

Synovus Market Update

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On Inflation: Powell Won't Throw in the Towel

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Increasing signs of inflation in the international economy have clouded the currency picture into the second half of 2021, despite very little wage pressure. After the Fed meeting in June, the U.S. Dollar (USD) strengthened predictably after spending most of the year on the back foot. What is in store for the dollar and major currencies heading into the fall and beyond? How is the policy outlook for other central banks changing as their countries come out of the COVID-19 pandemic, or will it remain the same as they address the Delta variant cases?

In his Congressional testimony, Federal Reserve Chairman Jerome Powell offered positive news on GDP growth, stating that it “appears to be on track to post its fastest rate of increase in decades”.¹ Ongoing vaccinations, the reopening of the economy, and accommodative monetary and fiscal policy have achieved all of these goals. With that said, “there is still a long way to go” regarding the labor market. Despite strong labor demand and record high job openings, workers are leaving current jobs and seeking new ones, leaving some slack in the job market. Inflation has been mostly the result of bottlenecks in production and service-related businesses that were hard hit by inflation. Powell sees the effects of inflation in asset prices but expects levels to “likely remain elevated in coming months before moderating”.²

The markets focus of Powell's speech was on tapering, especially as it relates to mortgage-backed securities. Some of the more hawkish Fed presidents in the minority opinion are attributing the rise in housing prices to the Fed mortgage bond buying. “There are some unintended consequences and side effects of these purchases that we are seeing play out,” Dallas Fed President Robert Kaplan said in an interview, which he concludes are contributing to skyrocketing home prices.³ Previously, he had questioned whether purchases were still needed. St. Louis Fed President Bullard seemed to share the sentiment adding, “maybe we don't need to be in mortgage-backed securities with a booming housing market”.⁴





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It appears most Fed officials perceive that mortgage bond buying lends support to the entire economy rather than just propping up the housing sector. Greater factors in spiking housing prices than mortgage-backed security purchases include inventory shortages, homeowners escaping high tax areas, remote work, and flight from cities because of higher crime. Furthermore, many Americans are reprioritizing their work/life balance, leaving cities for suburbs and better schools.

Powell is resisting the impulse to taper. The Fed is “continuing to increase our holdings of Treasury securities and agency mortgage backed securities, at least at their current pace until substantial further progress has been made toward our maximum-employment and price-stability goals”.⁵ Additionally, the 5.9% unemployment rate remains well below levels we saw pre-COVID-19, and wages are not seeing the same inflation increase as the other supply shock business inputs for a few reasons. The United States finds itself in a different circumstance than the rest of the world. Changes in border policy from the previous administration, coupled with the flood of relief money that has kept potential workers home, are contributing to keep wage price pressure low. Unless the U.S. sees the labor price input contributing to inflation pressure, the Fed will resist the need to taper or raise rates.

Central banks abroad are telling a different story. This week, the Reserve Bank of New Zealand ended its bond buying campaign, signaling a strong possibility they will raise rates in August. Rising commodity prices and an overall positive outlook on the economy have boosted demand and solidified the job numbers. Although Australia has seen a similar improvement in jobs, the Reserve Bank of Australia outlook for a rate increase is not until 2024. COVID-19 restrictions have been maintained in Sydney, dampening the growth picture.

Across the pond, the Bank of England’s Michael Saunders said they could stop its government bond purchases due to an unexpectedly sharp rise in inflation.⁶ Consumer prices were up 2.5% and Deputy Governor Dave Ramsden is calling for 4% inflation this year. Job growth has been has seen a real increase in wages, unlike the United States. This seems to be moving the U.K. away from a transitory inflation stance induced by supply shortages and more into a real inflation position based upon rising wage input for businesses.

