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Focus on financials: Why banks and asset managers are constructive about the economy in 2024

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Allison Nathan: The financial services industry is often seen as a leading indicator of the health of the economy. With inflation, high interest rates, and greater regulatory pressure weighing on the sector, what are the implications for the industry and beyond?

Richard Ramsden: Most banks have significantly reduced their view around the probability of a recession for next year. If you ask them what their base case is for the economy, will tell you that they expect a soft landing. And I also think that some of these tail scenarios around where interest rates could end up have been fundamentally reduced.

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

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To break down the outlook for the financial sector, I'm sitting down with my colleagues in Goldman Sachs Research Richard Ramsden, the business unit leader of the Financials group, and Alex Blostein who covers the Asset Management industry. Richard and Alex have just finished hosting their financial services conference here in New York where more than 100 firms across the industry spoke about the outlook for their business. Richard, Alex, welcome back to the program.

Both: Thank you, it's great to be here.

Allison Nathan: I had the pleasure of being there yesterday. Buzzing. Absolutely buzzing. Lots to talk about.

Richard Ramsden: There's definitely a lot of focus on financials heading into next year.

Allison Nathan: So, Richard, I just referred to the financial services industry as a bellwether for the economy. So, what did you hear from the industry over the last couple of days of the conference in terms of what they're seeing in the economy?

Richard Ramsden: So, the banks have a great insight into how both consumers and corporates are behaving. They obviously see what's happening real time in terms of consumer spending. They can see how corporates are managing towards this higher rate environment. And the message broadly coming out of this conference was really a very constructive one in terms of the outlook for the economy heading into next year.

Most banks have significantly reduced their view around the probability of a recession for next year. If you ask them what their base case is for the economy, will tell you that they expect a soft landing. And I also think that some of these tail scenarios around where interest rates could end up have been fundamentally reduced.

I think one of the concerns six months ago, nine months ago, was that interest rates could have to go up another one to 200 basis points to bring inflation down to an acceptable level. I think most banks now view that as extremely unlikely.

So, I think the banks are taking the view that the Fed has threaded the needle. That next year you will obviously see a slow down in growth. You are going to see a slowdown in spending. Maybe you'll see a technical recession for one or two quarters. But the things that the banks really care about, like unemployment and corporate default rates are going to remain really, really low.

So, the message was really very different to last year when, obviously, I think a lot of banks thought the probability of a recession was 50 percent or higher.

Allison Nathan: And even if the economic environment seems to be a little less uncertain, fewer tail risks as you've just described. We are nonetheless likely to remain in this higher for longer rate environment. It seems like the market is getting more excited about rate cuts. But we all are expecting rates to stay high for some time. How is that impacting banks? And what are we seeing in the data in terms of things like deposit flows?

Richard Ramsden: I think the interesting thing is that the deposit flows in the banking system have been remarkably stable over the last three or four months. And I think, look, there's a couple of reasons for that. I think the first reason is that banks have got a lot more competitive in terms of the rates that they're willing to pay, you know, especially for deposits that are effectively savings. So, there are a lot of things like CD specials, saving rates have broadly gone up, even for overnight deposits. And banks have realized that they need to be competitive with other alternatives like money market funds and treasuries.

But at the same time, there is a lot of what I would call operational or frictional cash in the banking system that really is not there to really get a yield. It's there to really pay bills over the course of the month. And that frictional cash is not leaving the banking system.

So, I think what we saw earlier on this year is that, yes, there was a lot of money that left the banking system that went into higher yielding alternatives. Like I said, money market funds and treasuries in particular. There was a lot of money that left the regional banking system because of concerns around, obviously, credit risk, default risk around what happened with Silicon Valley and First Republic. But these larger banks have largely seen stable deposit trends over the last few months.

In addition, when you ask these banks about competition for deposits, they will tell you that competition has really started to subside. And I think part of that is there isn't really a significant need for incremental funding for most of these banks. I mean, one of the things I'm sure we're going to talk about is loan growth and loan demand. Loan growth is actually zero at the moment. So, most banks don't really have a significant need for new funding to meet loan demand because there really isn't much at the moment in the banking system.

Allison Nathan: Well, let's talk about loan demand. Why is loan demand so depressed? Is that just a function of the macro environment?

