Goldman Sachs Exchanges
A perfect setup for the financial sector?

Richard Ramsden, Business Unit Leader, Financials Group, Goldman Sachs Research

Alex Blostein, Senior Analyst, US Asset Management, Goldman Sachs Research

Allison Nathan, Host, Senior Strategist, Goldman Sachs Research

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Allison Nathan: US financial companies have seen their share prices surge since Donald Trump won the US presidential election. Investors believe the new administration will loosen capital rules, lower corporate tax rates, and boost capital markets activity. But are investors getting overly optimistic? And what's the outlook from here?

To explain the outlook for the financial sector, I'm sitting down with my colleagues in Goldman Sachs Research. Richard Ramsden is the business unit leader of the Financials Group. And Alex Blostein covers the asset management industry. Richard and Alex have just finished hosting their Financial Services conference here in New

York where more than a hundred firms across the industry spoke about the outlook for their businesses. Richard, Alex, welcome back to the program.

Richard Ramsden: Great to be here.

Alex Blostein: Great. Thanks for having us.

Allison Nathan: So there's obviously been a lot of excitement around financial services firms. What are the key themes you're both tracking as we look toward 2025? Richard, let's start with you.

Richard Ramsden: So I think three or four things that really matter. The first is banks are the most macro of the micro sectors. So what happens to the economy is going to play a key role to the performance of these banks heading into next year, both around the performance of net interest income, which is very sensitive to what happens, not just to fed funds but to the shape of the yield curve. And then what happens to things like unemployment and corporate delinquencies, which is one of the primary drivers to credit quality. So the state of the economy is going to be front and center.

We do have a new administration with new policies. That does create some uncertainty, which is going to be something which I think we'll be monitoring very closely to try to see what impact that is having on corporate behavior in particular.

The second thing is, as I'm sure we'll discuss, there's a lot of enthusiasm around a potential recovery in capital markets activity. So M&A and ECM activity are actually at pretty depressed levels compared to the 10-year averages. All of the ingredients are really in place for that to pick up next year, which could be a pretty powerful driver to the top line of these firms.

The third thing is we're very focused on some of the operational trends around loan and deposit books and what that is going to mean for net interest income. So loan growth has been pretty sluggish for the last 18 months. I think there's some hope that will accelerate as we head into next year. And then you have interest rates that are coming down and banks repricing deposit books. And how that goes is going to have a really important impact on just the level of net interest income, which is a key revenue item for these banks.

And then lastly, the change in administration is going to have potentially a very big impact on the regulatory framework for these banks. Still a lot of moving pieces, but you could see some pretty significant changes in terms of the amount of capital these banks have to hold, the ability for them to merge, which is going to be something else that we'll be monitoring very closely.

Allison Nathan: Obviously with the election of Donald Trump there's been a lot of focus on tariffs and inflation down the road. There's inflation concerns potentially rising again. What would be the implication for the banking sector if that were to take place? And is some of that already being priced in?

Richard Ramsden: So I think a couple of things. The first is you've got to really unpack what tariffs could do both to the short end of the curve, so to the path of fed funds rates. And then secondly, what does it do to the shape of the curve?

I think at the short end of the curve, the risk is that, if tariffs do have a bigger inflationary impact than perhaps the market currently believes, you will just not see as many rate cuts over the course of the next 12 to 18 months. And that would then limit the banks' ability to reprice some of the expensive funding that they have. So, so far you've had two rate cuts effectively. These banks have pretty successfully bought down deposit funding costs around those rate cuts. So if you get fewer rate cuts, funding costs could remain structurally higher.

The second point, though, which I think is important, is, if tariffs lead to a structural change to the way that the market thinks about inflation over a period of time, you could actually see a steepening of the curve. And steepening at the kind of long end of the curve is quite positive for banks. And the reason is that banks have got a lot of fixed-rate assets that they put on in 2020, 2021, 2022 at very low yields that are repricing. So these banks have got securities that they bought in 2020 or 2021 that are yielding between 2-2.5%. Those securities are repricing to 4-5% today, if not even higher. They've got fixed-rate loans that are repricing much, much higher. And they've also got swaps, which are also repricing. So a steepening of the curve, provided that it happens without a recession, would actually be pretty positive for these banks from a revenue perspective.

