

Fiscal Package Critical

2021 & Beyond

The longer-term economic environment for financials continues to brighten while in the short-term there are remaining shifting sands. The ultimate positive is the likelihood of ongoing stimulus and, more importantly, the possibility of infrastructure spending. These also argue for net interest margin benefit from rising interest rates, partly from growing yet moderate inflation, and partly from enormous deficit financing, which will reduce net interest margin pressure. Inflation is expected to spike a bit early this year from pent up consumer demand fueled from savings. The primary negatives are lackluster credit demand and a stricter regulatory pressure under a Democratic government.

The nearer-term environment, certainly for the first half of 2021, is less sanguine. The chief impediment is again the lack of organic credit demand and latent credit risks lurking beneath an ongoing flow of stimulus. Features of the current underlying economy are largely unknowable or invisible while artificial stimulus is prevalent and likely to continue. Expectations for loss-reserve release is not a high quality fundamental driver and reserve adequacy remains arguable in the short term.

Low overall valuations tie both time frames to an overweight posture. Relative (to S&P) prices in relation to book values are still close to historic lows.

While one can get lost among the dissonant economic variables, we remain primarily focused on just two: Credit demand and credit risk.

There are two kinds of pervasive support to the American economy. The first is filling-the-hole assistance mandated by COVID damage, which by its nature has to be temporary or time limited. The second is true infrastructure spending, which is key to long term growth.

The tug-of-war nature between these two, time frame dependent arguments is hard to separate. It is hard to ascertain correctly weighing the pros and cons. Our view is that infrastructure spending can break the tie. This is because growth in the U.S. economy has been constantly declining for decades, largely owing to inexorable demographic headwinds. Our oft-cited graphic for this is the average GDP growth between recessions, clearly stair-stepping down after each.

Left to this evidence, once the pandemic is under control the economy is likely to surface, post-downturn(s) at lower momentum. Despite some ups and downs, the average momentum for GDP was only 2.1% per annum after the Financial Crisis and before COVID interruption. It is easy to see faster growth initially during a final recovery from this deadly period, but longer term core momentum is unclear. It seems likely to be sub-2% from the below exhibit. Without help, underlying trend growth is biased for disappointment by 2022.