The Canadian story echoes the British one, as the Bank of Canada announced they were reducing their bond purchasing program. In contrast, they will keep rates low, despite warning that inflation could be higher than previously anticipated. The Bank of Canada doesn’t seem to be as hawkish as the U.K, which is still looking to hike rates in late 2022. Oil also factors into keeping the Canadian Dollar strong over the long term, as companies transition to renewables that cost more than fossil fuels, passing those costs onto consumers. Canada is heavily dependent on oil industry revenue, so it is positively correlated to oil prices. Also, the opening of the economy after COVID-19 will keep upward pressure on oil demand, as Canada has been slower to open compared to the U.S. Moreover, supply chains that were disrupted over the last year, including the Colonial Pipeline hack and the Keystone Pipeline shutdown by the Biden Administration, should keep oil prices well supported into next year. The Central Bank of Norway, another oil reliant country, has also talked about future rate increases.

Increasing cases of the COVID-19 Delta variant could create similar disruptions as last year in some states and abroad, supporting current Fed policy guidelines. In the U.S., officials have stated virtually all recent COVID-19 hospitalizations and deaths are occurring among unvaccinated people. Breakthrough infections are rare, and about 75% of the people who die or are hospitalized with COVID-19 after vaccination are over the age of 65, according to data from the Centers for Disease



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Control and Prevention.⁷ That data supports what we already have learned about COVID-19, yet we already see Arizona, California, Colorado, Florida, Louisiana, Michigan, New Mexico, and Texas reinstating mask mandates. It is fair to assume other areas of the country will follow this example, warranted or not, disrupting supply chains and slowing growth. Despite rising vaccination rates, a return to pre-Corona normality seems questionable,» said Ulrich Leuchtmann, head of FX and commodity research at Commerzbank.⁸

Fed policy strongly indicates a soft USD policy, at least until there is significant pickup in labor activity. Inflation will continue to be elevated, yet transitory, and the dollar should weaken again into year end. The COVID-19 effect, with increasing cases, could lead to a correction in equities from this summer's highs, and a retreat in most crosses against the Japanese Yen (JPY). The 10-Year Treasury Yield has touched the lowest levels since January at 1.18%, as the market overreacted to growth slowing. Strong support in the 10-year resides at 1.15%, and the latter part of the week resulted in a correction to 1.28%. The USD/JPY pair (110.20) is lagging the 10-Year, as I discussed last month, and could reach 107.00 before a correction, but it may need a steep selloff in equities by 10% or more to see those levels. The USD has been stronger this summer, and I believe it presents an opportunity to be long(buy) New Zealand (NZD), Great Britain (GBP), and Canada (CAD), and eventually Norwegian Krona (NOK) versus the USD. The timing of this could be tricky if COVID-19 restrictions hinder the GDP outlook.



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Energy Update

Wade Fowler, Senior Trust Portfolio Manager

U.S. consumers are noticing rising prices throughout many parts of the economy. From groceries to durable goods and even certain parts of the service economy, prices are simply much higher today than they were a year ago. One of the most visible and impactful changes in prices consumers have experienced is the change in gasoline prices. According to AAA, the national average for a gallon of regular gasoline is currently \$3.15. That is an increase of 43% since this time last year and a level not seen since 2014.

It may seem odd that while many parts of the U.S. and global economy have yet to fully reopen from the pandemic, we are seeing crude oil prices at seven-year highs. The explanation for this is mostly related to the supply side of the equation. As seriousness of the pandemic was being fully appreciated in 2020, the dominant oil cartel in the world, known as



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OPEC, agreed to reduce production equivalent to approximately 10% of the global daily supply of oil. This action, together with lower oil prices due to much lower oil demand, forced a slowdown in production across U.S. oil-producing regions. Bankruptcies and restructurings in the energy sector were occurring practically daily during 2020. As the global economy has recovered over the past year, oil demand has also recovered. Oil inventories filled to the brim just a short time ago have been steadily depleted given the reduced production. In response, an OPEC agreement announced this week will allow for monthly increases to increase production fully to the baseline level of production that existed before pandemic-related cuts were implemented. As is true with many parts of the economy right now, we have significant unknowns that will impact the oil market soon. Some of these unknowns have the potential to create additional volatility in the oil markets. The COVID Delta variant, which has caused some angst in the market over the past month, threatens to slow and possibly reverse plans for reopening. Also, a potential new nuclear agreement with Iran would allow for significant new supplies of oil to be exported to global markets. Finally, when looking at technical factors in the oil markets, we can see high levels of optimism in energy trading markets that can be an indicator of additional risk. Our view is that the sticker shock you may be having when filling your tank has the potential to ease some in the second half of this year.