Allison Nathan: And then you also mentioned potential regulatory shifts. What's really at stake here for banks?

Richard Ramsden: Well, quite a lot. So if you think about the last four years, you've seen a lot of regulatory changes. So the capital framework for the banks has got harder to navigate, so capital requirements have gone up and the framework has become more complex. Second, you've had a whole range of initiatives from the CFPB, which is the Consumer Finance Protection Bureau. That has put in place pricing restrictions on things like overdrafts and late fees. Although that legislation hasn't been finalized, the banks have preempted some of those changes in pricing structures. And then the merger environment has also got very difficult for these banks. So it's taken a lot longer for mergers to close, and I do think that this administration has been looking through mergers through this multifaceted lens of what does it do to competition but also what does it do to the availability of banking services in certain markets?

So I think, look, in terms of the changes, I think where we are most focused is what happens to the capital rules? You've got a proposal out there, the Basel 3 Endgame Proposal, as it's referred to, that was going to lead to about a 10% increase in capital requirements for the biggest banks. It's possible that gets either watered down or it doesn't get finalized. But even beyond that, it's possible that this new administration is going to undertake what we call a comprehensive review of the capital standards and ask the question, look, are we getting this right? I.e., we've increased the capital requirements. That's reduced systemic risk. That's a good thing. But that's come at a cost, and the cost is that there is less lending capacity for the banking system. Has that held up economic growth?

So I think they're probably going to be more inclined to look at the cost benefit of these capital requirements and ask the question, can we bring down these requirements without generating a lot of systemic risk but provide more capacity to support economic growth?

Second, look, the merger environment I do think is going to get easier. I do think that the incoming administration is going to be more likely to look at bank mergers as a way of increasing competition because you create larger banks that have more scale. And then I think even on some of these proposals around fees, I suspect they're going to take their time to make sure that they really understand some of the unintended consequences in terms of what it could do in terms of product availability or lending availability for certain consumer groups that could be disproportionately impacted.

Allison Nathan: And Alex, if you think about the asset managers in particular, what are the themes you're focused on?

Alex Blostein: Yeah, I'll give you a couple highlights. First, I would echo a lot of the enthusiasm that Richard talked about for the banks or really the broader financial service industry. When it comes to the asset managers, a couple of things really stood out.

First, continued allocation towards private markets. It's a theme that we've talked about for many years. You and I have talked about it a bunch of times on this show. That's not really slowing down. But the one point I would make is it's starting to broaden. One of the challenges we've seen in the space is that it's been really concentrated within private credit for the last couple years. And I know we'll talk a little more about that later on in the podcast, but it's starting to expand into private equities. So there's a bit of a cyclical recovery there. There's a lot of capital needs in the infrastructure sector, and we're seeing a lot of capital raise there. And there are some early signs of stabilizing trends in real estate, which has obviously been under some pressure. So that's the first theme.

The second one is around the push from a lot of these private markets firms into the wealth channel. Really low allocations today. Effectively, every CEO of every major alternative asset manager has it on their to-do list, point number one, two, or three. So that'll continue.

And then the third point is around money in motion. We've seen continued growth in money market funds for the last couple years. There's almost $7 trillion in capital sitting on the sideline in cash vehicles. It's starting to come out. We've been waiting for that to start moving into fixed income finds more aggressively. It's starting to happen towards the back end of the year. If the yield curve starts to steepen, we could see that expand pretty meaningfully, and that will be obviously very positive for the asset managers.

Allison Nathan: And Alex, if we do see a recovery in M&A and capital markets activity, how will that affect alternative asset managers?

Alex Blostein: Yeah, the cyclical angle in the space could be pretty material. So if you look at deployment of capital from private equity firms, it's started to pick up already but the new administration and change in M&A backdrop could give it a really nice boost.

Couple things I would say on this front. First, the amount of dry powder is still very significant. Still sitting about a trillion dollars in the US, corporate private equity alone. Financing costs already starting to come down. You've seen that with lower base rates, but also credit spreads have contracted pretty nicely within the last 12 to 18 months. So the availability of capital, financing costs have been very supportive. So if you get a slightly better regulatory backdrop, you could see a lot more activity.