Financial Services Group

Robert Albertson

Managing Director and Chief Strategist

+1 212 466-7946

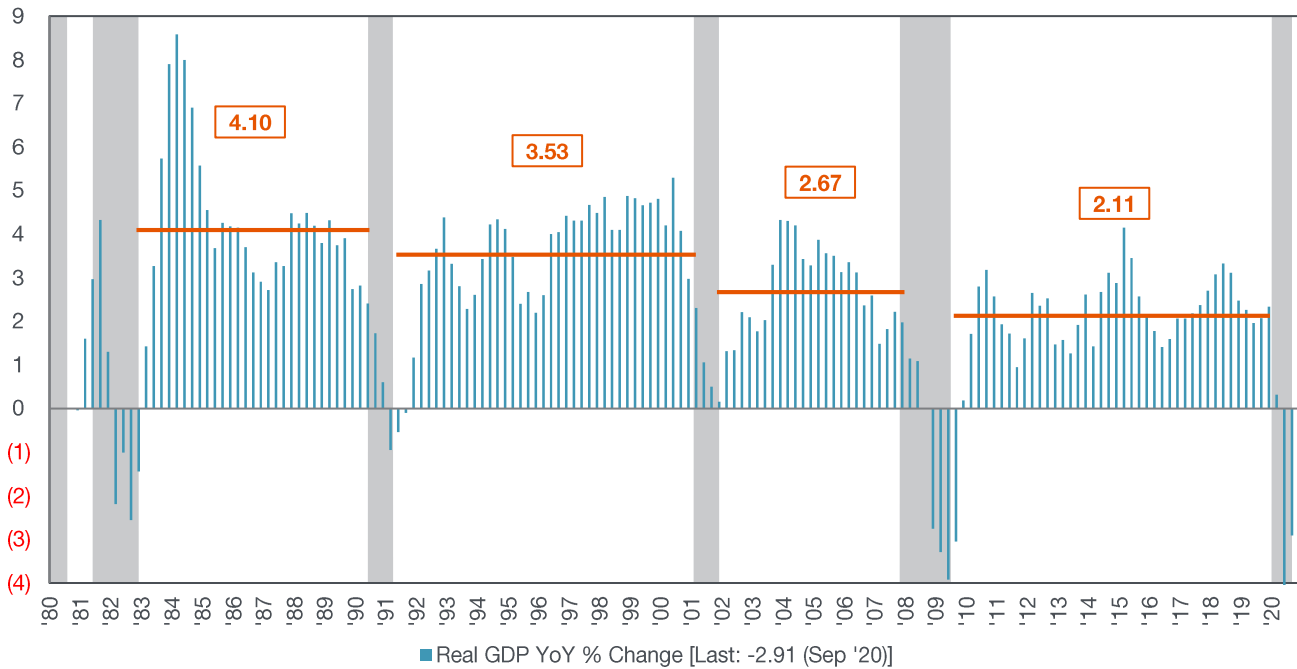
robert.albertson@psc.com**Weison Ding**

Director

+1 212 466-8005

weison.ding@psc.com

US GDP Growth Real YoY % Change



Source: U.S. Bureau of Economic Analysis

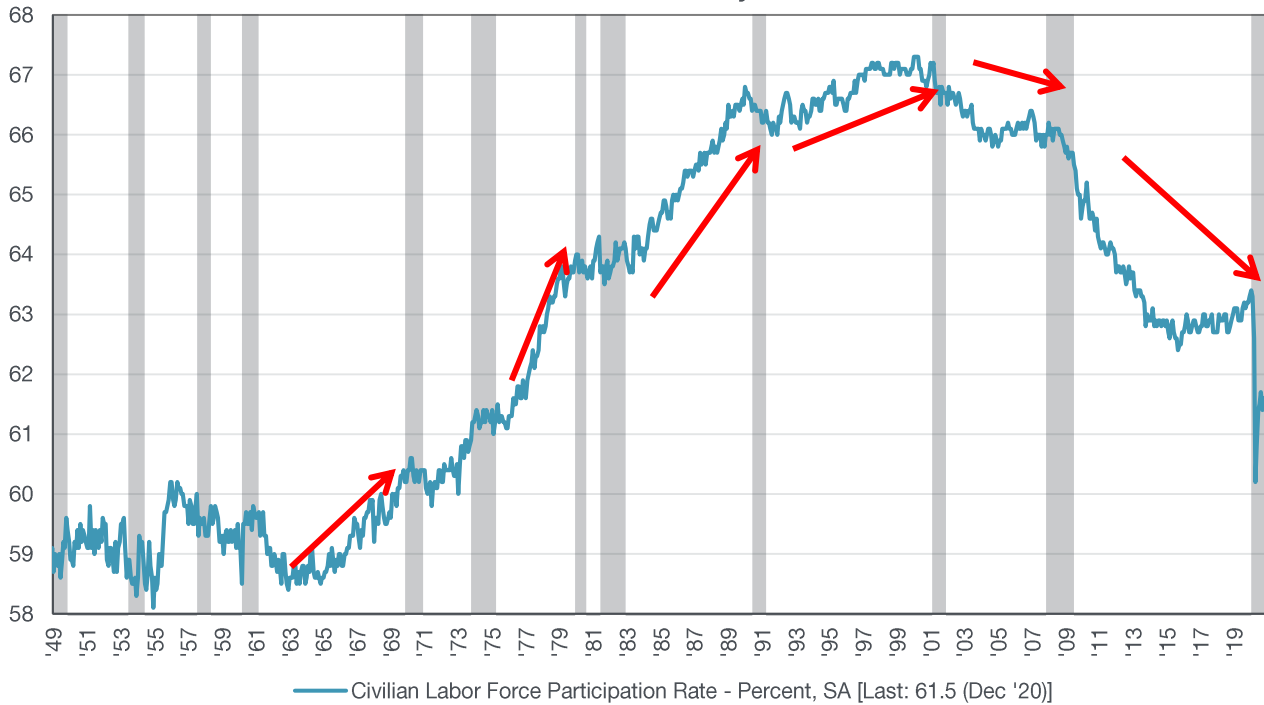
This is where infrastructure spending comes in – or doesn't. Stimulus spending from the CAREs Act and CAREs 2.0 is not lasting stimulus. It is swallowed during a recovery. It is only a bridge over the valley designed to repair damages. Infrastructure spending is ongoing stimulus. As we all know, infrastructure needs are heroic in America.

Most infrastructure packages are considered over a much longer time period, usually on the order of ten years. Being overly simplistic, the current rumor of a \$3 +/- trillion package, while actually less than the expected overall CAREs and attendant monetary support over a much shorter period could linearly amount to \$300 billion per annum on a ten-year scale, which is about 1-1/2% incremental GDP growth. This would not only break the unappealing picture above but assure stronger employment demand.

