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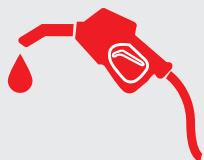


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Inflation hits 40-year high

Daniel Morgan, Senior Portfolio Manager

U.S. consumer inflation reached an 8.6% annual rate in May, its highest level in more than four decades as surging energy and food prices pushed prices higher. The Labor Department recently announced the Consumer Price Index (CPI) increased 8.6% in May from the same month a year ago, marking its fastest pace since December 1981. That also was up from April's CPI reading of 8.3%. The CPI measures what consumers pay for goods and services. May's increase was driven by sharp rises in the prices for energy, which rose 34.6% from a year earlier, and groceries, which jumped 11.9% on the year. Prices for used cars and trucks rose 1.8% in May from April, reversing three months of declines. Shelter costs, an indicator of broad inflation pressures, accelerated on a monthly basis in May and were up 5.5% compared with a year ago.



May 2022 energy prices were 34.6% higher than in May 2021.

The annual rate of inflation has risen sharply since early 2021. As the U.S. economy has rebounded from the pandemic, massive government stimulus, supply disruptions, surging commodity and oil prices have put upward pressure on consumer goods and services for longer than policy makers anticipated. In response to runaway inflation the Fed recently raised its Fund's rate by 75 basis points (bp) – the biggest increase since 1994 – to a

target of 1.50%-1.75%. Further, in an effort to douse out the inflation fire the Fed has signaled a 50 to 75 bp increase is on the table for the upcoming July meeting.

Q&A: Key facts about a recession

David Grimaldi, Foreign Exchange Sales Consultant

With all the talk of a recession lately, what exactly is a recession, what determines when we are in one, and how does a recession occur?

- A recession is a macro-economic term that refers to a significant decline in general economic activity in a designated region.
- Typically a recession was recognized as two consecutive quarters of economic decline, as reflected by gross domestic product (GDP) in conjunction with monthly indicators such as a rise in unemployment.
- However, the National Bureau of Economic Research (NBER), which officially declares recessions, now says the two consecutive quarters of decline in real GDP are not how it is defined anymore. The NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. (Investopia)



What have past recessions looked like?

- The most recent recession, which lasted only two months, was during the onset of the COVID-19 outbreak, when GDP fell to -19.2% and unemployment as high as 14.7%
- The Great Recession of 2007 lasted one year and six months, with peak unemployment at 10% and GDP -5.0%, driven mostly by the sub-prime real estate crisis.
- The period from 1969 to 1982 is probably most relevant to today; as U.S. expenditures on Vietnam, global shift of manufacturing abroad, high oil prices, and inflation produced four recessions, lasting more than four years of the 13-year period.

Why are some economists expecting another recession?

- First quarter 2022 GDP growth dropped by 1.5% in the U.S., leading many economists to think we are heading into a recession.

- Consumer prices and producer prices both gave indications that inflation is not slowing.
- The Federal Reserve Bank has a mandate of pursuing dual economic goals of maximum employment and price stability. The tools they use are raising or lowering interest rates and asset purchases of treasuries.
- The Fed has been raising interest rates to fight inflation along with stopping asset purchases and reducing their balance sheet. Theoretically the interest rate needs to be as high as the inflation rate to curb inflation. Current inflation is 8.6 %, while interest rate is now 1.5%
- Raising rates has the net effect of slowing the economy and increasing unemployment.



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- U.S. inflation has been more than 5% for longer than a year and the Fed has been slow to act. Housing, fuel, electricity, and food prices are still rising. Wages are rising but on a pace below inflation, reducing buying power and adding to monthly bills.

Forecasts

- The Atlanta Federal Reserve's GDP Now Tracker most recent forecast for growth, issued in late June, was a negative revision and indicated the economy could be headed for a second consecutive quarter of negative growth, which meets a classic definition for recession.
- The World Bank just slashed its global growth outlook, warning that a period of stagflation like the 1970s is possible.
- JP Morgan Chase CEO Jamie Dimon issued a warning about the economy and said "brace yourself." (CNBC)

The tools of the Fed are limited. The effect of the Ukraine War and U.S. injecting almost \$7 trillion into the economy since 2021, along with trying to eliminate fossil fuels without a viable alternative has increased inflation to 42-year high levels. With no end in sight for lower oil prices, the Fed will raise rates until it creates an uncomfortable amount of job losses, and then may pause to determine what to do next.