At the same time, the realization backdrop has been actually even worse. So deployment, as I mentioned, started to accelerate earlier in the year. The realization rates are running at all-time lows, and we've talked in the past that a lot of the private equity clients, the LPs of these firms, have been looking to get their capital back. There's been a big logjam in the system. So with more open ECM market and more capital market activity, more M&A market activity, you should see a pretty material acceleration in realizations. We're thinking in our models about 70% increase in performance fees into next year from that type of activity, which is obviously quite significant.

Allison Nathan: With that logjam really created by the valuation gap between sellers and buyers and it's just been very difficult to offload assets.

Alex Blostein: Yeah. And that spread is starting to narrow. I think financing costs coming down have a lot to do with that. And also public market multiples have actually moved up very nicely. So the public multiples are now slightly higher than what you find in much of the private market. So this actually gives a private market asset holder an ability to exit their investment at a more attractive multiple, at a more attractive price.

The other thing that's going to do -- and that kind of goes back to the point I made earlier around broadening of the fundraising activity -- this will create this flywheel, right? This is going to create some of the capital that will go back to the LPs, to the institutional investors. It will enable them then to commit to their next flagship fundraising cycle, etc., which is ultimately the point of what these companies do, right? They risk capital, they invest it, and they harvest it.

Allison Nathan: And Richard, you talked a little bit about loan growth and the outlook for loan growth. We look at banks because they tend to be a bellwether for the economy. So what did you hear from the many CEOs that you were with in this past week about demand and the underlying strength of the economy? And how does that feed into your outlook for loan growth in 2025?

Richard Ramsden: Look, consumer loan growth, especially card growth, has actually been pretty good. And I think the reason is that you actually still have relatively healthy levels of consumer spending. So consumer spending on credit cards typically leads to consumer borrowing on credit cards. You know, so I think you look at the outlook for consumer loan growth in card, it remains pretty good.

On the corporate side, it's been very weak. It's actually been negative for quite a lot of the year. And I think there's a few reasons. The first is it's only been 18 months since we saw the failure of Silicon Valley Bank, First Republic, and Signature Bank. And you did see the industry tighten up underwriting standards considerably after that because they did increase the probability of a recession after those bank failures. And that led to a slowing of loan demand because they did restrict who they were willing to lend to.

Second, you've had this increase in capital requirements. So banks have been prioritizing building up capital as opposed to lending money to some of the user groups.

And then third, there has been competition from private credit, which I'm sure is something we're going to talk about. And at the margin, I do think that the industry has lost some market share towards the private credit industry just because they can't compete with some of the terms and conditions that the private credit industry can offer.

But I think heading into next year, we do think that loan growth is going to pick up. Bank of America at the conference talked about 4% annualized loan growth in the fourth quarter, which is a pretty healthy level. And I think with the election behind us and with lower interest rates, which obviously improves affordability of borrowing, coupled with improving corporate confidence, you would expect a pickup in corporate loan demand in particular over the course of the next 12 to 18 months.

Allison Nathan: Alex, let's pick up on that private credit theme because obviously it's been a big market mover and focus of the markets and focus of regulators even.

Alex Blostein: Sure, yeah.

Allison Nathan: Well, first of all, where are we now? And then how do you see that evolving in the coming year?

Alex Blostein: Private credit has been one of our favorite themes for the last couple years. And if you look at the space today, it's running north of $2 trillion in total AUM, so it's up considerably. The average growth in the space has been high teen to 20% for the last couple years. And as I mentioned earlier, it accounted for almost 60% of all fundraising that we've seen in the private market space. So still a really big deal.

I would make a couple of distinctions, though. There is almost two separate lanes that have evolved within private credit. There is the direct lending business, the more traditional levered lending, that competes mostly with levered loan markets and high-yield markets. That is becoming relatively more mature, in our view. If you look at all of the levered space today, direct lending accounts for about a third. So still runway. Is it going to go to 60%? Probably not. Could it go a little bit higher? Sure. But the dynamic of compressing credit spreads is also at play, right? So the returns you were able to get six to nine months ago are likely not going to be the returns that you can get in the forward kind of 12 to 18 months. Part of that is lower base rate. Part of that is the fact that, as Richard mentioned, the banks are back and financing availability is pretty wide so spreads are compressing. Still really good returns but not what you used to get 12 to 18 months ago.