However, there is one caveat to this. The makeup of an infrastructure package must adhere to true infrastructure repair and modernization. It must not be diluted by indirect aid to state and local budget deficits. The political support for repairing state and local finances is now stronger than before and such dilution is a real possibility. This would not be the first time a stimulus bill became a "repair" bill. In the Obama administration, the \$800+ billion so-called stimulus package included only slightly more than \$100 billion for infrastructure and thus had little long-term positive effects.

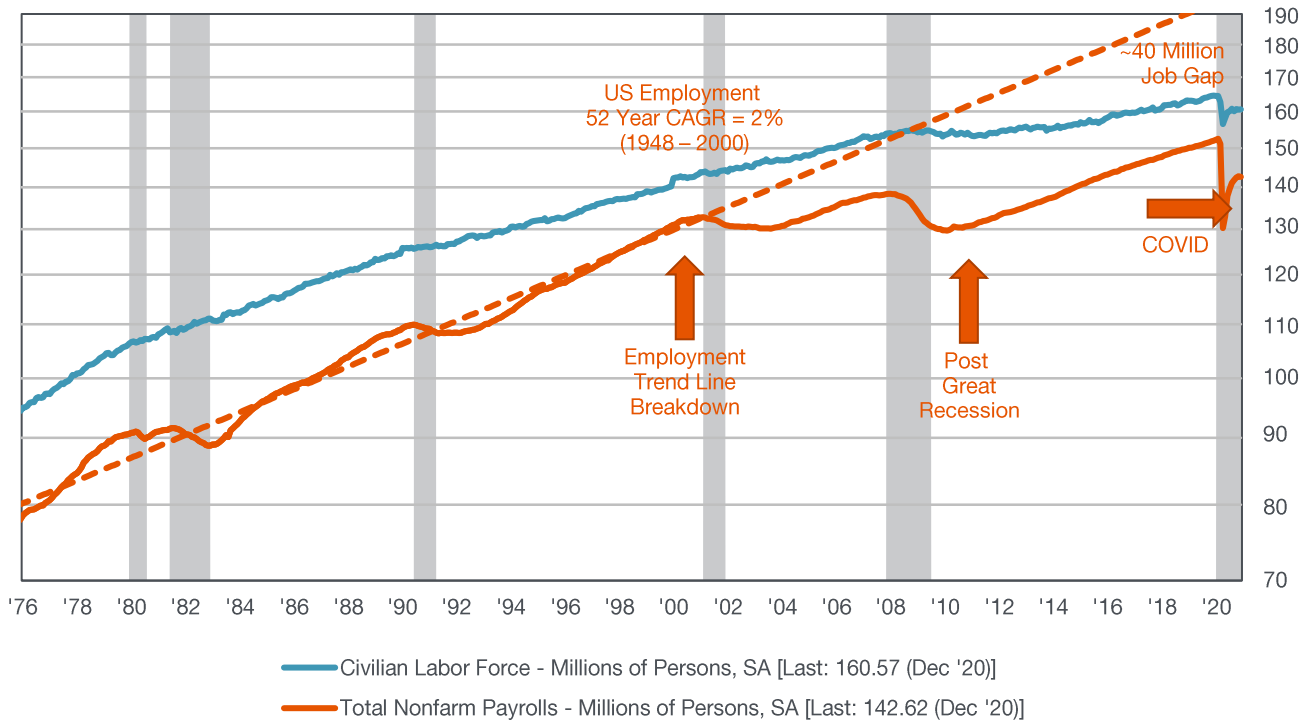
For perspective it is also worth considering how far we still are from the economic trend line. There are many measures of this. Simplistically we are barely half way there. Perhaps the most startling statistic is in the Participation Rate data, which takes us all the way back to the levels of the 1970s as seen below. Participation Rate decline had finally stopped by 2015 but sharply declined last year and that decline is barely half reversed. Another perspective on full recovery shortfall is in jobs data itself, where the rebounding current level almost takes us back to the 2007 pre-crisis level.