Oil Update

Wade Fowler, Senior Portfolio Manager

In our last oil market update, we highlighted the tight supply demand fundamental picture of the

oil market. At that time, we showed that crude oil inventories in the United States were at a level lower than what has been seen in more than five years. At the time of writing this commentary, the price of oil has declined from \$122/barrel to \$107/barrel, a drop of 12% over the past three weeks.

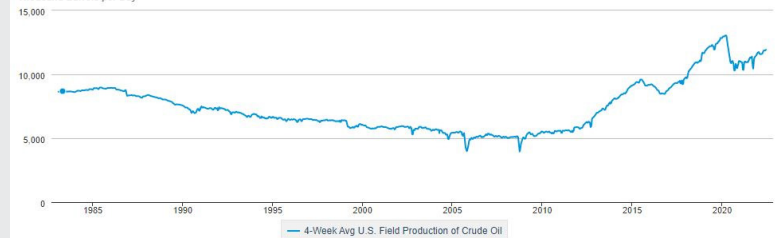
You may be surprised to learn that the inventory situation has not improved at all during that time. With an economy steadily recovering from the pandemic, oil consumption continues to increase while oil production is still approximately one million barrels per day below the peak production level in early 2020. Oil production in the U.S. is shown below.



Oil consumption continues to increase while oil production is still approximately one million barrels per day below the peak production level in early 2020.

