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Tier 1 Banks Q3 Earnings Top the Estimates – Drivers and Implications

By Suri Luo, Market Research Analyst

US Tier 1 Banks Morgan Stanley (NYSE: MS), Goldman Sachs (NYSE: GS), JPMorgan (NYSE: JPM), Bank of America Corp. (NYSE: BAC), and Citigroup (NYSE: C) kicked off their Q3 earnings reports on Oct 13, 2020. As the businesses coping with the pandemic for 8 months, most banks are seeing a recovery in their Q3 results. Except for Bank of America, the other major banks have topped the analysts' consensus. Given the uncertainty and high volatility in the current market, there are wild rides in Q3 revenues from trading. As consumers are doing better in paying their loans than expected, less credit provisions are needed to be set aside, which moves in the banks favor and adds to their earnings. On the flip side, the consumer banking and advisory services have lagged in performance due to a hard hit by the pandemic, as well as the Federal Reserves' protracted near-zero interest rate policy.

Stock Prices for U.S. Tier 1 Banks Slowly Recovered Since April

In light of the coronavirus pandemic, there has been a widespread concern for consumers and businesses across the globe. Similar to many other industries, the financial markets also suffered from a huge drop in consumer confidence in March, where the stocks for major banks slumped over 40% (Figure 1). As the economy began to recover and stores gradually re-opened in the summer months, the stocks have rebounded by an average of 20%. Although most of the banks have not recovered to their pre-virus levels, some banks such as MS and GS had their shares rising at a faster rate and reached higher prices than others.

Figure 1: Year-to-Date Stock Movements for Tier1 Banks (Source: TradingView)

MS and GS's leading positions in helping with Wall Street's recovery have begun since the 2008 Financial Crisis. MS's recovery amid pandemic was mostly attributed to its change of business model back in 2011 and 2012, where they started putting more focus on equity trading and wealth management. This leads to a lower-beta revenue model that helped MS get huge earnings this year with two M&A deals and surging IPO businesses. As for Goldman Sachs, given its undoubtful advantage in trading among all the Tier 1 Banks, the rising VIX index explains the massive rally in their trading income, as well as their rapid rebound in stock prices.

Price Movements After the Earnings Release:

- **MS** - After the release of the Q3 earnings, the stock was up by 1.5% to $51.4. 23 analysts polled by CNN forecasted that Morgan Stanley's share price would have a 12-month median target of $58, with a low estimate of $45 and a high estimate of $78 [6].
- **GS** - The shares rose 3% after the earnings reported [14].
- **JPM** - Shares rose 1.7% in pre-market trading [8].
- **BAC** - Shares dropped 5.3% as the bank missed the Q3 revenue target by $0.35B [21].
- **C** - Despite the 34% YoY stock's decline, the shares rose 2% in premarket trading [18].

Drivers for Banks that Beat the Consensus

Morgan Stanley beats revenue estimates by $1 billion on higher-than-expected trading

Morgan Stanley (NYSE: MS) came out with Q3 earnings of $1.66 per share, beating the consensus estimate of $1.26 [1]. Although the earning surprise was not as big as that of the last quarter, it marks the third time that the earnings surpassed the consensus in the past four quarters [1]. The net revenue was at $11.7B, surpassing the estimate by 13.20% [3], with some segments highlights as follows:

Financial Summary[2,3]

($ millions, except per share data)

Firm	3Q 2020	3Q 2019
Net revenues	$11,657	$10,032
Compensation expense	$5,086	$4,427
Non-compensation expenses	$3,084	$2,895
Pre-tax income[6]	$3,487	$2,710
Net income app. to MS	$2,717	$2,173
Expense efficiency ratio[8]	70%	73%
Earnings per diluted share	$1.66	$1.27
Book value per share[9]	$50.67	$45.49
Tangible book value per share[10]	$44.81	$39.73
Return on equity[4]	13.2%	11.2%
Return on tangible equity[4]	15.0%	12.9%
Institutional Securities		
Net revenues	$6,062	$5,023
Investment Banking	$1,707	$1,535
Sales and Trading	$4,154	$3,455
Wealth Management		
Net revenues	$4,657	$4,358
Fee-based client assets ($ billions)[11]	$1,333	$1,186
Fee-based asset flows ($ billions)[12]	$23.8	$15.5
Loans ($ billions)	$91.3	$76.6
Investment Management		
Net revenues	$1,056	$764
AUM ($ billions)[13]	$715	$507
Long-term net flows ($ billions)[14]	$10.4	$4.2

Figure 1: MS Q3 Financial Summary

- Institutional Securities net revenues reflect strong performance with a 20% YoY increase in Sales and Trading

- The results from Wealth Management Segments indicate a strong fee-based flows and the increases in bank lending and deposits

- The strong performance in both asset management fees and AUM contribute to the 38% increase in investment management revenue

The strong quarterly earnings were driven by the overall optimism through the summer months, with the institutional securities division becoming the best performer across all segments.