Richard Ramsden: Look, I think there are several reasons. Again, I think the only area that's really been growing rapidly has been credit card lending. I mean, that's been growing at double digit. And that's just a reflection of growth in consumer spending. So, you spend money on a credit card, it obviously shows up as a loan. And you either pay that loan off at the end of the month or you revolve that loan. So, consumer spending has definitely translated to increased consumer lending.

Outside of that though, loan growth has been either zero or, in some cases, negative. And I think that there's a couple of reasons why. The first is banks have been tightening underwriting standards throughout the course of the year. And part of that is because of concerns around where the economy could end up, not so much next year, but over the next two to three years. It's normal for banks to start to tighten underwriting standards in the middle of an economic cycle. Who knows if this is the middle. But I do think they're taking the view that rates have peaked and they're going to start to fall. That usually does coincide with some weakening of the economy. So, tightening underwriting standards is one reason.

The second is there are increased capital requirements coming for most of these banks. And I think they're starting to prepare for that. And one of the ways that they are preparing, I think, is by being less competitive in terms of the rates that they're willing to offer on certain types of loans as they look to accumulate more capital.

And then the third thing, which I'm sure we're going to hear a lot about from my colleague Alex Blostein, is there's a lot of competition from nonbanks. I mean, private credit is a very dominant theme. There's enormous growth in terms of pools of private credit. That is a direct competitor to banks from a lending perspective. And I do think that has had an impact.

Allison Nathan: So, Alex, let's go ahead and dig into that a little bit more, the rise of private credit. It's been a big theme. Before we really dig in, maybe just remind us quickly what private credit is and why it's seen such tremendous growth.

Alex Blostein: Sure. To your point, private credit has been a very powerful and important theme in capital markets for the last couple of years. But everything that happened with the banks this year really exacerbated and amplified that growth.

So, just to put some numbers around it to your point and level set, it's about a 2 trillion-dollar AUM market today. And the way we define private credit, it's more than just levered lending to financial sponsors, which is about half of that 2 trillion-dollar number. It also includes distressed. It also includes mezzanine. But it also starts to include things like real estate lending, infrastructure lending, asset-backed finance. Right? So, that's where that pool of available capital and pool of investable capital has really opened up incremental investment opportunity for the space.

Now, the space has grown at about a 20 percent CAGR for the last five years. Despite really strong growth this year, we still think the space is really just a fraction of the overall fixed income market. And the way we think about it is from an institutional asset allocation perspective. When an insurance company or pension fund or sovereign wealth fund decides where they want to allocate capital, they think about alternatives. And they think about private equity, private real estate. And private credit kind of sat in the middle between this alts bucket and really traditional fixed income.

We think increasingly it's starting to move into this fixed income bucket which really opens up the addressable market. And that 2 trillion-dollar number is only 7 percent of global fixed income AUM allocations.

So, where is this going? We broadly think it's still a 20 to 25 percent grower for the next five years. And that's a function of both supply and demand. So, on the demand side, as we talked about, the allocations are still pretty small. On average, institutional allocations towards private credit is about 3 percent. There've been a number of companies at the conference talked about that number going as high as 10 percent.

And on the wealth management side, it's just started to scratch the surface. So, we think there's going to be continued supply of capital going into that space.

And in terms of where they're investing, it's twofold. So, on the one hand, we are going to see M&A pick up at some point in time. So, some of that levered lending will start to accelerate and then we'll use some of that dry powder that's built up.

And the second one is what Richard talked about, is banks are facing increasingly regulatory scrutiny. On the back of the regional banks crisis, there are going to be continued shifts in liquidity and capital requirements in the banking system. And that's where some of these private lenders will likely continue to step in.

Allison Nathan: Well, let's talk about that a little bit more because there seems to be a lot of concern that a market of this size and that is growing so rapidly has not been tested during a downturn. And, you know, the idea that regulation could push more and more flows is causing a lot of concern in the industry. How big are the risks?

Alex Blostein: For sure. That's come up in every conversation over the last couple days of the conference. And I think there are some notable differences between what a lending activity looks like in a fund structure versus what it looks like at the bank.

Now, at the core of your question is, look, credit is credit. And once we go through a credit cycle, will there be losses? Sure. At the end of the day, it's a loan. And just like a loan on the bank's balance sheet, could default and have losses. The same exists. And to your point, it has not been tested yet.