4-Week Avg U.S. Field Production of Crude Oil

Thousand Barrels per Day

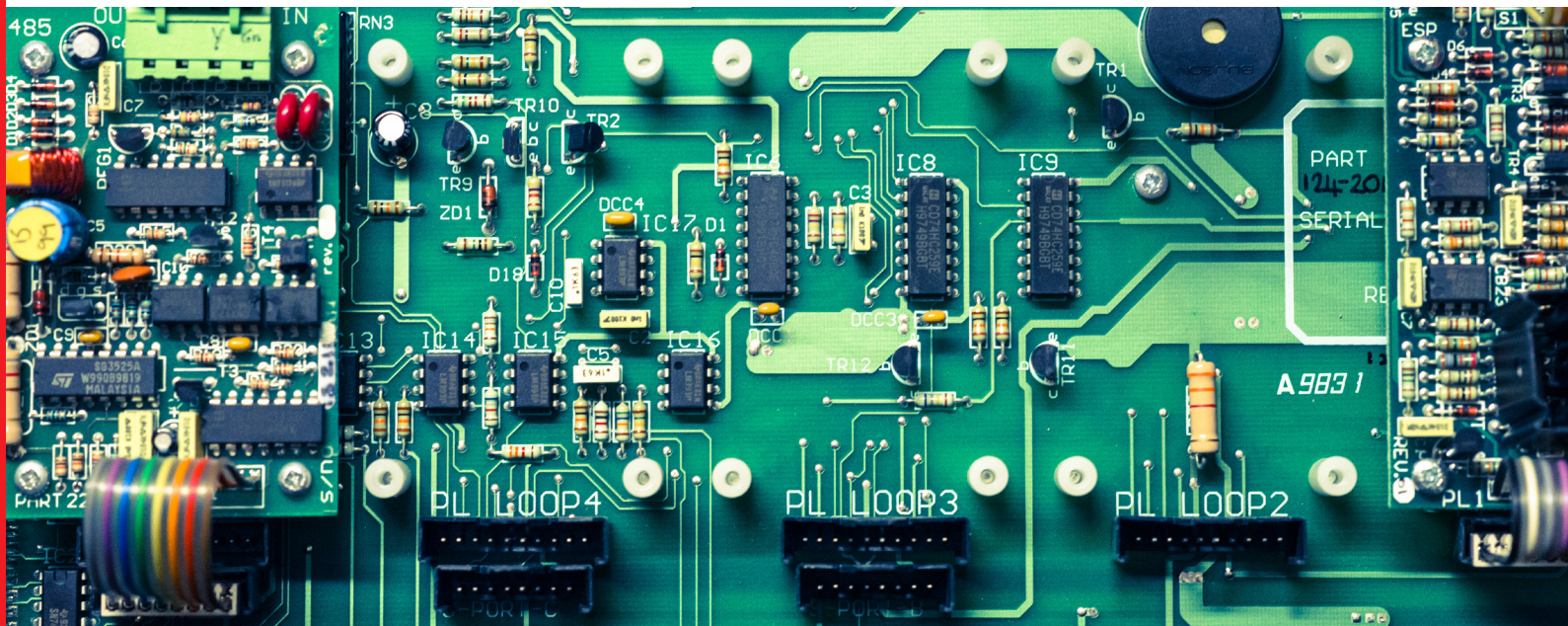


Source: U.S. Energy Information Administration

In short, the fundamental picture today still argues for high and rising prices. What has changed during the past few weeks is a shift in the market's attention to the rising risk of recession. The Fed's tightening of policy is having an impact not on the oil market directly, but on the overall economy and market participants are now starting to discount



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the possibility of a recession on the horizon. We can see this shift not only in the oil markets, but in other commodity markets and in the stock and bond markets as well. Unfortunately, given the supply picture currently, the only thing that would bring about a drop in the price of oil would be a drop in demand associated with an economic recession. Given the elevated price of oil and the constructive fundamental picture for the energy markets, one would think production would be increasing at a more rapid pace. However, in a recent reporting of drilling activity in the U.S., the number of rigs drilling is roughly a third less than in 2020. As is the case in many other parts of the U.S. economy, comments from company management teams across the industry indicate shortages of equipment and labor are a contributing factor to a lack of activity. However, these constraints are only part of the problem, the American Petroleum Institute recently published a recommended list of 10 policy changes to increase energy production in the U.S. The majority of the recommendations relate to industry regulation that will likely be very difficult if

not impossible to change given the current political power structure in Washington. To learn more about the list you can visit the website at API.org.

Technology Corner: Is the broad-based sell off in the Semiconductor Sector warranted?

Daniel Morgan, Senior Portfolio Manager

Many Institutional/Hedge Funds are extremely bearish on the semiconductor sector. This investor sentiment largely stems from negative data points across the handset, notebook, and other consumer-related areas. Investors cite inventory build ups in the PC space (gradual quarter over quarter rise in inventories for Lenovo, Dell and HP) and slower demand in China for smartphones. This coupled with higher inventories in both OEM and Cloud has raised some eyebrows. Some investors have pointed to recent TSMC commentary about a handset inventory build, a consumer slowdown, along with used car pricing data starting to roll over. Most investors



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seem to be waiting for future earnings cuts. This is the highest level of negative sentiment we have seen since the tariffs and the trade war with China.

Congress has been calling to boost U.S. semiconductor manufacturing, but government industrial policy isn't needed to correct this supply-demand problem. Governments helped create the chip shortage, starting with their lockdowns during Spring 2020. Auto makers reduced orders for new chips as car purchases plunged. They didn't anticipate how demand for cars would rebound. Meantime, manufacturers pivoted to more profitable chips that power laptops, consumer electronics and data centers. Demand for these chips has surged amid the pandemic and will grow in the 5G era, which will enable artificial intelligence

their skilled workforce, geographic supply-chain synergies and government subsidies. While U.S. companies make up nearly half of global chip sales, America accounts for only 12% of global chip manufacturing. America's comparative chip advantage is engineering, and those jobs are high paying. The U.S. accounts for 50% of chip manufacturing equipment and 52% of intellectual property design. If U.S. semiconductor firms that farm out chip production are worried about their supply chains, they and the U.S. government can prod TSMC and Samsung to diversify their manufacturing base out of the Pacific Rim into the U.S.