Labor Force & Payrolls



Source: U.S. Bureau of Labor Statistics

Labor Force & Payrolls (Log Scale) United States

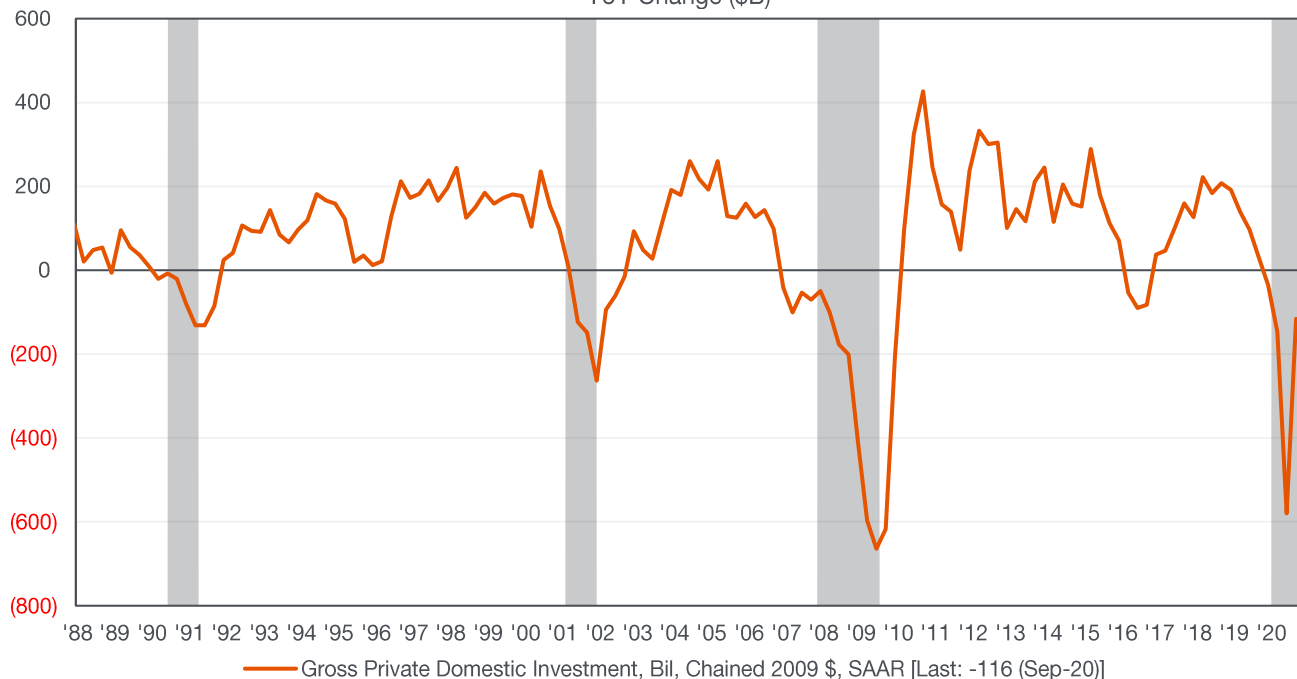


Source: U.S. Bureau of Labor Statistics

Credit demand is likely to remain soft while CAREs lending continues, which at least will influence the first half of this year. Credit demand will also follow the soft cycle of business spending and investment that has been with us for at least two years, preceding its dive during COVID. While well less than 18% of direct GDP composition, private direct investment drives employment. Nonresidential fixed investment is still off nearly 5% from year ago levels. However the residential side is continuing to expand, up \$86 billion annually and offsetting the \$135 billion decline in nonresidential through the most recent,

third quarter data. This is the only area of our economy that has benefited from COVID inspired migration to the suburbs. But for now, commercial loan growth remains weak.

Personal Consumption Expenditure & Private Domestic Investment YoY Change (\$B)



Source: U.S. Bureau of Economic Analysis

Finally, from the perspective on job recovery by sector, two things emerge. First, we are only half-way there at best and,

Job (000)s	----- DECLINE -----					----- RECOVERY -----				
	February	April	2 mos	%	Feb mix	December	from bottom	from peak	recovered %	from Feb
Education & Health	24,586	21,805	(2,781)	-11%	17.5%	23,292	1,487	1,294	53%	-5%
Government	22,745	21,776	(969)	-4%	16.2%	21,401	(375)	1,344	-39%	-6%
Professional & Biz Svcs	21,550	19,254	(2,296)	-11%	15.3%	20,692	1,438	858	63%	-4%
Leisure & Hospitality	16,867	8,549	(8,318)	-49%	12.0%	12,959	4,410	3,908	53%	-23%
Retail Trade	15,672	13,288	(2,384)	-15%	11.2%	15,261	1,973	411	83%	-3%
Manufacturing	12,852	11,489	(1,363)	-11%	9.1%	12,309	820	543	60%	-4%
Financial Svcs	8,845	8,566	(279)	-3%	6.3%	8,743	177	102	63%	-1%
Construction	7,639	6,556	(1,083)	-14%	5.4%	7,413	857	226	79%	-3%
Information Svcs	2,894	2,609	(285)	-10%	2.1%	2,626	17	268	6%	-9%
Mining & Logging	714	653	(61)	-9%	0.5%	630	(23)	84	neg	-12%
Oil & Gas	157	155	(1)	-1%	0.1%	164	9	(7)	neg	5%
Other Svcs	5,941	4,571	(1,370)	-23%	4.2%	5,488	917	453	67%	-8%
TOTAL in SECTORS	140,462	119,271	(21,190)	-15%		130,978	11,707	9,484	55%	
TOTAL	152,442	131,072	(21,370)	-14%						

