

Synovus Market Update

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Inflation and the Supply Chain

Wade Fowler, Senior Trust Portfolio Manager

Inflation has become a hot topic in the United States lately. Prices for nearly everything we buy have gone up noticeably over the past year. While expectations for additional increases are more moderate in 2022, some areas of our economy are just starting to increase in price. The most recent official figures for inflation are from October. The monthly Consumer Price Index (CPI) report showed a 6.2% increase in consumer prices compared to October 2020. While this figure is helpful to give us an idea of the average inflation for all consumer products, it also hides some big increases in individual areas of the economy that tend to cause the sticker shock we sometimes experience when inflation occurs.

The Federal Reserve Bank of Atlanta tracks the price changes of different baskets of items, which provides some insight into consumer prices beyond the monthly CPI number. The chart below shows a flexible price basket and a sticky price basket. The flexible basket contains consumer goods subject to more frequent changes in price, such as new and used cars, hotel stays, gasoline, and groceries. The sticky basket contains items that adjust in price less frequently and are typically more service-oriented. Examples of items in this basket are rent for a primary residence, medical care services, and meals eaten outside of the home. As you can see in the chart, the flexible goods basket has experienced a substantial increase over the past year, while the sticky basket has only very recently started to move higher.

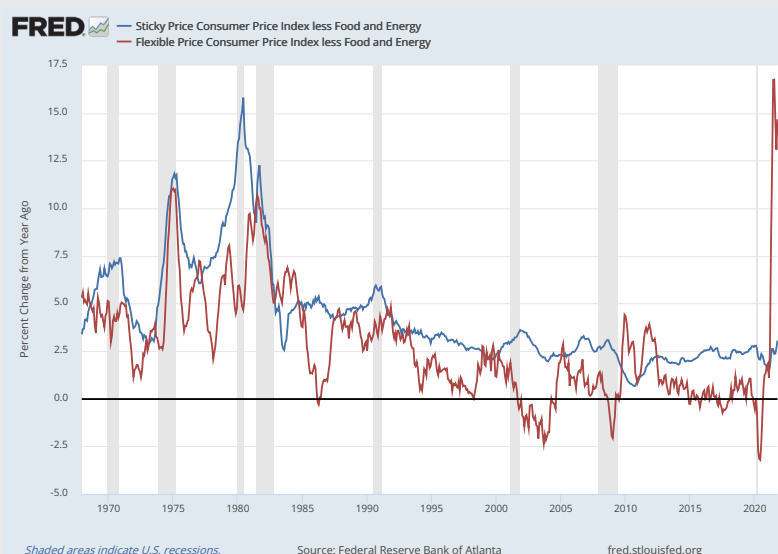
Reasons and causes for inflation can be a long discussion, but at its most basic level, the prices we pay for goods are defined by the intersection of supply and demand. Over the past year and a half, various parts of the global economy have been stopped and restarted. Consequently, disruptions to the global supply chain have created shortages of all types of goods across the country. It should be no surprise that the largest

increases in prices can be found in goods most impacted by problems in the supply chain.

Our view is that as bottlenecks currently existing in the supply chain resolve themselves, the extreme level of inflation in the flexible basket will come down substantially. We feel there is more room for the sticky basket figures to increase. There are two primary reasons to expect this to occur. First, home prices have risen substantially over the past year, likely leading to higher rents charged over time. Second, the labor market is currently very tight, leading to wage increases for workers. As wage increases impact pricing for service industries, we expect to see further upside in pricing in that part of the economy.



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Source: FactSet, Federal Reserve Bank of Atlanta



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These views are based largely on the assumption that consumer demand will stay relatively stable over the next year, and that pandemic-related disruptions will subside. If demand suddenly increases, or there is an unexpected disruption to the supply of goods again, a more prolonged period of inflation would likely result.