The Semiconductor Industry Association reported overall revenue/growth of \$553 billion (+25.7%)

	2013 A	2014 A	2015 A	2016 A	2017 A	2018 A	2019 A	2020 A	2021 A	2022 E	2023 E
Revenues (\$ Millions)											
Discretes / Optos / Sensors	53,808	58,541	60,684	62,233	69,087	75,446	78,953	79,164	92,945	101,726	106,813
Analog	40,117	44,365	45,228	47,848	53,069	58,380	53,939	55,658	73,816	90,148	94,656
MCU	14,659	15,310	15,479	14,573	16,430	17,027	15,808	15,484	19,622	24,885	26,129
MPU	41,120	44,033	43,268	43,142	44,370	46,371	47,974	51,812	56,766	61,454	64,527
Other	2,909	2,728	2,551	2,869	3,286	3,262	2,658	2,382	2,845	2,400	600
Total Micro	58,688	62,072	61,298	60,585	64,086	66,660	66,440	69,678	79,234	88,739	91,256
Logic (ex Micro)	85,927	91,633	90,753	91,498	102,196	109,411	106,535	118,408	153,710	191,801	201,391
Total Logic	144,615	153,705	152,051	152,083	166,281	176,071	172,975	188,086	232,944	280,540	292,647
DRAM	34,788	46,858	44,970	41,179	72,802	98,604	62,475	64,324	92,960	99,943	94,543
NAND	27,465	28,234	28,845	32,023	47,227	54,263	40,180	49,390	55,953	72,460	85,082
Other	4,790	4,140	3,390	3,565	3,946	4,428	3,785	3,769	4,921	5,429	5,429
Total Memory	67,043	79,232	77,205	76,767	123,976	157,295	106,440	117,482	153,834	177,832	185,055
Total ICs	251,776	277,302	274,484	276,698	343,326	391,746	333,354	361,226	460,594	548,520	572,357
Total Semiconductor	305,584	335,843	335,168	338,931	412,414	467,192	412,307	440,389	553,540	650,247	679,170
Y/Y % Growth	4.8%	9.9%	-0.2%	1.1%	21.7%	13.3%	-11.7%	6.8%	25.7%	17.5%	4.4%

Source: SIA, Morgan Stanley Research

and the Internet of Things (IoT.) Right now, China, Taiwan, Japan, and South Korea account for about 75% of chip manufacturing capacity in part due to

in 2021 and is forecasting revenues to hit \$650.2 billion (+17.5%) in 2022. In 2023, semiconductor revenue growth is expected to plateau to \$679.1



billion representing a 4.4% growth rate as capacity builds out to meet current shortages. From a stock perspective, anticipate continued volatility in the semi/semi-equipment space until the market starts to refocus on the strong industry fundamentals... opposed to geopolitical events and Fed action.

What can investors conclude after bell-weather semiconductor companies – Texas Instruments, Intel, Advanced Micro Devices, Qualcomm – reported 1Q22 results? YTD the sector is down 33%, while the S&P 500 is down just 20%. Why all the pessimism surrounding the semiconductor sector? One area of concern is global PC shipments that are expected to fall by 10% in calendar 2022. Weakening Chromebook demand and supply issues in China are major headwinds. Data points on PC shipments continue to be negative as lockdowns slow supply. In addition, most companies are calling out supply headwinds from the COVID lockdowns in China.

Intel recently warned that a weaker economy will affect demand and hurt financial performance, this news dragged down chip industry. For Intel, the industry weakness is exacerbated by the fact that the company is losing market share to rivals. According to Mercury Research, AMD gained about seven percentage points of share from Intel in the X86 processor market for the first quarter, compared with the prior year. AMD's high-end server-chip business has been thriving. The company's EPYC server processor revenue more than doubled during the March quarter, AMD said in its latest earnings report. Over the same period, Intel reported just 22% year-over-year (YoY) growth for its data-center server unit. Intel's latest delay won't help counter this trend.