The newer lane is this kind of asset-backed finance. We can call it Private Credit 2.0. But that is much more of a private investment-grade credit. And that is growing much faster, and the addressable market is also much, much larger. If you think about the equivalent in the public domain, that is investment-grade bonds. It is loans sitting on the bank's balance sheet. It is real estate loans, things like that. So a lot of the private markets firms are going after that part of the market. It's more complex, so I do think the value of the space will accrue to fewer players. You need to have robust proprietary origination. The structures are more complex. It requires more people. And the fees are also a little bit lower than you would find in typical direct lending loans.

So all in all, we think the total growth in this space is likely going to be still pretty strong. So in the teens, 15-plus percent, for the next several years. But we do think the source of that growth will pivot more towards this investment-grade private part of the market.

Allison Nathan: And Richard, will that dent the performance of the big banks we think of? Or will it enhance it? There's a lot of commingling here between these businesses from my understanding.

Richard Ramsden: Look, there's no question, I think private credit is both a threat but it's also an opportunity, especially for the big banks. And the threat comes from the fact that they are, to a degree, competing to provide credit to the real economy, and these private credit firms are obviously just not regulated in the same way. And that just gives them a lot more flexibility in terms of the types of products and the types of structures that they can offer.

I think against that there is an opportunity. The first opportunity is to team up with a private credit firm, and you've actually seen a number of these joint ventures. Which means that, if a client does want a nontraditional loan, they can team up with a private credit firm to perhaps offer them a product that they wouldn't have offered them themselves. So you can actually enhance the client experience by offering a broader range of products than a bank could offer standalone.

Second, look, this growth, this tremendous growth that Alex talked about in private credit is creating this financing opportunity. There is underlying leverage in a lot of these private credit products, and the banking industry is financing some of that. So you have seen this growth in what's been referred to as fixed-income financing over the last few years. And one of the big drivers of that has been this growth in private credit and alternative assets in general. And look, those are quite complex products. You've got to be comfortable with the collateral. Again, you're often dealing with clients, which are important to these firms in a range of different ways. And look, the banking industry has benefited from providing that financing. The risk-adjusted returns on that product are actually quite attractive.

Allison Nathan: So keeping all of this in mind, how are banks and asset managers thinking about their strategic priorities heading into 2025?

Richard Ramsden: I don't know if the strategic priorities have changed that much. Most of these banks are focused on opportunities to grow organically, and I think at the margin they feel that the opportunities for growth are better today than they were six months ago. So I think you will see an acceleration of these large banks filling in geographies where they don't have a big presence on the consumer front. And I think you probably will see them push a little bit more aggressively in terms of opening up underwriting boxes, both to consumers and corporates, because they feel better about the prospects of a recession next year. And I think they're also anticipating that deregulation across the economy could also spur an increase in CapEx, which in terms could lead to a pickup in loan demand. So I think a lot of them are trying to position for this better growth environment.

Second, I think that these banks continue to focus on ways of improving operating leverage. So automation and AI are obviously very important themes for the industry. Although, you know, all of these banks will say, look, AI isn't that new. It's just a continuation of what we've already been doing over the last ten years. And just to give you a really interesting number here, you look at Bank of America over the last 15 years, their balance sheet's more than doubled and their headcount has shrunk by 100,000 people. It's pretty remarkable, the substitution of technology for labor. And then the technologies are obviously a lot more scalable. The marginal costs are a lot lower. Which means that, when you do grow, the margins from that new growth do tend to be really attractive.

And then third, I think when we do get the new capital rules, to the extent that we do get them in the next 6 to 12 months, I think these banks will go back and rethink their priorities around dividends, buybacks, and the opportunity to make inorganic acquisitions, so M&A.

Allison Nathan: Alex?