There is history in direct lending, probably more so, than in some of these other asset classes. But ultimately, there will be probably some losses. But at the core of your question, I think, from a regulatory perspective it's how systemic is it? And the difference is, unlike the banks, the fund market has four, five, six-year duration on the funding side. So, you can't take your money out. And this foreselling dynamic that could exist in the financial system from some of the banks doesn't really exist in the fund structure. So, that would be the first one.

The second one is leverage. The banks are obviously levered institutions. The fund themselves are way less levered than the banks are. And then the third is concentration. I mean, so much of the banking activity takes place with a handful of banks. And it really varies by asset class. So, if you take CRE, commercial real estate for example, it is dominated by smaller banks. When you spread it across multiple different funds, that concentration and systemic risk really just doesn't seem to be that pronounced.

So, look, I think there is going to be a lot of education. I think there's going to be a lot of regulatory discussion. But it's really not clear to us if bank-like regulatory framework is really that applicable to the fund market.

Allison Nathan: Richard, Alex just brought up one other area of the economy that has also generated some concern. Commercial real estate risk. And the concern is really that banks have exposure to this. Alex mentioned mostly regional banks. But break down for us how big of a risk that could present to the banking universe.

Richard Ramsden: You know, so, that was obviously another area of discussion at the conference. Credit risk, broadly. Commercial real estate, in particular, has being an area of focus all year. I think what's interesting is that most of these banks now feel that they've got to the right place in terms of reserves against their office commercial real estate portfolio.

Obviously, office exposure is at the epicenter of this because of weak demand for office space, overbuilding going into the pandemic. So, over supply. As well as, obviously, a 500 basis point move in rates that's put a lot of pressure on the ability of some of these borrowers to refinance.

If you look at where these banks have got to, at least the large banks, they're now somewhere between 8 to 12 percent reserves against their office loan exposure. Which basically means they're expecting that they're going to lose between 8 to 12 cents on the dollar on their entire office exposure. Which is actually pretty high. I mean, that's comparable to what they lost on office exposures back in 2008/2009.

Obviously, they're tracking what's happening in terms of delinquencies. But at this point in time, I think they feel that they've got to the right place based on everything they can see in terms of reserves.

The big concern is, look, are we going to see contagion elsewhere? And I think the area that people are most focused on is multi family. A number of banks proactively addressed this at the conference. So, Wells Fargo talked about this. PNC also talked about this. And I think what they will tell you is the dynamics in the multi family market are just very, very different to office.

And I think they would point to two or three things. The first is that rental prices have consistently gone up for a period of time. So, yes, refinancing costs have gone up. But rental income against that has also gone up. Second, obviously, buying a new home today is expensive if you need to take out a mortgage. So, demand for rental properties is very high. And then thirdly, you haven't had the over building in multi family that you've had in office. There is still a deficit of multi family homes in a lot of major metropolitan cities. So, they will tell you, look, office is really very unique from a demand/supply perspective relative to multi family. And they're not really seeing any significant deterioration in terms of credit quality yet outside of office.

Allison Nathan: And Alex, you mentioned earlier the regulatory issues and concerns. I know there was tremendous discussion about this at the conference. Richard, maybe talk to us a little bit about what's going on that banks are so worked up about. Explain Basel III endgame, what that means and our views on it?

Richard Ramsden: So, Basel is basically the capital framework that governs banks globally. It's basically a capital framework that dictates the amount of capital a bank needs to hold so that you minimize the probability of a failure. I mean, that's what Basel is.

It started off as a global standard that was pretty uniform around the world. After the financial crisis in 2008 though, there was a fragmentation. You know, different geographies decided to head in different directions, frankly, based on their experience in the global financial crisis. And the US, obviously, had a really difficult financial crisis. There was a very large number of bank failures that, obviously, led to a very deep economic recession. And, ultimately, a very sizable government bailout.

So, coming out of the financial crisis, there was a lot of work done to make sure that that didn't happen again. And that included the US really adopting its own version of the Basel framework.

And this has really been a work in progress, frankly, over the last 15 years. This is supposed to be the final iteration of that 15-year body of work. And what effectively predominantly the Fed concluded is that the large US banks need more capital. And they came out with a proposal earlier this year that would require the largest US banking institutions, give or take, to hold somewhere between 15 to 30 percent more capital than they currently have.