Top semiconductor equipment maker Applied Materials now sees 3Q sales between \$5.85 - \$6.65 billion and EPS of \$1.59 - \$1.95, which is below analyst expectations. The recent downtrodden profit forecast is due to component shortages, the Russia pullout and power supply issues in China, not demand problems. Applied Materials continues to see strong demand and back-log growth.

Texas Instruments delivered first quarter revenue of \$4.9 billion, which was up 14% YoY. With the increase driven by growth in industrial, automotive, and enterprise. Industrial and auto market revenue were up 20% and communications was up 10%. Management expects second quarter revenue to be in the \$4.2 - 4.8 billion range, which was below consensus estimates. The company took a 10% haircut to revenue guidance due to uncertainty around COVID.

Despite these dark clouds over the semiconductor group, earnings season kicked off with several other large players reporting upbeat results. Major themes include continued strength in server and cloud, recovery in auto and industrial, with handsets holding up well. TSMC (one of the world's largest chip foundries) is expected to earn roughly \$17 billion from Apple orders in calendar 2022. This is up from roughly \$13.8 billion in calendar 2021. Apple remains a key customer for TSMC as it pushes further at leading nodes. TSMC now expects revenue to grow about 30% in 2022, signaling resilient demand for electronics despite global



Despite dark clouds over the semiconductor group, earnings season kicked off with several other large players reporting upbeat results.



macroeconomic uncertainty. Sales growth this year should accelerate from 2021's 24.9%. That's in line with executive remarks in April that gave an official outlook of topping mid- to high-20% growth in 2022.

Unlike Texas Instrument's muted outlook. Broad-based chip manufacturer Analog Devices (ADI), which builds chips for a wide spectrum of sectors including auto, industrial, consumer, data center, and communications, reported stellar 2Q results. ADI saw 2Q revenue of \$2.97 billion with double digit YoY growth across all end markets. Further, double digit sequential growth across all B2B end markets. Management stated that "Despite increasing geopolitical uncertainty and ongoing supply chain disruptions, we enter the second half from a position of strength with increased capacity and continued bookings momentum".

Top CDMA smart phone chip producer, Qualcomm delivered record revenues of \$11.2 billion, representing YoY growth of 41%. The QTC segment that produces chipsets served as the growth engine of the company. IoT revenues grew 61% YoY, with strong growth across all three categories. Consumer, edge, and industrial all grew 50% compared to the year ago quarter. While, the RF front-end revenues grew 28% YoY, and handset revenues grew 56% YoY. The automotive design win pipeline is now over \$16 billion, up \$3 billion since fiscal Q1. Handset revenues of \$6.3 billion increased 56% versus a year-ago quarter. Qualcomm is one on the top producers of modem solutions for Apple.

Apple reported a strong 2Q22 despite COVID-related disruptions and silicon shortages in the legacy nodes, and the lockdowns in China, specifically in Shanghai, hurting supply and demand. Despite these hurdles iPhone revenue grew 5% YoY to a March quarter record

despite supply constraints. Growth was driven by a strong response to the iPhone 13 and the SE model. Mac revenue of \$10.4 billion was a March quarter record despite supply constraints while 15% YoY growth was driven by strong demand for the M1-powered Pro. Wearables, Home, and Accessories set a March quarter record, up 12% YoY. Total iPhone unit shipments for FY21 was 241 million (vs 190 million in FY20) an annual growth rate of 26% YoY. Apple is now planning on maintaining flat production in 2022 targeting 220 million new iPhones. Unit volume is expected rebound at 250 million units for FY23.

The doom and gloom report posted by Intel was offset by a huge beat from one of its largest competitors, Advanced Micro Devices (AMD). AMD reported quarterly earnings of \$1.13 per share, which beat the analyst consensus estimate of \$0.91 by 24.18%. This is a 117.31% increase over earnings of \$0.52 per share from the same period last year. The company reported quarterly sales of \$5.89 billion, which beat the analyst consensus estimate of \$5.52 billion by 6.65%. This is a 70.89% increase over sales of \$3.44 billion the same period last year. AMD's EPYC chip design appears to be gaining marketshare from Intel in data center server markets.