source: Bureau of Labor Statistics and PSC estimates

second, the largest deficit remains in Leisure & Hospitality which indicates a 47% shortfall since February and increasingly viewed as facing the largest hurdles to restoration. We are recovering to a different economy than we once had, and this is an example. Travel has already leaned in favor of business and more toward only leisure. Business models have changed and are unlikely to completely revert. There are other examples but our ongoing view is still that a large part of the remaining jobs will not fully recover. We will not see these model shifts until well after COVID is behind us and social and behavioral norms stabilize.

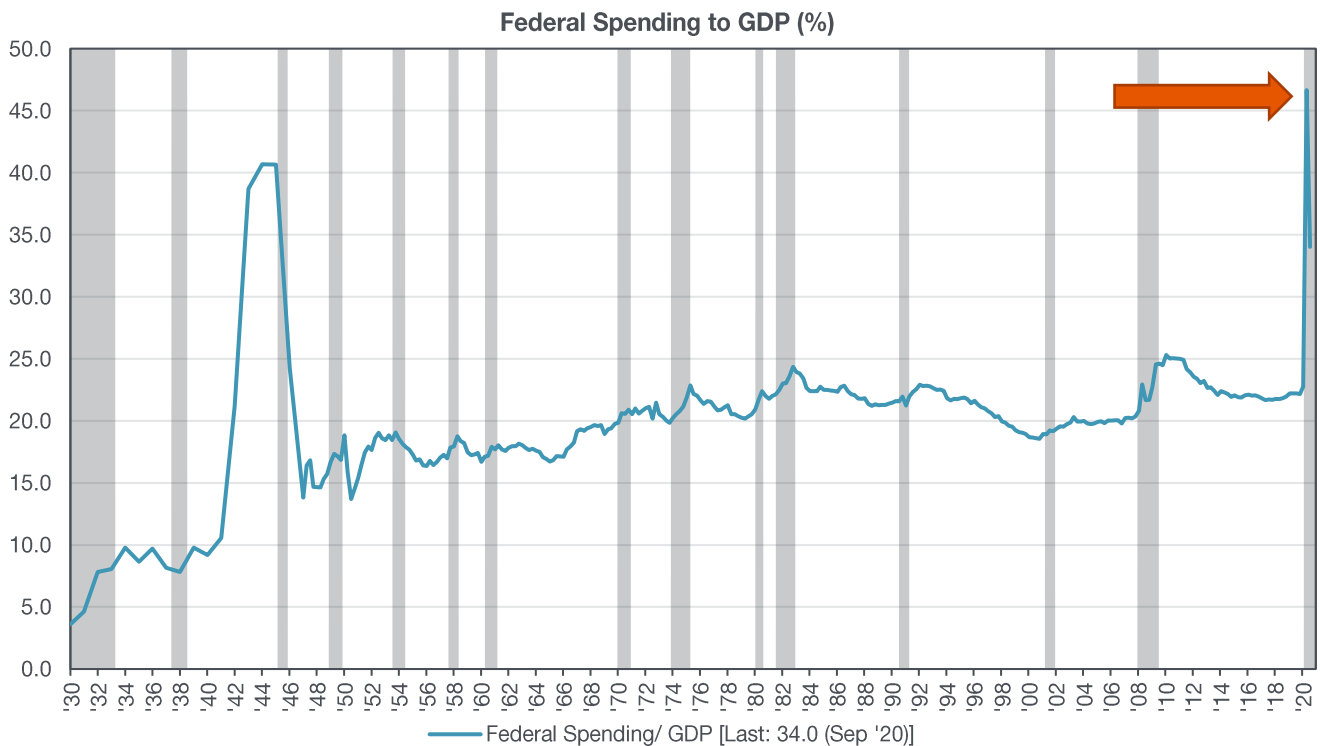
Which brings to mind the credit risk issue. Most of us have become relieved and optimistic that the loss cycle can be contained, as we wrote previously. However, it is too soon to be releasing reserves in our view and investors are not going to reward it.

