US Daily: Our Financial Excess Monitor Indicates Moderate Concern About Valuations (Walker)

- Our GS financial excess monitor — a tool for assessing macro risks from stretched valuations and sectoral imbalances — now indicates modestly greater risk than in our last update at the start of 2021, though the overall risk level remains moderate. Risks from financial imbalances remain low, at least in the private sector. Some valuation metrics now look more stretched — in particular for corporate credit, commercial real estate, and housing — though with long-term real rates now negative, other valuation metrics that are calculated relative to interest rates look less worrisome.
- Some Fed officials have expressed concern that their MBS purchases are adding fuel to the flames of a red-hot housing market where prices have already risen 17% over the last year. While the financial excess monitor now provides a gentle warning about the level of home prices, we see little risk of a crash in the near-term and only a very modest negative impact ahead from the eventual end of the Fed's MBS purchases.

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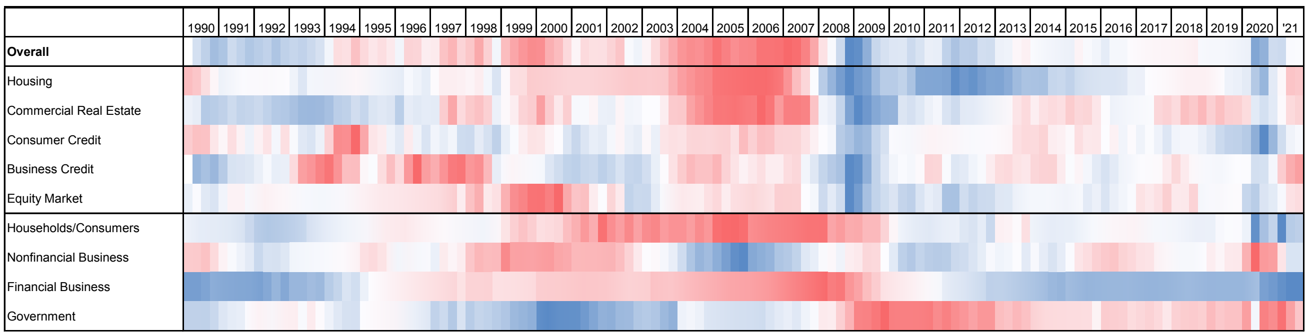
Our Financial Excess Monitor Indicates Moderate Concern About Valuations

In today's *Daily*, we take stock of financial stability risks by updating our financial excess monitor, our tool for evaluating macro risks from stretched valuations and sectoral imbalances. We use a range of price and non-price measures of valuation and risk appetite to assess risks in five major asset classes (Exhibit 1, rows 2-6), and we use debt levels, growth rates, and servicing costs to assess the risk of imbalances and vulnerabilities in four major sectors of the economy (Exhibit 1, bottom four rows). We aggregate the individual measures to produce overall risk scores relative to historical norms, with red indicating high risk and blue low risk.[1]