Demand for semis is holding up, with industry sales steadily increasing.

Top memory and smartphone maker Samsung communicated that it expects strong server demand in memory through 2022. Memory saw better than expected results due to lower than expected ASP declines in Q1. The company set a record for memory sales into the server market. Memory demand in Q2 for server is expected to remain strong. Management noted an improved availability of components in



for server is expected to remain strong. Management noted an improved availability of components in mobile. For 2022, memory should see continued strong server demand and a second half mobile recovery.

In summary, what can we make of all this information? The semiconductor stocks are trading as if a recession is imminent, and profits will slowdown. However, demand for semis is holding up, with industry sales steadily increasing. So far this earning season, about 86% of chip companies have reported better-than-expected revenue, compared to 74% for the overall S&P 500 Tech sector, according to data compiled by Bloomberg. Bell-weather chip names are trading at bargain-basement valuations. Examples are Micron Technology at 7x earnings, Intel at 10x earnings or top equipment makers Applied Materials and Lam Research both trading at just 13x earnings. We suggest maintaining a positive view on semiconductor companies exposed to cloud datacenter spending, 5G infrastructure, and gaming. We expect to see a bounce back in the auto/industrial space, followed by near-term weakness in the consumer/PC markets as we head into FY22 earnings.

Is the glass half empty or half full? With the overall markets trading in bear territory, it is often difficult to see a silver lining. However, there are many signposts that point to fundamental strength in the semiconductor sector. But each investor will have to sort through the tea leaves and make their own determination!

Market Outlook Second Half of 2022

Daniel Morgan, Senior Portfolio Manager

U.S. equities are likely to whipsaw throughout 2022 and will most likely have trouble recovering back to their levels set in January 2022. Multiple headwinds – Fed tightening, slowing GDP growth, more difficult profit comparisons and rising inflation – will create an uphill battle for the markets for the remainder of the year. Years of transition from economic recovery to expansion are characteristically uneasy for stocks, and this one may be particularly challenging given the unique aspects of geopolitical turmoil, extreme inflation and the delayed policy unwind of pandemic support. The S&P 500 and Russell 2000 fair-value models imply the indexes are likely to be far below all-time highs in the year ahead. Each index must contend with tricky inflation conditions and come to terms with diminished policy support. The leading sectors that can prosper during a period of inflation/higher interest rates – energy, materials, small caps and financials – are expected to out-perform.

As the Fed normalizes policy with multiple rate hikes anticipated throughout the year, earnings growth is likely to provide some support for stocks in the year ahead, but a bear case is emerging where the central bank is forced to choke off growth to root out dug-in inflationary conditions. Multiple scenarios are on the table. One unlikely scenario is that a bigger than expected surge in the economic growth creates S&P 500 Index profit growth of 21%, mainly due to stronger-than-expected new-



The leading sectors that can prosper during a period of inflation/higher interest rates - energy, materials, small caps and financials - are expected to out-perform.



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order gains and rising commodity prices. Another scenario is a bear case, that is the U.S. hits a typical recession in 2H2023, causing profit growth to fall 13%. Another negative scenario is a stagflation case, that would be potentially less severe on earnings growth, as commodity-driven sectors stay afloat, yet total profits fall due to higher labor and input costs.

Earnings trends are pointing to tougher comparisons going into the 2H2022, with S&P 500 Index profits expected to rise just +4.6% in 2Q22, +9.96% in the 3Q22 and +10.54% in the 4Q22. Every sector in the S&P 500 is expected to face an earnings per share

(EPS) slowdown, though real estate and other defensive sectors should see the smallest reductions as 2023 approaches. Industrials and materials may be impacted the most by an economic slowdown. While energy has the strongest upside revision breadth powered by soaring oil prices, followed by tech and materials. Due to their strong cashflow and ample dividend yields, traditional defensive sectors, such as utilities, communications and staples, would be minimally impacted from slower economic and profit growth. In summary, it appears to be an upward climb for stocks the remainder of the year with the Fed tightening cycle just beginning, rising inflation and slower economic growth.

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