Turkey's Dangerous Monetary Experiment

David Grimaldi, Foreign Exchange Sales Consultant

Erasing any remaining confidence in the Turkish lira, President Recep Tayyip Erdogan has taken the unusual step of installing central bank leaders who will execute his favored policy of cutting interest rates. The central bank has cut interest rates 400% since September 2021, and the value of the lira has dropped 46% versus the U.S. dollar since February. Turkey relies heavily on imports for food and goods it cannot produce at home. As such, the increased costs of imported goods, coupled with a depleted inventory, have accelerated inflation. "The price increases due to the rise in the exchange rate do not directly affect investment, production, and employment," Erdogan said on November 22, 2021. "The competitive power in the exchange rate leads to an increase in investment, production, and employment."¹ Meanwhile, Turkish Consumer Confidence dropped 7.4% last month to its lowest level since 2004. Furthermore, Turkey's 10-year bond yield surged above 19%, as these deep interest

rate cuts have delivered the export growth that Erdogan has sought. Since the cost of insurance for Turkey's debt is soaring as credit default swaps topped 450 basis points, creditors have become reluctant to invest. Erdogan has been slowly increasing his control after narrowly surviving a failed coup attempt in 2016 for his role in decreasing secularism, violating human rights, and stifling democratic control. Consequently, an already impoverished nation will suffer due to shortages of food staples, as prices continue to rise.

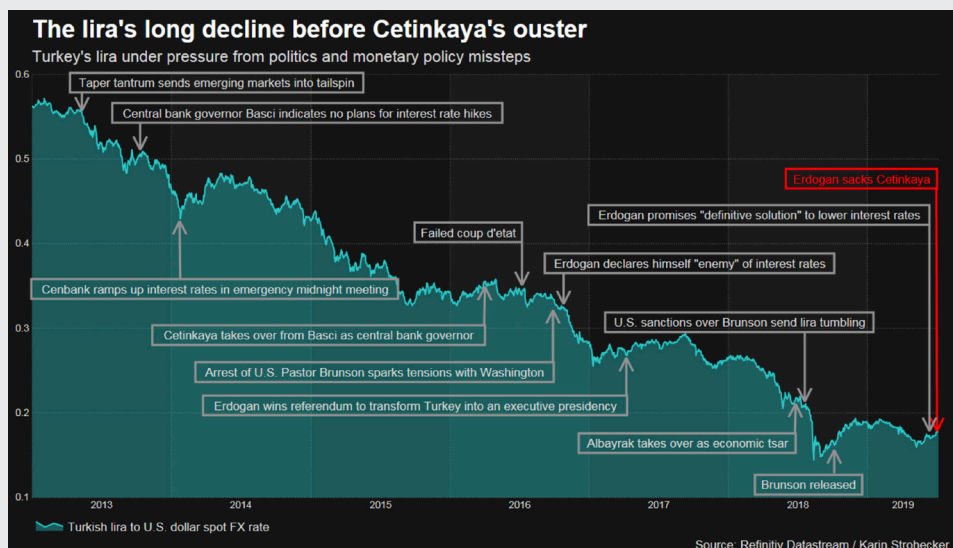


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Consensus estimates conclude that annual inflation in Turkey is above 50%, compared to the figure just below 20% given by the country's official statisticians. And it looks set to rise further in the coming period. Turks, scrambling to protect their savings, are discussing "hyperinflation".² Monetary policy has been a cause of concern dating back to 2018 when Erdogan fired the more hawkish central bank head Naci Abgal. Subsequent losses are now mirroring 2018, as the value of the lira has lost almost 47% of its value against the dollar since February 2021. Erdogan, who does not come up for re-election until 2023, seems hyper-focused on expanding the country's growth and

credit. However, loan growth has seen very little expansion due to country risk factors, and global inflation has caused a flight to safety in assets. Although GDP figures could be as high as 10-12% due to Erdogan's monetary policy, inflation at 50% has eroded any of that benefit.