Exhibit 1: Our Financial Excess Monitor Continues to Indicate Only Moderate Risk

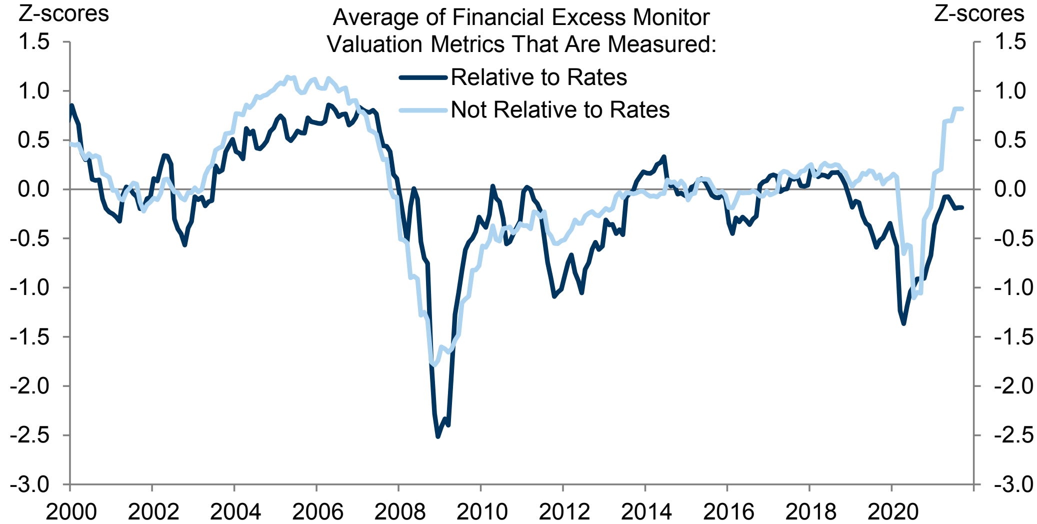


Source: Goldman Sachs Global Investment Research

Our tool indicates modestly greater risk than at the start of 2021, though the overall level of risk remains moderate. While risks from financial imbalances remain low, some valuation metrics — particularly those that do not compare expected returns to risk-free interest rates — now look a bit more stretched (Exhibit 2). Of course, with even long-term real rates now negative, the choice of whether or not to judge valuations relative to interest rates matters more than ever. That choice ultimately depends on whether real rates are low because of cyclical or structural forces. Since we ascribe today's low rates to both forces and are unsure how long it will take for cyclical pressures to unwind, we include some valuation measures that control for interest rates and some that do not.

[1] Our financial excess monitor focuses on major asset classes. For an asset class to constitute a macro risk, potential losses have to represent a major threat to either spending or lending. Price declines in giant asset classes held largely by households like housing and equities pose the first risk, while losses on mortgage assets by highly levered banks during the financial crisis are an example of the second. For further details on the methodology and the series included, see David Mericle, Avisha Thakkar, and Marty Young, "US Economics Analyst: Monitoring Macro Risk from Financial Excess in the US Economy," 2018.

Exhibit 2: Valuation Metrics That Compare Expected Returns to Risk-Free Rates Look Less Stretched Today Than Those That Do Not



Source: Goldman Sachs Global Investment Research

Commercial real estate valuations have increased on net since early this year as spreads have narrowed and underwriting standards have eased. Our financial excess monitor indicates that the market has returned to pre-pandemic levels of risk. However, we did not see significant macro risk from commercial real estate before the pandemic, and risks are further dampened by stricter underwriting standards than prevailed pre-financial crisis and lower interest rates — which both reduces concerns about valuations and helps to moderate default risk for commercial mortgages with near-term maturities. But there are some segments of the market that have been disproportionately impacted by the pandemic, notably office properties, where our credit strategists believe that risks are to the downside in the long run, as slow-moving adverse trends, such as a more permanent shift to work-from-home, could further impair fundamentals.

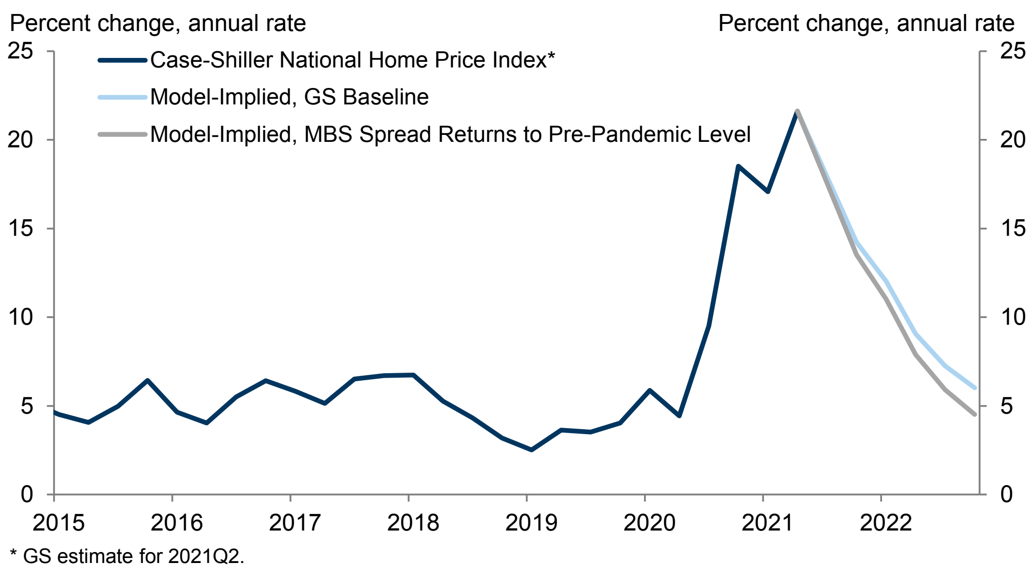
Valuations in the corporate credit market have become particularly stretched, especially for this early in the economic cycle. Spreads are at historically tight levels and our financial excess monitor ascribes additional risk from an increased share of high yield issuance[2] and easier lending standards for commercial loans. Additionally, our high yield credit research team recently noted that strong reach-for-yield motives have enabled issuers to raise capital with increasingly flexible terms, fueling a deterioration in covenant quality and extending a pre-pandemic trend. That said, balance sheet fundamentals for nonfinancial corporates remain strong, as businesses have maintained high levels of liquidity since last year's record-high issuance volumes, which would provide a buffer against an unexpected slowdown in growth.