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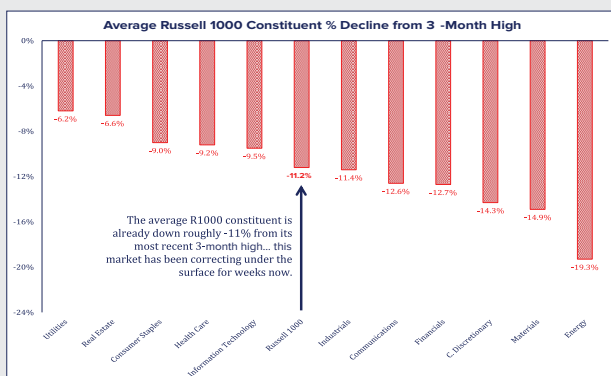
Technical Analysis

Bob Hanberry, Senior Trust Portfolio Manager

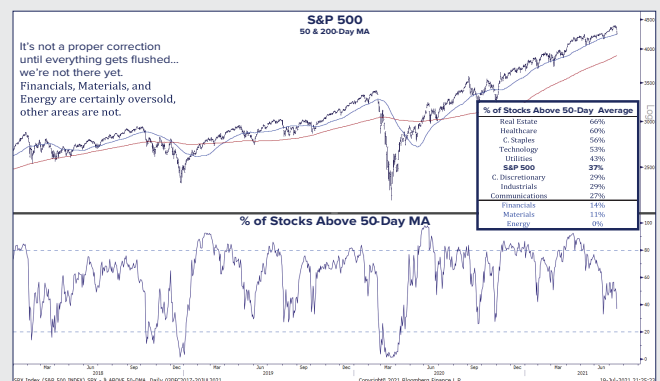
While some areas of the market oversold, others did not. Parts of the market have been correcting since May or earlier, and some sectors are pretty washed out. Greater than 50% of issues traded to a 3-month low in financials (51%), materials (57%), and energy (55%) sectors on July 19. Industrials and discretionary are also close while other sectors are not. The S&P 500 is currently being held up by larger weighted names in technology, real estate, healthcare, and staples sectors. The market has not gone through a proper corrective phase until everything gets flushed, and we are not there yet. It will be interesting to see if we get a meaningful correction as the market moves through the seasonal weak pattern of mid-July through mid-October. Headlines have certainly turned in recent days on increased COVID-19 cases from the Delta variant.



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Source: Strategas





Technology Corner: Is Robinhood's Forthcoming \$35 Billion Projected IPO a Sound Value Investment?

Dan Morgan, Senior Trust Portfolio Manager

Robinhood Markets (symbol: HOOD) has filed to become one of the most anticipated initial public offerings of the year. A financial services company founded in 2013, Robinhood's mission is to provide everyone the opportunity to make fee-free investments. Its main product is an app designed to make it easy to buy and sell stocks and options without a financial broker or paid commissions. In addition, Robinhood offers cash management accounts and cryptocurrency trading capabilities. Furthermore, the app allows investors to browse the 100 most-held stocks to help determine what to buy next. Robinhood's rapid growth has resulted in 18 million retail clients, and more than \$80 billion in customer assets. However, the brokerage firm lost \$1.4 billion in the first quarter of 2021, tied to emergency fundraising-related losses during January's GameStop trading mania. The name Robinhood Markets has become synonymous with the wild momentum stocks GameStop and AMC Entertainment, which have dominated recent financial headlines.



