Synovus Market Update

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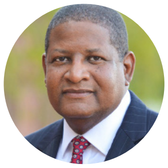

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Inflation and the Dollar

David Grimaldi, Foreign Exchange Sales Consultant

Consumer prices in May accelerated to the fastest growth rate in over a decade, rising 5% versus 2020. On top of that, Core CPI was up 3.8%, the largest increase since 1992. We are seeing it in the food we buy, our trips to the local home supply store, and at the gas pump, but are we really heading back to the 1970s of high interest rates and long gas lines? Well, don't break out your pet rock or your disco ball just yet, because some factors may be missing to complete an entire runaway inflation picture.

Although consumer prices are higher, inflation isn't simply calculated by evaluating the price of consumer goods. Job input must be factored into the equation. As help-wanted signs go up all over the country, wage pressure is still failing to drive inflation. Part of the reason is that, in some cases, COVID-19 relief money may be keeping workers at home, workers who would have ordinarily sought employment. Joe Lavorgna, former White House Chief Economist, states that without wage growth, we typically don't have inflation. Unit labor costs are growing at less than 2%, and inflation expectations remain in check. He believes the price boost we are seeing is a result of supply chain interruptions as we exit the pandemic—and that it "is very temporary".[1] How has this inflation, temporary or not, impacted the U.S. Dollar (USD) picture? We can talk about the USD versus the Japanese Yen (JPY) as it relates to a positive risk environment and 10-year Treasury yields. The 10-year and USD/JPY often have a positive correlation in a few ways. Some of this is attributable to what is called the carry trade. Investors borrow the low-interest rate currency Yen and can purchase the USD, or another currency such as AUD, that is paying a higher interest rate on their bonds. Therefore, the investor can receive a higher interest rate on the USD or the AUD investment, while paying a lower interest rate on the borrowed Yen. In a stable or a "risk on" environment, the investor can earn a solid, relatively risk-free rate of return.

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This practice by traders and investors is even adopted by households throughout Asia for personal accounts. We saw this in January when 10-year yields broke 1%, with USD/JPY trading below 103.00. The carry trade performs well when markets are optimistic or lacking direction. So, while the dollar has weakened against some currencies in 2021, it has strengthened against the Yen.

Has the USD/JPY versus 10-year Treasury correlation lost steam? As the 10-year retraced from 1.74 to below 1.45 this month ahead of the FOMC meeting, it may have found a bottom for now. The USD/JPY is challenging highs we saw at the same time in March after the FOMC announcement. If USD/JPY moves up above last year's highs at 112.20, we could possibly see 115-116 before a correction. The Fed just announced two rate hikes in 2023. Although initial market reaction seems to be inflationary, the Fed statement is unchanged, and they are remaining very accommodative for the next year and a half, which should provide strong growth. Back in March, Lavorgna thought risky assets were still at a "sweet spot", even if the Fed sticks to its plan to run the economy hot and get inflation up – and by not raising rates and not tapering asset purchases. He expects the U.S. will get a big GDP number not seen since Reagan in 1983.[3]

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What are some factors that could bring a *Saturday Night Fever*[4] to the inflation picture and the dollar? As we continue to exercise a budget deficit spending policy, despite which administration is in the White House, we could see a dramatic USD selloff that could trigger greater inflation fears. Sterling (GBP/USD) is approaching a key area near 1.5000, one we have not seen since Brexit began back in 2016, and that could trigger a demand shift in the currency pair – back to 1.7000. The EUR, which already has strengthened on the back of a weaker USD and higher oil, could break highs from 2018 at 1.2500 and test 1.4000. While I believe the USD will be weaker over the next year, I think it will be gradual and orderly. Volatility remains low for most currencies as markets are focused on other assets. The 10-year yield made some dramatic moves higher to start the year, but the long-term chart going back to 1987 is still very much intact. Market talk about 10-year Treasuries at 2% yields or higher had a lot to do with high expectations of Biden being able to pass big-ticket agenda items from his 2020 campaign, especially after the Georgia Senate results evened out the chamber 50/50. Congress seems to be at an impasse on infrastructure, or a smaller package will emerge, and COVID-19 relief should wind down into year end. Joe Manchin appears to be the most powerful man in Washington, as he has tempered expectations of big spending programs.