Repercussions of inflation have depleted the Turkish people's disposable income to purchase food staples, housing, fuel, and raw materials. The most tangible impact of inflation has been on consumer food prices. Market-stand owner Kadriye Dogru often goes hungry to feed her kids at night. She states, "I had never experienced such a deplorable life. I go to sleep; I wake up and the prices have



Source: Reuters



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gone up. I bought a 5-liter can of (cooking) oil, it was 40 lira. I went back, it was 80 lira,” she said. “We don’t deserve this as a nation.” Turkey’s main source of flour comes from Russia, which makes up close to 65% of trade. In the first four months of 2021, Turkey’s wheat imports fell by 24%.⁴ Food prices are up over 27% annually. Higher prices are also impacting housing. Protests by students sleeping outdoors in parks have brought a rebuke from Erdogan, who has deemed the demonstrations terrorism. Home sales and rent pegged to the U.S. dollar are causing large price increases. Turkey is also a net importer of energy and raw materials, which is consequently adding to price hikes due to a free-falling currency. Erdogan is reacting as most leaders who cannot manage an economy or increase the currency value by promising higher minimum wages from already struggling business owners.

Turkey’s central bank has failed in its role to appear independent of Erdogan in his pursuit of a declared war on economists, opportunists, and “financial acrobats”.⁵ Ali Babacan, who served for years as an economy chief in Erdogan’s government, now heads the opposition Deva party that accuses Erdogan of “bankrupting” the country. Ahmet Davutoglu, a former prime minister and one-time chair of Erdogan’s ruling Justice and Development Party, went further. “This is no longer ignorance, this is treachery”.⁶ The return of investment in Turkey can only occur with some semblance of an independent central bank and the stabilization of the lira to prevent its collapse. Unfortunately, both cases are unlikely, as Erdogan seems to embrace the paradox of slowing inflation by devaluing

currency. He believes focusing on growth will stop his negative slide in the polls. Central Bank Governor Sahap Kavcioglu echoes Erdogan’s belief that these policies will turn the current account deficit into a surplus. While exports have increased this year, imports are still surpassing this growth, keeping the current account negative.

Global investors and governments who are watching these events unfold in Turkey do not foresee that the country will return to an independent central bank or prevailing economic theory. Erdogan has replaced three central bank governors in the last three years who disagreed with his assertion that high rates cause inflation, which runs counter to almost all economic theories. Private Turkish lenders are hesitant to boost credit given the risks of stoking a hot economy and possible company defaults. Nevertheless, the big three state banks have followed the central bank’s lead and slashed borrowing costs in line with the easing.⁷ Credit had already expanded in Turkey because of COVID-19 in 2020, resulting in the central bank correctly tightening rates until March 2021. Since then, the reversal in rates has resulted in the worst losses to the lira in 20 years. Erdogan’s actions have abandoned all practicality and are scaring investors away instead of



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attracting them. Citizens who get paid in lira, however, are the real losers as their buying power continues to get crushed, for what little available goods they can afford on the store shelves.

Opposition leader Kemal Kilicdaroglu simultaneously excoriated and summarized the effects of Erdogan's policies. "You have turned the Turkish lira into a discredited currency and have put our economic independence up for sale."⁸ Unfortunately, the administration appears to be doubling down on these failed policies.

Johnson & Johnson Plans to Spin-off its Consumer Health Business: What Does this Mean for the Two Stocks?

Daniel Morgan, Senior Trust Portfolio Manager

Johnson & Johnson recently announced it will split its pharmaceutical and medical device business (84% of revenue, 85% to 90% of profits) from its consumer business. Although investors have called for a split for many years, the company has historically resisted the idea, on the premise that the sum is more valuable than its parts. However, the company believes that the healthcare environment has evolved, and the change is warranted. The split should lead to more focus and greater agility between the two remaining businesses. The capital market environment is a contributing factor, given its appetite for new issuances. While J&J's consumer business has provided stability over the years, there are few selling synergies, and the company's segments are largely run independently. All in, this should be viewed as a shareholder-friendly action and has the potential to unlock additional value.