Allison Nathan: Which was, by the way, much more capital than they had prior to the financial crisis, just for some context.

Richard Ramsden: To put it in perspective, if this proposal went through the average US bank would hold 2.5 times more capital than what they had in 2007 for the same unit of risk. So, 2.5 times. I mean a very, very significant increase in the amount of capital.

There's been an enormous amount of push back, not just from the banking system, but also from end users. I mean, the way to think about this a little bit is, look, capital is really an input into cost of goods sold for a bank. You know? Capital has a cost associated with it. If you need to hold more capital, you need to pass that onto the end user. In the same way that if the price of bricks goes up, a home builder is going to have to charge you more for the same home.

And I think what regulators and end users are realizing is that this could result in a significant increase in the price of certain types of loans, including mortgage loans. Including loans to renewable or green energy companies. Loans to lower income households, so, credit card loans. As well as loans to small businesses. And I think, really, this debate is around has there been a cost benefit analysis done around this? There's clearly going to be a cost to end users. But what is the benefit?

And I think the reason there's this debate about the benefit is if you look at the two real world stress tests that the banking system has gone through over the last three or four years, the first in 2020 around COVID, and then the more recent one around this mini banking crisis, there is no indication whatsoever that the larger banks needed more capital.

So, I think there is really this debate that's taking place around, is this necessary, especially for the largest institutions?

I think the other thing just to add is this could have pretty far-reaching ramifications for liquidity in certain parts of the financial markets as well, including the treasury market. And the treasury market has obviously grown exponentially over the last decade. And this would make it a lot more expensive for banks to provide liquidity and leverage to participants in the treasury market, which, in turn, could increase the funding costs for the US government as well. Which I think, again, is part of this whole discussion process.

Allison Nathan: Right. I mean, that is part of this trade-off. If banks are having to hold onto more capital, they obviously can't be an intermediary in ways that they would otherwise choose to address liquidity and other issues in the market.

Richard Ramsden: That's exactly right. And again, to kind of explain what that means is if you have less liquidity in financial markets and you get an event, the correction in markets just tends to be that much bigger before you get someone stepping in to buy those assets that, ultimately, get mispriced. You know? And I think that one of the things that we have seen, in 2020 in particular, is that in the early days of COVID there were enormous disruptions in financial markets, including in very short, dated funding markets for investment grade corporates. And what really caused those markets to correct was banks providing leverage to end users, so mutual funds, pension funds, sovereign wealth funds, and hedge funds who stepped in to say, you know what, J&J commercial paper trading at 95 cents on the dollar with a three month duration doesn't make any sense. I know the world is a really scary place. But I'm going to step in and buy that on leverage because I think that is a really mispriced opportunity where I can make an outsized return. You know, the bank's ability to offer that type of leverage to end users is going to get significantly curtailed.

Look, that is, though, one of the objectives, I think, of this proposal. I do think regulators are starting to worry about leverage building up in the nonbanking part of the financial system. And one of the ways to control that is through reducing the availability of leverage from the banking system. And this is clearly going to do that.

Allison Nathan: There's also this argument that other players could step up, Alex, maybe some players in your universe, if that bank's capital is more constrained. What are we seeing in terms of the evidence of that?

Alex Blostein: Yeah. So, we talked about private credit providers. I mean, that's certainly an area. But that is much more on a longer dated kind of funded basis. I think in the near-term, if you think about intermediation of markets, there's definitely been more electronic market makers and more high frequency type of firms that are entering the markets, fixed income markets, that they have not played at in the past, with significantly lower capital requirements.

Now, the challenge with that is those kind of players at times of extreme volatility has also a really easy ability to pull back and not really fill that void or being a backstop to when prices go down very sharply. So, there will be new entrants, but it's not clear whether or not they'll actually be there when liquidity is needed most.

Allison Nathan: And we touched a little bit on the regional banking crisis. Some people quibble with that term. But the severe difficulties of regional banks, a few of them, earlier this year. And if we think about this regulatory reform, as you said Richard, it's been very long in coming, really spurred by the financial crisis, not that crisis. But how has that experience impacted how banks are thinking about their risk, if at all?

Richard Ramsden: Yeah. I think, look, the one thing I think that we learned out of the, let's call it the banking tremor that we had in March and April, is that liquidity risk for banks really is very different to what we have seen historically. And it's really this interplay between technology and social media that has really, frankly, changed the way that you need to think about the risk of a run on a bank.