As U.S. and global economies open back up, we should see continued strong growth and a weaker dollar. As we continue into next year, government deficit spending will return to lower levels, or levels we have become accustomed to in recent years, and GDP growth will drop to 2-3%. Unless we have some labor cost spike or unforeseen risk event on the horizon, the inflation picture is looking more like a *Close Encounter*[6] than a *Towering Inferno*[7].

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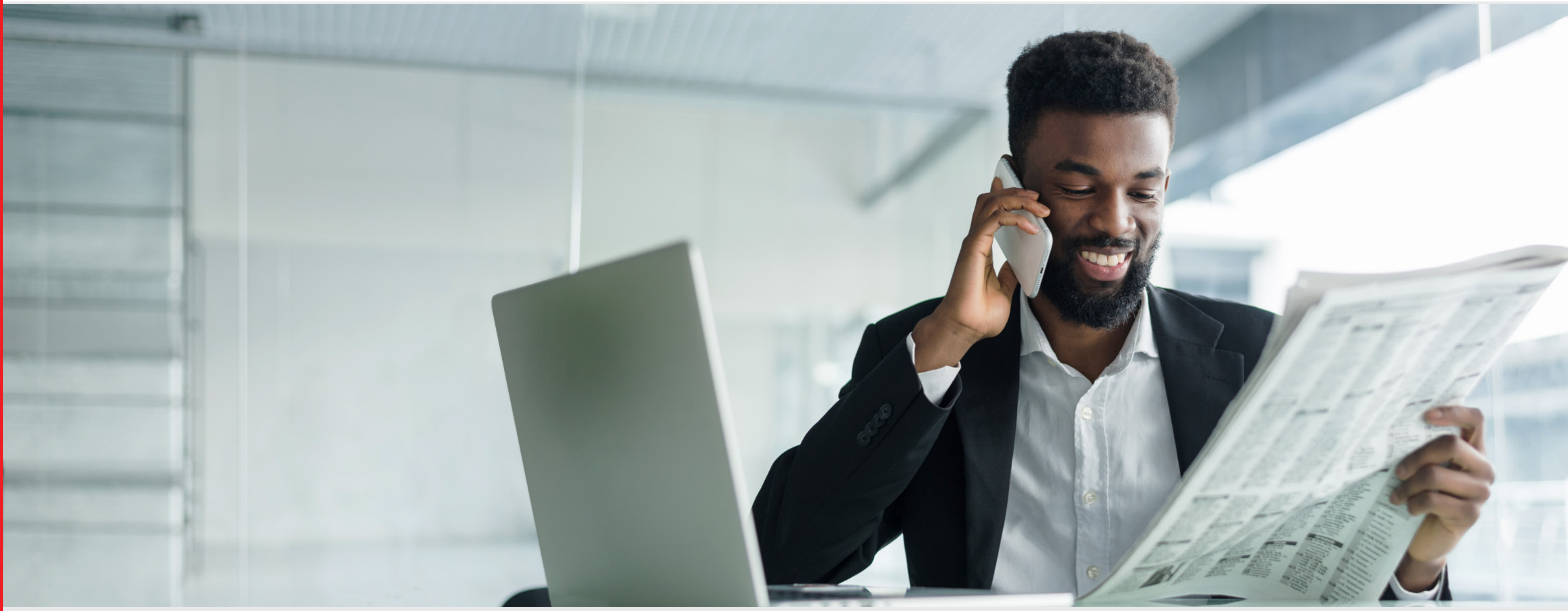

Fixed Income Strategy – “What Should Bond Investors do with Rates at Historical Lows?”

Dan Morgan, Senior Trust Portfolio Manager

Seems like every day I pick up a financial journal, there’s an article predicting interest rates at all-time lows and, conversely, the bond market trading at all-time highs. The message is that the entire bond market is heading for a bubble that’s ready to burst, reminiscent of the dot.com bubble that exploded in the summer of 2000. Typically, these types of comparisons do not fully disclose true characteristics of bonds and how fixed income securities drastically differ from stock investing.