The transaction will be a tax-free spinout. The overall dividend is expected to be at the same level as it is today. J&J's new consumer business is expected to have a "strong investment grade" profile, and the new J&J is expected to have a "superior investment grade" profile. Notably, J&J is only one of two companies with a AAA credit rating. The new J&J will continue to be the industry's largest healthcare company and should generate 5% revenue growth. J&J expects approximately \$500 million to \$1 billion in cost dis-synergies. However, the

company's goal will be to minimize this amount through operational improvements and efficiencies. Despite these expectations, Moody's placed J&J on credit negative shortly after the announcement. Although there is currently no change to J&J's Aaa long-term rating, Moody's will continue to evaluate credit implications of the separation as additional details become available.

The new J&J (or remaining company) will be led by the incoming CEO Joaquin Duato, and current CEO and Chairman Alex Gorsky will transition to executive chairman of the board beginning in January 2022. Although the new consumer health business leadership has not been announced, the separation is anticipated to be completed in 18 to 24 months. The transaction is expected to qualify as a tax-free separation, and the overall shareholder dividend (between the two companies) will remain at least at the same level post separation. The new consumer health business is expected to generate an estimated revenue of \$15.2 billion in 2022, and the pharmaceutical (excluding vaccine) and medical device segments are expected to generate \$83.7 billion, based on a recent analysis by Morgan Stanley.⁹

Given the market's focus on higher-margin, higher-growth businesses, the removal of the consumer business should be viewed positively, as it could unlock greater returns from more concentrated investments for the pharmaceutical and medical device business. Additionally, the pharmaceutical and medical device segment as a stand-alone entity should generate a pre-tax income margin of 36.1% versus just 24.0% for the consumer business spinoff. J&J's pharmaceutical and medical device segment profit margin compares favorably to its pharmaceutical peers Bristol Myers, Eli Lilly, Merck, and Pfizer, whose cumulative average margin is approximately 39.9%.



Notably, J&J is only one of two companies with a AAA credit rating. The new J&J will continue to be the industry's largest healthcare company and should generate 5% revenue growth.



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J&J's story has been the same for years; its peer-leading drug unit drives strong growth and delivers a fat margin, while its medical-device and consumer-health businesses have been a drag on the company. This is unlikely to change, given its strong drug pipeline. COVID-19 made only a minimal dent in J&J's pharmaceutical business – 55% of 2020 revenue versus 47% in 2017 – while medical-device sales tumbled.

J&J received funding from the U.S. Biomedical Advanced Research and Development Authority to develop its SARS-CoV-2 vaccine. The single-dose regimen has been authorized by various governments; however, blood-clotting and Guillain-Barre syndrome cases have overshadowed its rollout. While side effects are rare, the FDA added a warning label to the vaccine. Although the FDA has approved the use of a second shot, the majority of second vaccinations may be with mRNA vaccines from Pfizer-BioNTech or Moderna, not J&J. Commercial profit isn't expected until late 2022-23, a year behind previous expectations.

J&J's pharmaceutical segment key cash cows – Remicade and Zytiga – are facing increased competition. Remicade, one of the very first biologics for the treatment of rheumatoid arthritis, is facing pressure from Pfizer's biosimilar Inflectra, launched in 2016. Consequently, Remicade's 2020 global sales are down 13% operationally.

Zytiga is a much more straightforward story, given that it is facing standard pressure as a small-molecule drug, with 20% decline in sales after a full year of generic pressure.