Our underlying economy, including consumer and commercial balance sheets is still largely invisible under the cloak of massive support measures. These are clearly going to be extended until March, if not longer, which means a credible read on credit damage is very unlikely until the second half of this year.

We should add interest rates to our outlook. Most expect little change from the Fed, but possibly a gradual rise in long term rates. We cannot strongly disagree with this assessment but we are nevertheless cautious and would not embrace interest rate risk in either direction. Our thought is that abnormally low rates can self-correct and, given the choice, we would lean toward expecting some rise in 2021, possibly more than expected.

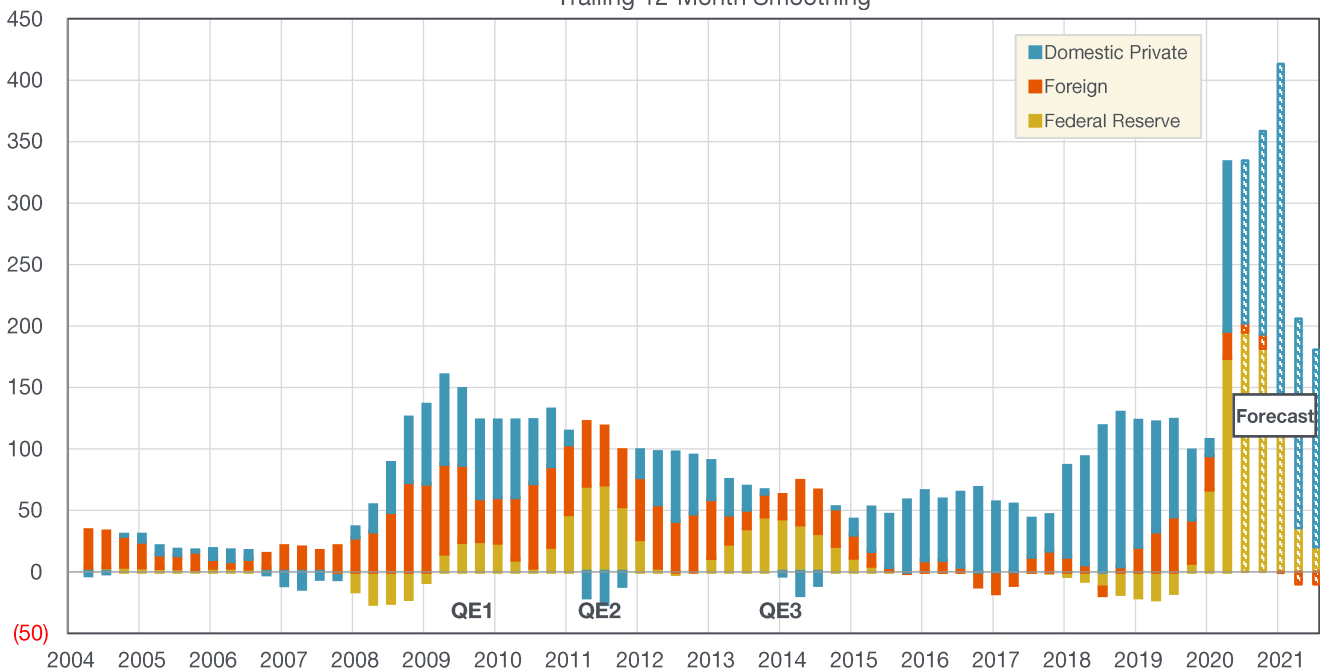
There are two reasons for this. First, the net supply of new Treasuries at auction has now doubled and, second, that CAREs and CAREs 2.0 will be followed by another assistance package and hopefully the beginnings of an infrastructure spend based on our shift in political balance, pushing Treasuries supply to an extreme. An almost unified Democratic government will likely attempt more spending on both, driving supply even higher.

The first sign of this shift is in the sheer size of assistance so far. We completely agree with the need for this and more. However, we note that in 2020 the level of Federal outlays, relative to GDP, exceeded that during World War II, as shown above. The supply/demand exhibit below does not include this additional supply, which can prove to be even more mammoth than it already has been. Is this the final “tipping point?” There is the \$900 billion Coronavirus Relief Bill signed in December, up to another almost \$1.3 +/- trillion for CAREs round three under the Biden Administration, and the mooted \$3 +/- trillion infrastructure package that would add close to another half trillion per annum. The total approaches well over \$5 trillion and almost \$3 billion of it could occur during 2021. Such largess, however needed, would drive the “Forecast” bars shown above literally off the chart! If bond vigilantes actually exist. This will be their year.