First, fixed income securities are issued at par value (typically $1,000 per bond), pay a semiannual coupon rate, and mature at a set date. A bond holder is entitled to the coupon (or interest rate) during the length of time he/she holds the bond. Further, at maturity, the bond holder will receive the entire par value (typically $1,000 per bond) back in the form of one lump-sum payment. Changes in interest rates during the life of the bond dictate price movement of the security before the bond matures. However, unless the holder sells the bond before maturity, the holder is guaranteed to get par value back. That is the major difference between buying a stock versus a bond. A stock’s value can drop (or rise) significantly below purchase price, and the investor may never realize the amount of the original investment.

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Considering all this information, there is a lot of debate going on today as to when the Federal Reserve will raise interest rates. During previous FOMC meetings, the Fed outlined a mandate stating that inflation (measured by the PCE Index) must rise over 2%, and the economy will need to be at full employment before tightening begins. Based on the June FOMC meeting, the Fed announced to expect two rate hikes by the end of 2023, and they have begun discussions on scaling back the $120 billion in monthly bond purchases. Now, Fed officials are seeing their preferred measure of price pressures (PCE Index) rising 3.4% in 2021, 2.1% in 2022, and 2.2% in 2023. FOMC sees GDP expanding 7% in 2021, 3.3% in 2022 and 2.4% in 2023.

Members of the Federal Reserve have also been rumored to be embracing a “Yield Curve Control Strategy” on the short

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end of the U.S. Treasury 2- to 3-year yield curve. Explicitly, this would prevent yield spread on the 2-year to 10-year from steepening. The result would be keeping short-term rates low and interjecting into medium-/long-term portions of the yield curve by purchasing bonds in the open market – keeping all rates low. All this activity has led to yield spreads between USTs and corporate and municipals to be below 5-year averages.

So, we know the Fed has guided investors to expect a rate hike in 2023, but many capital market strategists are expecting rates to rise before then. More recently, there has been a slew of economic data pointing to higher inflation. First quarter real GDP expanded at an annual rate of 6.4% as a massive surge of 10.7% in consumer consumption boosted growth. GDP is set to match its pre-pandemic peak set in the fourth quarter of 2019. Closely watched inflation measures like the PCE index climbed to an annual 2.3% in the first quarter, while May's CPI surged to 5.0, the largest jump since 2008.[8] The consensus among bond investors is that the Fed will raise short-term rates sometime in the second quarter of 2022. However, the U.S. Treasury 10-Year (1.50%) and 30-Year (2.10%) yields do not seem to reflect these expectations. This may be due to projected legislative action by the Biden administration that includes tax hikes at the corporate and personal level. Tax hikes would slow future economic growth and inflation into 2022 to 2023, delaying the need for aggressive Fed tightening.

Therefore, with corporate and municipal bond yield spreads versus U.S. Treasuries at five-year lows, and current bond yields at or near all-time lows, what should an investor who needs income do? Synovus Trust Company will utilize three fixed-income portfolio structures – bullet, barbell or ladder – to manage a bond portfolio, depending on expectations for future rates and shape of the yield curve. A laddered bond portfolio is a structure that has roughly equal amounts of investments maturing in sequential years out to the longest desired maturity. Because some of the portfolio is maturing each year, a ladder allows an investor to participate in changing rate environments and limits exposure to any portion of the yield curve. A ladder fixed-income portfolio reduces interest rate risk, as annual proceeds from maturing bonds can be reinvested at a future higher/lower rate, and it limits overexposure to any one segment of the yield curve. Meanwhile, a barbell approach creates somewhat of a hedge against interest rate risk, with a potential for greater yield over the life of the portfolio versus a ladder. Further, a barbell is able to reinvest the shorter-term portion when bonds mature, placing more weight on the short-term/long-term portion of the

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curve. A bullet approach allows an investor to invest for a specific maturity date to meet a known liability/distribution. Finally, a laddered approach may be considered a more passive portfolio structure. Although, studies have shown that a laddered structure across all time periods, because of the benefits of investment of maturing proceeds mitigating interest rate risk, led to outperformance versus barbell/bullet portfolios.