J&J Key Clinical Catalysts Potential Clinical Data Presentations

Phase III

✓	Stelara (ustekinumab) Chron's Disease H2H vs. Humira (Seavue)
✓	Invega Hafyera (PP6M) Schizophrenia (ROUTE 6)
✓	Imbruvica (ibrutinib) Frontline chronic lymphocytic leukemia (I+V fixed duration) (GLOW)
✓	Erleada (apalutamide) Metastatic castrate sensitive prostate cancer- Final Analysis (TITAN)
✓	Darzalex (daratumumab) Multiple Myeloma (MAIA) Overall Survival Benefit

Phase II

✓	Rybrevant (amivantamab) 2L NSCLC (CHRYSALIS)
	milvexian (factor Xla) Total Knee Replacement AXIOMATIC-TKR)
✓	ciltacabtagene autoleucl (BCMA CAR-T) Multiple Myeloma (CAARTTUDE-1 Longer term follow-up)
	teclistamab (BCMA/CD3) Relapsed refractory multiple myeloma (TECLIMMY 1001)
✓	VAC18193 RSV Adult Vaccine (CYPRESS)

in the U.S., countered by strong growth outside of the U.S. Lastly, Pfizer's Xtandi and J&J's newly launched Erleada have also contributed to Zytiga's decline.

Despite competitive hurdles, J&J has a strong pipeline of promising compounds. Phase II trial data on use of the new anticoagulant drug Milvexian, used to reduce the risk





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of postoperative venous thromboembolism in patients undergoing total knee replacement surgery, will be presented in November with secondary stroke-prevention data expected in early 2022. Other promising compounds currently in Phase III trials include Stelara (Crohn's disease), Invega Hafyera (schizophrenia), Imbruvica (chronic lymphocytic leukemia), and Erleada (prostate cancer). A more extensive pipeline update is expected in the fourth quarter. Darzalex (multiple myeloma), could be one of J&J's most important growth drivers, as early data has been impressive. Darzalex, which originated from Genmab, is an example of the strength of J&J's in-licensing capability. The drug has progressively made its way from use in late stages of multiple myeloma to earlier lines of treatment and is rapidly becoming a standard of care. Furthermore, positive trial data in first-line myeloma has supported label expansion, pushing Darzalex into first-line therapy. J&J pays Genmab an average of 15% on sales up to \$3 billion, and 20% above that. In March 2020, Sanofi's Sarclisa was approved



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by the FDA, and while the drug poses some threat, data from clinical trials is still being collected. Finally, CAR T therapies pose some low market risk to J&J's Darzalex.

In summary, J&J's pharmaceutical and medical device business (84% of revenue, 85% to 90% of profits) seems to generate greater potential profit growth than its smaller consumer business brother (15% of revenue, 15% to 0% of profits). However, this type of company split does not always yield a predictable outcome.

For example, in November 2015, Hewlett Packard split into two companies—the mature cash cow, HP Inc. (printer and PC segment), and the faster growing and higher margin entity HP Enterprises (cloud and networking segment). Since the official breakup date of Hewlett Packard, HP Inc. has generated a total return for shareholders of 213% versus just 102% for HP Enterprises shareholders. Will J&J's pharmaceutical and medical device stand-alone company outperform its smaller consumer business brother? Only time will tell.



Will J&J's pharmaceutical and medical device stand-alone company outperform its smaller consumer business brother?

Source Footnotes:

¹<https://www.al-monitor.com/originals/2021/11/food-price-hikes-feared-turkey-after-currency-slump#ixzz7D39sBzt0>

²<https://www.intellinews.com/turkey-cuts-rates-again-as-erdogan-defies-crisis-warnings-227435/>

³<https://abcnews.go.com/Business/wireStory/dont-deserve-inflation-hits-turkish-people-hard-81203247>

⁴<https://www.al-monitor.com/originals/2021/11/food-price-hikes-feared-turkey-after-currency-slump#ixzz7D39sBzt0>

⁵<https://www.ft.com/content/42c4a40c-8aec-4aee-94dc-dba5208a12f9>

⁶<https://www.ft.com/content/42c4a40c-8aec-4aee-94dc-dba5208a12f9>

⁷<https://www.reuters.com/markets/europe/erdogans-risky-experiment-heal-turkeys-economy-2021-11-23/>

⁸<https://finance.yahoo.com/news/lira-weakens-past-12-per-104006032.html>

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