Source: U.S. OMB, U.S. Bureau of Economic Analysis

Purchases of U.S. Treasuries
 Net Monthly \$B
 Trailing 12-Month Smoothing



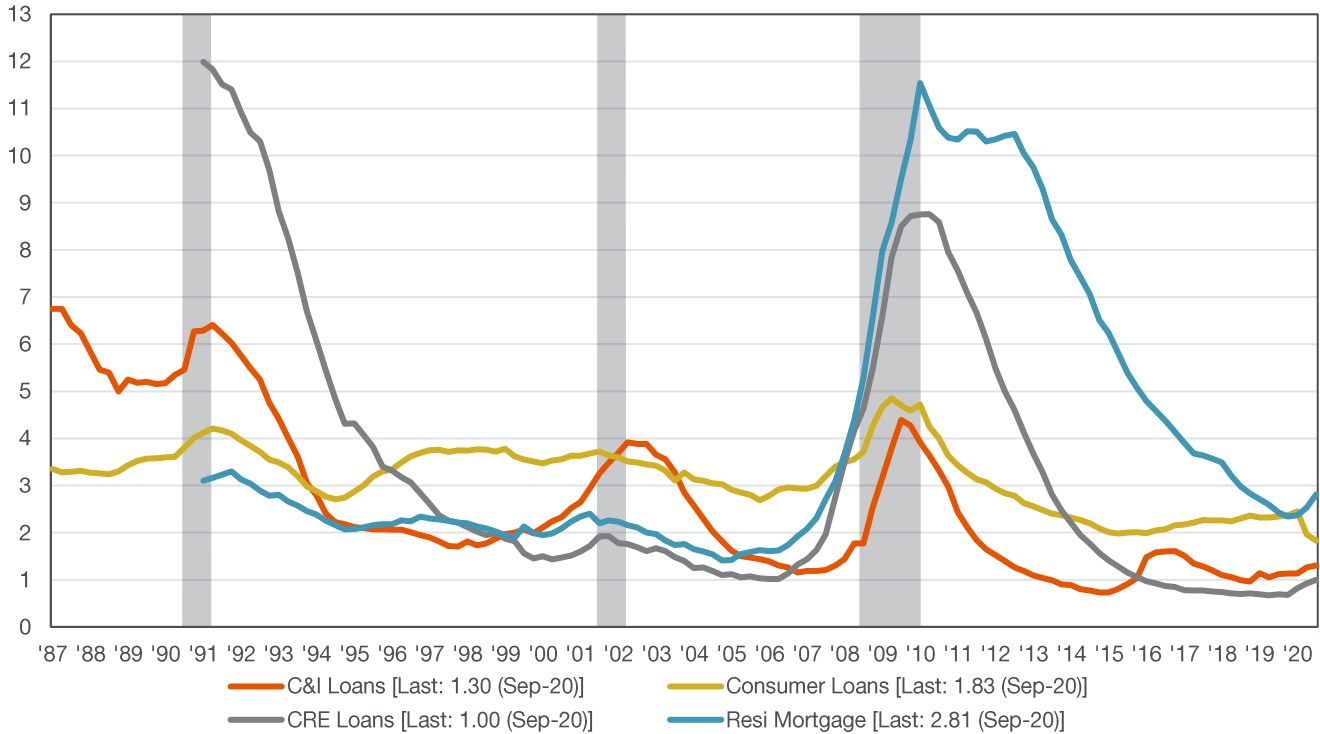
Source: Net Supply History and Projections: CBO & UST; demand projections: Piper Sandler

Finally, credit is a two-edged sword. As we have discussed previously, loss reserves could prove high as there has been little deterioration in credit metrics to date (below), although there are now clear upticks in residential and commercial portfolios (below). There have been many months for lenders to comb their portfolios for risk and a surprisingly sharp decline in deferrals. But it is very premature to declare victory or begin reducing reserves in our view.