Despite revenue declines in advisory and fixed income underwriting services, there has been a notable increase in equity underwriting revenue from some high-profile IPOs such as Snowflake Inc, Royalty Pharma, KE Holdings Inc and Warner Music [5]. The 20% YoY increase in sales and trading was attributable to both equity and fixed income sales and trading, with particular strength in credit products benefiting from an active primary market.

Even as the outperformance of trading activities plays a key role in the strong quarterly results, Morgan Stanley has been expanding its wealth and investment management businesses to cover the bank from losses on economic hedges associated with certain parts of the firm's borrowing and corporate lending activities. Followed by closing a $13 billion acquisition of the online trading platform E*TRADE, Morgan Stanley announced another mega deal in mid- October to purchase Eaton Vance, an investment management firm, for $7 billion [5]. Those M&A activities signify there will be more revenue under investment management segment yet to come in the following quarters.

JPMorgan has topped consensus profit estimates - fueled by strong equity markets performance, as well as decreased credit losses provisions

JPMorgan (JPM) reported the third-quarter profit of $9.44 billion that beats the consensus, attributable to the 32% revenue rise in the bank's equity markets division. The bank also topped estimates in its investment banking and fixed-income divisions, with a 12% and a 29% growth, respectively [7]. Although there was no significant YoY improvement on net revenue, the $29.9 billion revenue still surpassed expectations by $1.5 billion.

Thanks to the policies put in place by the Federal Reserve to keep low borrowing rates, the high credit flow drives the rally of bonds and commodities, which provides JPMorgan with opportunities for growth in its commodities, credit, securitized products, as well as fixed income vehicles [8].

Similar to Morgan Stanley, the revenue driven by investment banking fees was also offset by lower advisory fees as fewer M&A deals or large transactions took place amid the pandemic.

Despite the fact that Consumer & Business Banking's net revenue was down 18% this quarter versus last year, JP Morgan had an YoY decrease of $517 million in provisions for credit losses, indicating that the company is having a relatively healthier business. In addition, the stronger production in home lending also positively contributed to Q3's performance [9].

According to Barron's report, JPM has factored the downside scenarios in their reporting, while building its reserves. The accounting treatments will allow the company to release those reserves into earnings once the economy is recovered, which is something worth looking for in the upcoming quarters [13].

Goldman Sachs Q3 earnings crush estimates with continued strength in trading

With Goldman Sachs' focus on trading, the Q3 revenue sits at $10.78 billion, $1.38 billion above the expectation. The earnings per share came in at $9.68, almost twice as much as the consensus. According to the CEO of GS, David Solomon, as the services of helping clients recover from the lousy economy brought on by the pandemic, the company is gaining a higher market share, which significantly adds to the earnings as well [15]. The shares rose 3% after earnings reported [14].

Compared to Morgan Stanley and JPMorgan, Goldman Sachs' revenue are sourced more from deal-advising and trading activities. Although there is disappointing news on the lower completed M&A transactions, the trading performance remains strong in Q3. Both equities and fixed-income sales and trading revenue beat expectations. Equities revenue is at $2.1 billion, up 10% from last year, and fixed-income revenue hits $2.5 billion, with an YoY increase of 49% [14].

Citigroup's revenue beats consensus despite a 34% slump in profit

Citigroup (NYSE:C)'s stock has been declining recently as the profit had a YoY slump of 34% in Q3 earnings report [18]. With an EPS of $1.40, the company still beats the consensus by $0.48 per share. The shrank of the profit margin is mainly contributed by the increase in operating expenses, rising cost of credits, as well as a 2% increase in effective tax rate. Despite the efficient savings and reductions in discretionary spending, the company's operating expenses went up by 5% due to the civil money penalty, investments in infrastructure, risk management and controls, and the raised compensation spending [16].

The company reported a revenue of $17.3 billion, with a 7% decline YoY, driven by lower revenues in Global Consumer Banking (GCB) [16]. The divisions such as Fixed Income, Investment Banking, Equity Markets and Private Bank had strong performance which partially offset the decline in Consumer Banking.