You think about what happened with Silicon Valley Bank and how that then translated to concerns about Signature Bank and then ultimately First Republic, it was really the fact that the concerns around the institution were just amplified in ways they couldn't have been 15 years ago just because of just this tremendous rise in social media platforms like Twitter and TikTok and various other platforms, coupled with the fact that if you want to move your money from an institution, you don't need to show up. You can just do it on your iPhone.

And I think that what we've realized, and I guess this isn't new, but it was just a reminder is that during periods of stress, depositors act like creditors. I mean, if you're an uninsured depositor, i.e., if you're above the FDIC limit of $250,000, if the bank goes out of business, if it goes into insolvency, you're treated as an unsecured creditor. You know?

So, if you're a corporate or a high net worth individual, you're not really compensated for the risk in terms of holding your money at one of these smaller, riskier institutions that have got less capital and less liquidity. You know?

And I think, look, the regulators are going to have to think very carefully about this because it's really, really clear that, you know, these deposit runs, frankly, run at the speed of sound. And that is something which I think bank regulation is going to have to start taking into account. I mean, what does it mean? It means that banks ultimately will probably have to hold more liquidity. They're going to have to think differently about the types of secretaries that they buy. Buy shorter duration securities than perhaps they historically have done so. But also, think more broadly about diversification of deposits. So, making sure they're not over reliant on a particular sector or industry or geography so that you don't have the same type of run risk.

Allison Nathan: So, keeping that all in mind, how are banks and asset managers thinking about their strategic priorities as we head into 2024?

Richard Ramsden: Let me talk about the banks first. I think it really depends on who the bank is. So, I think the biggest banks are really focused on opportunities to continue to grow. What these banks are realizing is that consumer preferences are changing very rapidly. You know, branches are important. But they're not as important as they were in the past. It's really important that you've got a very competitive technology offering, both for consumers and corporates. And if you do, frankly, you can charge a bit more and consumers are still going to flock to you because convenience, frankly, for a lot of people, has become more important than just price.

So, I think the bigger banks are really pushing on the competitive advantage to have just in terms of their ability to spend more on this. While I think the smaller banks are trying to think of ways in which they can become more competitive.

I think the very smallest banks are going through a more existential question around how the regulatory framework is going to change for them and what that means in terms of the size you need to get to in terms of being competitive. I mean, frankly, if the smallest banks are going to see an exponential increase in their capital liquidity requirements, for them to be competitive, they have to get bigger. Which means that they have to think about M&A. But I do think at some point, there is going to be a wave of consolidation across some of the smaller banking institutions in the US as they look to gain scale to be competitive.

Alex Blostein: Yeah. And when it comes to asset managers, I think this private credit theme is really here to stay. This is not a one-year trade. And as we talked about earlier, I do think it's only going higher from here.

So, for both alternative managers that are looking to expand capabilities here, and even traditional managers that are looking to enter this space, this will remain one of the key priorities. And the sub bullet point to this main point I would say is building out origination capabilities is going to be critical.

So, one of the things that Richard talked about is banks will have to start thinking about how they manage the asset side of the balance sheet differently. Whether they have to shorten duration, how much loan origination they can really deliver into the ecosystem. That leaves that void. And you need to have enough origination platform to fill that void. So, we think a lot of them will focus on that part of the market.

The more liquid part of the market, so the traditional asset management space, has a really interesting opportunity ahead of them. This time last year, we talked about how cash is an asset class again. And you can earn over 5 percent in a money market fund or your savings account. With rates coming to a pause, we'll see whether or not we'll get rate cuts or not next year, but clearly top of mind for folks is starting to extend duration. And to say, look, I've earned 5 percent or so, over a trillion dollars moving into money market funds, over the course of 2023. So, some of that capital is going to start to come out of money funds.

Likely to go into some form of fixed income. Whether it's going to take duration or credit risk, TBD. But I think that's going to be an important opportunity for them to focus on.

Allison Nathan: Richard, Alex, thanks so much for joining us.

Alex Blostein: Great.

Richard Ramsden: Pleasure to be here.

Alex Blostein: Thank you for having us.

Allison Nathan: Thanks for listening to this episode of Goldman Sachs Exchanges, recorded on Thursday, December 7th, 2023.

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