you talk to the banks, they're not as concerned as to what the bank down the road is going to do from a competitive position over the next decade. They're worried about what tech companies are going to do. And increasingly, they view those as the companies that they, quote/unquote "have to beat" from a quality-of-service standpoint and from just a consumer experience standpoint.

So, there's no question you are going to see higher levels of investment as banks look to improve the range of digital
services that they offer to their customers. Because if they don't, they understand they won't be competitive over the next decade.

**Allison Nathan:** And Alex, what about strategic priorities for asset managers?

**Alex Blostein:** Yeah. So, technology and distribution, definitely front and center. In terms of product development, despite the recent volatility, it still seems like the alternative products is very central to where people are investing on the new product side of things.

And look, I think broadly seeking for ways to outsource is another important element here where a lot of the asset managers, especially on the traditional side, have been facing significant revenue headwinds this year. But they've also been facing a lot of structural outflows for many years. So, these kinds of pressures are really exacerbating margin compression and forcing companies to seek out more efficient ways of doing business, which often will lead you to outsource some of that [UNINTEL] corporations.

**Allison Nathan:** Richard, Alex, thanks so much for
joining us. And congratulations on the conference.

Richard Ramsden: Thanks a lot.

Alex Blostein: Thanks for having us.

Allison Nathan: Thanks for joining us this episode of Exchanges at Goldman Sachs, which was recorded on Thursday, December 8th, 2022.

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