The outperformance of Citi's fixed income trading leads to the revenues' best quarter in eight years, with an YoY increase of 18% [16]. Like JPMorgan, Citi's trading revenues are mainly driven by credit and commodities trading. Citi also set aside less money for bad loans provisions, with a drop from $7.9 billion in the second quarter to $2.26 billion in Q3.

Implications of the Earnings Results

For Banks

With the threats that coronavirus pandemic imposed on capital markets and the banking industry, banks need to consider the following aspects to achieve better efficacy of crisis managements.

- **Ultra-low interest rates** - The almost zero interest rate will lead to overly low profit margins for banks – they should therefore continue looking for opportunities to achieve efficient cost-cutting.
- **Restrictions on shares repurchase** - The Federal Reserve's announcement on extending the ban on share repurchases to Q4 could imply more challenges for banks to face [20]. Banks usually used repurchases to drive value for shareholders, to boost ROE or ROA ratios, as well as to get a higher share price. The ban could possibly raise the cost of capital for the banks. Therefore, the banks should reach out to regulators and professionals if they have any difficulties adapting to the policy.
- **Clients engagement** - The clients would like to see their financial institutions and advisors staying strong in this unprecedented situation. Communication with clients is extremely crucial especially when things are happening remotely, and therefore the banks should be checking in with the clients frequently to keep a high level of transparency. Furthermore, from the technical perspective, maintaining strong cybersecurity to ensure the clients' information is properly protected. With the connection and trust built with clients, the banks could keep existing customers and have more chances to win new business.

For Investors

Although the reports show that the banks are beating targets, the big banks may not be as strong as they appear for the following reasons:

- **"Brewing Bubble" in trading income** - According to Americans for Financial Reform, in the first 6 months of this year only, the Federal Reserve's unprecedented intervention in capital markets boosted the banks' trading income by at least $19.6 billion [22]. However, the strong performance in Q3 is mainly driven by trading activities, implying that the good results could be deceiving.

- **Fed's permission on provisions for credits** - Banks' delay to hit their capital ratios attributed to the provisions of loan-loss and credits they set aside, which also inflated their earnings in Q3.
- **Performance boosted by accounting measures** - The huge increases in banks' possession of cash and treasuries are currently excluded from leverage ratios calculations [22]. Once those numbers are adjusted for regulatory relief, the banks statements will look less healthy than they appear.

Given the economic strain under the current condition, the demand for fresh credit has declined substantially. Investors should be paying attention to not only the banks reported financials, but also their scope as well as ability to win new business.

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Microsoft Beats Wall Streets Projections with $37.2 Billion in Quarterly Revenue

By Onat Karacan, Market Research Analyst

Earlier this Tuesday, on October 27, 2020, Microsoft reported $37.2 billion in quarterly revenue, compared with Wall Street's projections of $35.72 billion. Microsoft reported profit of $1.82 a share, beating the Streets consensus of $1.54 a share[1]. This was a great surprise, but the stock still dipped 2.5% after the earnings report, and is 5% down by the end of the week. This report will look at Microsoft's business and areas of growth that resulted in this earnings surprise, why the stock price reacted the way that it did, and some drivers and risks for investors looking to purchase this popular stock.

Business Overview and Areas of Growth

Microsoft is a business that continues to make acquisitions and diversify its revenue. The vast amount of businesses that Microsoft acquires and services it provides is quite astounding, and this can be seen through their segmented income statement. Microsoft divides its revenue into three segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. From the following brief list, it can be seen just how many products and services
Microsoft offers.

<u>Productivity and Business Processes</u>

- Microsoft Office
- Microsoft Exchange
- Skype
- Outlook
- OneDrive
- LinkedIn
- Dynamics 365
- Office 365 Security and Compliance

<u>Intelligent Cloud</u>

- SQL and Windows Servers
- Visual Studio
- GitHub
- Microsoft Azure

<u>More Personal Computing</u>

- Windows original equipment manufacturer (OEM)
- Window Operating System licensing
- PC accessories
- PCs, tablets,
- Gaming and Entertainment consoles

Microsoft initially had most of their revenue through their More Personal Computing segment, through the licensing of their operating system and various devices that they sold. They experienced a great increase in revenue for their Productivity and Business segment and are currently experiencing strong growth in their Intelligent Cloud segment. With growth in these two segments, they have now evened out the distribution of their revenue. These changes can be observed in the following figures.