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Valuation

Market pundits are throwing different IPO valuation values around, and the last published estimate valued a HOOD IPO at \$35 billion. After running some valuation metrics for companies like HOOD, we can see how these figures would stack up against their most likely publicly traded competitors, TD Ameritrade and E*TRADE. E*TRADE was acquired by Morgan Stanley, and TD Ameritrade was purchased by Charles Schwab. Large Wall Street firms like Goldman Sachs, Morgan Stanley and Merrill Lynch do not really have similar business models to HOOD, so we cannot use those metrics for purposes of comparison.

Robinhood's Valuation					
Company	Ticker	IPO/Market Cap	Revenues	Price-to-Sales Ratio	Assets-to-Price
Robinhood	HOOD	\$35 billion	\$2.088 billion	16.8x	\$2.30
Charles Schwab*	SCHW	\$126.724 billion	\$14.574 billion	8.7x	\$3.00
E*TRADE**	ETFC	\$13 billion	\$2.886 billion	4.5x	\$27.60
*Based on a calculated Revenue Run Rate for the 1Q21 Sales of \$522 Mn					
**Figures taken from E*TRADE's 2019 10-K as of the February 2020 acquisition by Morgan Stanley					

A HOOD IPO valuation of \$35 billion would be equal to a price-to-sales multiple of 16.8x (IPO Market Cap \$35 billion/\$2.088 billion revenue run rate) the current revenue run rate of \$2.08 billion (\$522 million of sales as of the first quarter 2021). If we value HOOD based on its fiscal year 2020 annual net deposits (assets) of \$80 billion, this will equate to a multiple of 2.3x (\$80 billion assets/\$35 billion IPO market cap). This means that for every dollar invested in the \$35 billion IPO price, a given investor will acquire \$2.30 worth of actual company net deposits (assets). To assess how the HOOD multiples appear, it is worthwhile to compare them to the market leader Charles Schwab, currently valued at a price-to-sales of 8.7x (\$126.724 billion market cap/ \$14.574 billion trailing fourth quarter 2020 sales) with a multiple 3.0x short-term/ long-term investments or assets (\$382.4 billion assets/market cap \$126.724 billion).



Additionally, if we look at the price Morgan Stanley paid for E*TRADE back in February of 2020 and compare it to the \$35 billion IPO value for HOOD, we can draw the several conclusions. When Morgan Stanley bought E*TRADE, they paid \$13 billion or \$58.74 a share. At the time of the acquisition, E*TRADE had revenues in fiscal year 2019 of \$2.886 billion, 5.2 million customers with \$360 billion in assets, (versus \$80 billion annual net deposits/assets for HOOD), which resulted in E*TRADE's valuation at the time of the acquisition by Morgan Stanley at a price-to-sales of 4.5x (\$13 billion acquisition price by Morgan Stanley/\$2.886 billion fiscal year 2019 revenues). Looking at the value of the assets acquired would result in a multiple of 27.6x (\$360 billion assets/\$13 billion purchase price), meaning that Morgan Stanley received \$27.60 in deposits/assets for every dollar invested at the \$13 billion acquisition price, which is certainly not a bad deal compared to the \$2.30 in deposits/assets for each dollar invested that a Robinhood investor is slated to receive at the time of the IPO.

According to Robinhood's first quarter 2021, the company stated that it had 17.7 million monthly users, which would mean that the average HOOD platform user had a medium account size of about \$4,519 (\$80 billion assets/ 17.7 million Users). Ultimately, from every angle, a \$35 billion IPO for HOOD looks very rich.