Alex Blostein: Yeah, I would say growth clearly is top of mind, but I think the evolution of the asset management space is happening at a pretty rapid pace. And there are new channels that are opening up to a wide variety of asset classes that really didn't participate in these channels before, mainly the wealth channel. So as we look across the whole landscape, whether it's a traditional asset manager or an alternative asset manager, thinking of ways of becoming bigger in private markets and then getting those products into the wealth channel is definitely top of mind for effectively most of these CEOs.

The second one is a bit cyclical, but back to this point of money in motion. If we finally get to a point where there's more capital flowing back into the more traditional long-dated funds, whether it's fixed income or equities, you want to be there in a position to capture it and you need to have obviously the right product, the right structure to do that. So we've seen a significant push into things like active ETFs. Quietly, it has been one of the fastest-growing products in all traditional asset management landscape, and we think there will be innovation when it comes to that.

We think convergence between private markets and public markets will be another really big theme. So if you think about the retirement channel as an example and that dovetails a little bit into the regulatory framework -- we didn't get to that -- on the asset management side. But the 401(k) market has been effectively closed to any private investment. And if you think about the duration of that capital, it's really no different than a public pension plan or any institutional pension plan. It's 20-year-plus type of money. So having an illiquid asset as part of your 401(k) allocation doesn't seem that crazy, but the regulatory environment has been really not allowing for that. So to an extent that changes, I imagine we'll see more partnerships between private market firms and the established liquid players in the space that are already in the 401(k) channel to bring more product to market then. So lots of innovation and lots of focus on growth.

Allison Nathan: Interesting. So Richard, as we were walking over here, you made the comment that the tone of the overall conference last week was just bullish. Everyone was bullish. And I said, "Well, that makes me nervous." Does it make you nervous? What could go wrong?

Richard Ramsden: It definitely makes me nervous. I mean, we've been doing this coreference for a long time. I think this is the 35th Annual Financial Services Conference that we have done. And this was definitely or one of the most bullish terms that I've heard. So look, what could go wrong? A few things.

The first is I think we've gone from this environment of political uncertainty to policy uncertainty. So yes, the election being behind us is a good thing in that the uncertainty around the outcome is removed, but now we do have all these open questions around what will be the impact of tariffs? What will happen around the immigration policies? Is it going to lead to a labor market that is too tight in the US? What's going to happen to corporate taxes?

And I think, look, what worries me is I agree with these banks that the direction of travel is up, but it's not going to be up in a straight line. I think you are going to have a lot of volatility as some of these policies unfold and as the market digests the impact of some of these policies over the next 12 to 18 months.

I think, look, the second thing is I do worry about interest rates. We talked about this. But I think the extent to which not only do you not get a lot of rate cuts, but you enter into more of a stagflationary environment, that would be pretty negative for the banks because you could end up with an inverted yield curve. So a lot of this asset repricing that we've discussed wouldn't happen. So that would be negative.

And then I think the third thing that worries me is, on the regulatory side, some of these changes could just take a very long time to come into effect. These regulators do tend to move slowly. It's very possible that we could be sitting here next year and still not have clarity over what's going to happen to the capital framework. And that uncertainty could just lead to banks continuing to remain in a holding pattern in terms of redeployment of that capital.

Allison Nathan: Alex, what worries you?

Alex Blostein: Look, the asset managers are the market, right? The markets are at an all-time high, and that's always a little worrisome. I would say, though, interest rates is probably the one big fundamental factor that are hard to ignore. Particularly parts of private markets, as we said earlier, was obviously set to benefit from easier financial conditions and then that goes the other way, that could clearly slow down the pace of M&A recovery that we're all anticipating. But also there are still lots of unanswered questions around a chunk of the real estate market. And I think, for the most part, people anticipate 10-year to either hang around this level or come down further. If that's not the case then a lot of the 2021 vintage that has yet to make its way through the pipe, so to speak, will remain in question. And that will be a big deal.

Allison Nathan: So there are a lot of reasons to be optimistic but also some reasons to be cautious. Does that sound right?

Richard Ramsden: I think that's fair.

Alex Blostein: Fair enough.

Allison Nathan: Richard, Alex, always a pleasure. Thanks for joining us.

Alex Blostein: Great.

Richard Ramsden: Thank you for having us.

Alex Blostein: Thank you.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Monday, December 16th, 2024. I'm your host, Allison Nathan. Thank you for listening.

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