Uppermost in this concern is the massive support to our economy in the form of unemployment benefits and PPP lending to small businesses, along with the extremely accommodative monetary policy. The true level of portfolio risk will not be convincingly clear until this support is removed and at least some victory lap is deserved after vaccination deployment. At the moment this deployment is suffering well known delays. With perhaps unfounded but significant resistance within the population, achieving “herd immunity” at 60-70% may take more time than some consider, leaving the possibility of a third round of infections and economic constraints in the fall of this year. COVID is still very much controlling the economy globally. We are unlikely to see full exposure of credit risk until well after support has been removed, certainly not before the second half of this year. We all expect loan losses but we still cannot adequately quantify their severity.

There are multiple risk verticals to watch. Commercial real estate is undoubtedly the largest and repurposing will eventually take years to complete. Hospitality and travel is undoubtedly the hardest hit from employment data. And while CAREs 2.0 has theoretically delayed CECL and TDR recognition, the political tolerance for these may pressure regulators to tighten their judgment and enforcement.

Delinquency Rates: All Commercial Banks (%)

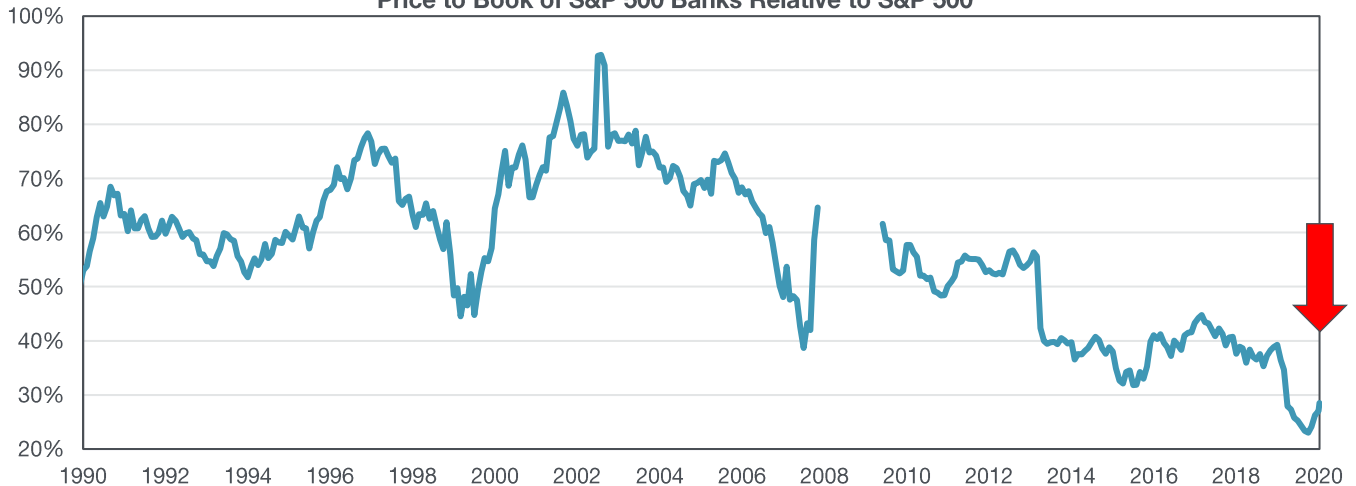


Source: Federal Reserve System

Consolidation is a brighter light as revenue growth remains in the distance and size continues to matter even more so in our outlook. The handful of larger transactions in 2020 revealed many things, including the possibility of significant upside in a buyer's stock when creative product combinations occur. There is also the more liberal definition of acceptable geographic expansion that is winning over the time-honored branch overlap model. One thing has not changed – the lack of ready buyers. MOEs and low premium deals should dominate this next wave of consolidation and the average size of transactions could rise as regionals consider steps toward becoming super-regionals.

In general, we believe earnings and balance sheet valuations for equities have already skipped 2021 and rest on 2022 and beyond projections and estimates. We want to note that it is unusual for “new year” outlooks to immediately see through to the following year, this time made necessary by ongoing COVID. It is also possible that managements come to view 2021 as a year of “kitchen sink” spending, primarily in the race for applied technology. Nonetheless, relative valuations for this sector remain historically low and strongly suggest overweighting.

Price to Book of S&P 500 Banks Relative to S&P 500



Source: Bloomberg

General Information and Disclaimers

This report has been prepared and issued by Piper Sandler & Co., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. The information contained in this report (except information regarding Piper Sandler & Co. and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice. Contact information for Piper Sandler & Co. and the author of this report is available at www.PiperSandler.com

This report has been prepared and circulated for general information only and presents the author's views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice.

Neither this report, nor any portion thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Piper Sandler & Co.

© 2021 Piper Sandler & Co. All rights reserved.