Transaction Fees

Since HOOD relies primarily on transaction-based revenues (equity trading fees represented 80% of total revenues as of the first quarter 2021) as opposed to fee based revenues (mutual funds & managed assets), the stability/continuation of its model is highly dependent on high equity market volume. Furthermore, approximately 15% of HOOD's revenues come from cryptocurrency trading. According to the recently filed S-1, "Transaction-based revenues consist of the amount earned from routing customer orders for options, equities and cryptocurrencies to market makers. When customers place orders for equities, options, or cryptocurrencies on our platform, we route these orders to market makers, and we receive consideration from those brokers".⁹

Additionally, the S-1 stated that 50% of HOOD's customers are relatively new to investing. Therefore, it may be safe to say that that a typical HOOD customer has not invested through major market downturns like the tech bubble or housing crisis. During the 2008-2009 housing crisis downturn, it took five and a half years for the stock market to bottom out and return to its previous high. Often, during severe prolonged market downturns, speculative investors lose interest as the bear market works itself out and trading volume on speculative types of securities dries up, such as internet stocks following the tech bubble burst in 2000. Thus, the major concern with HOOD's model is how durable the revenue base is without fee-based income, especially if the market goes through a prolonged bear market (not like the quick V-shaped COVID-19 selloff).

Scalability to Profitability

Many of the most recent high-flying IPOs with huge revenue growth rates, but no profits to show for it, have not performed well in today's market (shares of Uber year to date (YTD) -7.2%, Airbnb YTD -5.5%, Snowflake YTD -5.8%). A dramatic example of poor market performance is Lyft, which IPOed at \$72.00 on March 28, 2019, and is now trading at \$54.55. The "growth at all costs" mantra is being superseded by investor desire to see new up-and-coming companies turn a profit. So, the big question is, will investors be willing to pay up for HOOD, another high-flying growth company with an inconsistent path to profitability?

If we evaluate HOOD's expenses as a percentage of revenues, it has been relatively consistent. Quarterly operating expenses have typically exceeded revenues. In the past nine quarters, (periods ending March 31, 2018 to March 31, 2021), HOOD only made a small operating profit twice. This is because as revenues rise, operating expenses as a percentage of revenues also rise the same or more. So, at what revenue plateau does HOOD need to get to in order to drive the percentage of operating costs down to become consistently



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profitable? Lyft and Uber are still trying to achieve their goals of positive EBITDA on a much higher revenue basis. Is it possible for HOOD to ever become profitable when relying mostly on transaction fees received from a fixed percentage of the difference between the publicly quoted bid and ask at the time the trade is executed?

Other Challenges for the HOOD IPO:

1

HOOD's S-1 filing outlines the company's plans to democratize finance, yet, Robinhood faces controversy over its business practices and is also dealing with numerous legal issues.

2

The company is growing rapidly, but suffered huge monetary losses at the beginning of 2021 as increased deposit requirements were imposed on Robinhood by the NSCC as a response to unprecedented market volatility, causing the company to temporarily restrict trading of both GameStop and AMC Entertainment on their platform.

3

Initial trading will be extremely volatile, as the same momentum generated by the investors it has propped up could someday turn against the company.

Source Footnotes:

¹ <https://www.federalreserve.gov/newsevents/testimony/powell20210714a.htm>

² <https://www.federalreserve.gov/newsevents/testimony/powell20210714a.htm>

³ <https://www.wsj.com/articles/fed-officials-debate-scaling-back-mortgage-bond-purchases-at-faster-clip-11624872602>

⁴ <https://www.wsj.com/articles/fed-officials-debate-scaling-back-mortgage-bond-purchases-at-faster-clip-11624872602>

⁵ <https://www.federalreserve.gov/newsevents/testimony/powell20210714a.htm>

⁶ <https://www.reuters.com/article/us-britain-boe-saunders/boe-may-need-to-end-bond-buying-early-as-inflation-mounts-saunders-idUSKBN2EL16F>

⁷ <https://www.cnn.com/2021/07/12/most-fully-vaccinated-people-who-get-covid-delta-infections-are-asymptomatic-who-says-1/index.html?recirc=taboolainternal/>

⁸ Top News | Risk FX retreat catapults dollar to 3-month top as reflation doubts reemerge (thomsonreuters.com)

⁹ Form S-1 Registration Statement for Robinhood Markets Inc. July 1, 2021

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