Some Fed officials have expressed concern that their MBS purchases are adding fuel to

2 That said, the composition of the high yield market has improved over the last year (as documented by our credit strategists here) reflecting the wave of 'fallen angel' downgrades and material uptick in defaults.

the flames of a red-hot housing market where prices have already grown 17% over the last year. While the financial excess monitor now provides a gentle warning about home prices, rapid home price appreciation over the last year has been driven by a fundamental supply-demand imbalance that could take years to equilibrate, as opposed to speculative purchasing or lower borrowing standards that could lead to a swift crash. Lower interest rates have surely boosted demand, but the Fed's MBS purchases have only had a modest incremental impact on home price appreciation. We estimate that the widening of mortgage spreads to pre-pandemic levels — equivalent to undoing our strategists' estimate of the impact of the Fed's MBS buying on mortgage rates — would only slow the rate of annualized home price appreciation over the next six quarters by 1pp, as shown in Exhibit 3.

Exhibit 3: Our Model Suggests That a Complete Stop to Fed MBS Purchases Would Slow Home Price Appreciation by 1pp on Average Through End-2022



Source: Standard and Poor's, Goldman Sachs Global Investment Research

While valuation measures for some asset classes have increased and appear somewhat elevated, our analysis suggests that financial stability risks remain moderate overall.

Ronnie Walker

Inputs to the Financial Excess Monitor

Asset Valuations / Risk Appetite	Housing	Price-to-rent ratio Price-to-income ratio MBS spread SLOOS question on home mortgages Median credit score on mortgages at origination Case-Shiller HPI Rental yield relative to the real risk-free rate Urban Institute's Housing Credit Availability Index
	Commercial real estate	Commercial cap rate relative to the real risk-free rate CMBS spread SLOOS question on CRE lending Commercial real estate price index
	Consumer credit	SLOOS question on consumer (ex. credit card) loans SLOOS question on credit card loans Subprime share of auto loan originations Credit card interest rate relative to the risk-free rate Personal loan interest rate relative to the risk-free rate
	Business credit	IG bond spreads HY bond spreads SLOOS question on C&I loans Issuance of HY bonds
	Equity Market	Cyclically-adjusted PE ratio Equity risk premium VIX
Sector Imbalances / Vulnerabilities	Households/consumers	Personal saving rate Mortgage debt / personal income Mortgage debt / personal income growth rate Mortgage debt service / personal income Non-mortgage consumer credit / personal income Non-mortgage consumer credit / personal income growth rate Non-mortgage consumer credit service / personal income
	Nonfinancial business	Corporate financing gap Debt to GDP growth rate Debt to assets ratio IG debt to earnings ratio IG interest expense to income ratio HY debt to earnings ratio HY interest expense to income ratio
	Financial business	Broker-dealer leverage Loan-to-deposit ratio Financial sector liabilities / GDP Tier-1 common equity ratio
	Government	Federal government debt / GDP State debt / GDP Federal deficit / GDP Total state and local deficits / GDP

Source: Goldman Sachs Global Investment Research

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