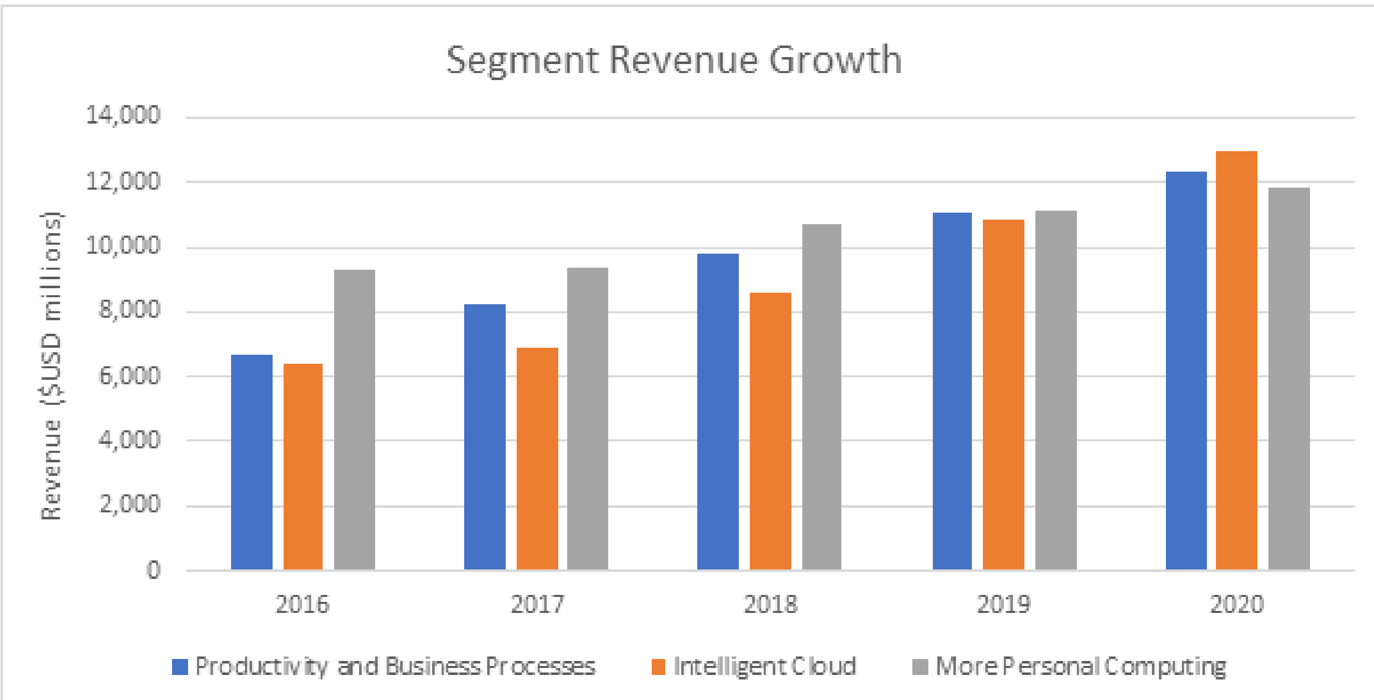

Figure 1: Five-year Segment Revenue Growth (2016-2020)

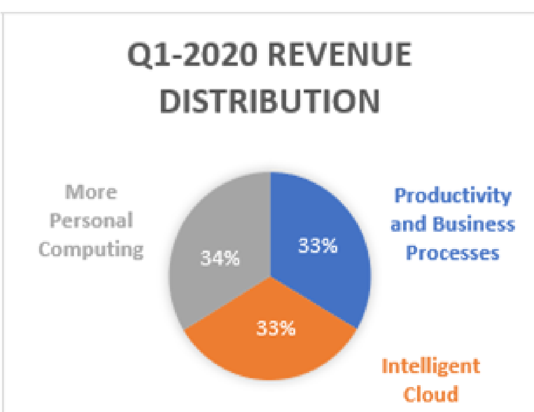

Figure 1: Distribution of Revenue (Q12020)

Year-over-year revenue growth has been exceptional for their intelligent cloud system, as it is up 27%. Their productivity and business processes segment has grown 13% year-over-year, and the more personal computing segment has grown at 4% year-over-year. This can be seen in the comparison between the two graphs, as their intelligent cloud segment has risen in

proportion of revenue and is equivalent to that of the other two segments. The reason for the growth in this segment is partially fueled by COVID-19, as there is a push towards cloud-based computing.

Microsoft defines cloud computing as the delivery of any computing services such as servers, storage, databases, networking, software, analytics, and intelligence over the Internet, or over the ‘cloud’.[1] One of the main reasons to use cloud computing is cost-efficiency, in that business owners don’t have to spend excessive amounts on hardware for IT and companies only spend on what they need at the time, instead of holding on to depreciating IT resources.