Housing Market

Wade Fowler, Senior Trust Portfolio Manager

One of the more dynamic parts of the U.S. economy over the past year has been the housing market. What began as a boom in home improvement projects during the pandemic lockdowns of 2020 has developed into a nationwide red-hot housing market. Fueled by historically low mortgage rates and a lack of supply of new houses, the price of an existing single-family home is up a record 24% when compared to 2020. Likely, anyone reading this commentary would have anecdotal evidence of the jump in prices and a story to tell about a house in your neighborhood that recently sold more quickly and at a higher price than would have been thought just a short time ago. There is little doubt that most of the country finds itself in a seller's market.

However, despite strength in home prices, if we look more closely at the recent housing data, we can see a slowdown emerging. First, housing inventory (measured in months of supply) has increased the past two months to just under five months of supply, indicating the tight supply/demand picture that persisted for most of the past year is finally easing. Second, various sentiment data compiled by Fannie Mae, the Conference Board, and the University of Michigan show homebuyer confidence declining dramatically in the past month as buyers react to big jumps in prices. Finally, one of the more surprising indications of the strong housing market has been a surge in the price of lumber. Over the course of the past year, lumber prices had increased 400% at their peak. But in the case of lumber prices, as is true of many of the other housing indicators, the peak occurred in May. In less than two months, lumber prices are down by more than half.

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Second Quarter Earnings Outlook

Robert Nobles, Trust Chief Investment Officer & Senior Portfolio Manager

Restrictions on activity continue to fall, and the economy is moving into a higher gear of growth. Corporate earnings are benefitting and will likely show the highest rate of quarterly growth in the past decade. For companies in the Standard & Poor's 500 (S&P 500), second quarter earnings growth is estimated to be 63%, accompanied by revenue growth of 20%. An earnings growth of 63% is expected to be led by companies in economic sectors of energy, industrials, consumer discretionary, financials, and materials. The significant increase in earnings expectations, if met, will be the largest year-over-year growth rate since the fourth quarter of 2009 during the Great Financial Crisis. First quarter reported earnings results topped out at 53% growth and growth in revenues of 11%. Since the end of the first quarter, 20% of the companies in the S&P 500 have issued higher earnings guidance driven by positive revenue expectations for their business. Technology companies are leading the way with the number of companies issuing higher earnings and higher revenue guidance for the second quarter of 2021. We have noticed analysts becoming more optimistic in their expectations for companies to meet or exceed profit expectations. Last year, the second quarter of 2020 was greatly impacted by the shutdown effects of COVID-19 across many industries. The prospect of easy comparisons, continued earnings momentum from the first quarter, and faster economic growth has led to increased earnings expectations. We have seen recent stock market highs because of the higher near-term profit outlook factored into stock prices. For the second half of 2021, higher profits are expected as analysts project double-digit earnings growth. The next major move in stock prices will be determined by second half 2021 earnings guidance provided by companies, communication by the Federal Reserve on monetary stimulus, and the ability of companies to rehire workers to meet excessive demand for goods and services.

The significant increase in earnings expectations, if met, will be the largest year-over-year growth rate since the fourth quarter of 2009 during the Great Financial Crisis.

Source Footnotes:
[1] https://www.cnbc.com/video/2021/03/16/all-risk-assets-in-a-sweet-spot-right-now-as-fed-meeting-kicks-off-says-joe-lavorgna.html/
[2] Chart courtesy of TradingView
[3] https://finance.yahoo.com/video/maneuvering-inflation-volatility-185114960.html/
[4] Director Badham, John, Saturday Night Fever, (1977, Paramount, RSO).
[5] Chart courtesy of TradingView
[6] Director Spielberg, Steven, Close Encounters of the Third Kind (1977 Julia Phillips and Michael Phillips Productions and EMI Films)
[7] Guillermin, John, The Towering Inferno (1974, Twentieth Century Fox)
[8] "News Release", Bureau of Economic Analysis, April 29th, 2021.