Microsoft does not report revenue growth for individual products, but has stated that Azure, their cloud computing business, has gone up 48% year-over-year, which accounts for a lot of the growth in the Intelligent Cloud segment. They have also stated that their commercial cloud gross margin was 71%, which is a strong increase from 66% a year ago. In addition to cloud-based computing, COVID has proven beneficial for online collaboration software, and for Microsoft it is Microsoft Teams. They have reported that their daily users have risen to 115 million from 75 million in April, which is a significant increase in such a short period of time. [1]
Although the More Personal Computing segment has not grown too much, as it is only up 4% year-over-year this quarter, there is very strong demand and sales growth for Xbox and Surface devices. Microsoft reports that Xbox revenue was up 30%, which also highlights another COVID-benefited sector, as gaming has gone up in popularity. Surface revenue has also increased by 37%.

How the Stock Reacted to the Earnings Release

Surprisingly, despite such a great quarter, the stock fell by 2.5% (~$213 to ~$207) after the release of the earning report and is down 5% by the week ended October 30th. The reason Microsoft’s stock fell was not because of the performance during the quarter, but because of its outlook on the future. Analysts stated that the outlook for the next quarter was not as robust as they expected. The post-earnings conference call with investors, CFO Amy Hood stated that the company expects sales of **$12.75 billion to $13 billion for Productivity and Business Processes, $13.55 billion to $13.8 billion in Intelligent Cloud, and $13.2 billion to $13.6 billion for More Personal Computing.** In total, the company projected 39.5 billion to 40.4 billion in revenue, when the average estimate was $40.5 billion. Analysts expected more next quarter due to the release of Microsoft’s next-generation gaming console for Xbox. However, the expected amount for the More Personal Computing segment is lower than expected, and is much more volatile than expected as well, which is throwing off some investors. It is believed that guidance missed on More Personal Computing due to the result of Xbox supply constraints and a lower expiry base for Windows.

The two other segments however are expected to grow 11% year-over-year in the second quarter, and most investors own the Microsoft stock for these two segments. In the years to come, it is their cloud-based computing segment that will experience the most growth, as their products and services in the More Personal Computing segment face extreme competition and cyclicality, where as the intelligent cloud becomes increasingly important in an age of digital transformation, which is further crystallized by COVID-19.

Figure 3: Stock Price During Week of Earnings Report (October 26th – October 30th)

Drivers and Risks for Investors Interested in Microsoft

(Long-term) One of the strongest drivers as mentioned prior in this report is the cloud computing opportunity. In this current era, information and applications are increasingly stored and protected in the cloud, where a varying number of devices can access them. Software provides are increasingly offering tools as a service based on subscription. Microsoft's Azure is in its growth stage and is available in more than 60 announced regions globally. This immense growth in Azure, as seen by the revenue figures earlier, strengthens Microsoft's position in the cloud computing market, which is expected to grow exponentially in the years to come. Top competitors in this sector include Amazon's Amazon Web Services.

(**Short-term)** The expansion of Microsoft Teams as noted by the figures expressed prior in this report is very promising and is strengthening Microsoft's position in the enterprise communication market against top competitors such as Zoom and Slack. Teams has been experiencing this increase in demand mainly due to COVID-19, which is why this is expressed as a short-term driver. An interesting fact is that 93 out of the Fortune 100 companies have implemented Microsoft teams. It is not expected that work-from-home, stay-at-home, or online learning will last forever, but nonetheless, it is expected to contribute to the top line for quarters to come.

(Long-term) Management execution has been very strong. Microsoft has built cash and short-term investments to $137.98 billion as of Sep.30, 2020, compared to $136.53 billion as of Jun. 30, 2020. An increase of approximately ~$1.5 billion in one quarter's worth of time during a global pandemic and weak performance of the U.S. dollar is not an easy feat to accomplish. Their debt position has remained relatively the same.

(Short-term) A strong immediate risk that is influencing the More Personal Computing segment is the mobile cannibalization of computers. A large percentage of the company's revenue as seen prior in this report is dependent on this segment, which faces very strong competition and a change in the sector, as it is crucial that Microsoft builds a strong position in mobile devices, specifically in tablets.

(Short-term) A weak job market as seen in unemployment levels and lower spending on advertising are detrimental to the top line as a strong decline is expected for LinkedIn and Search revenues. Decline in transactional businesses is also expected to affect Office consumer revenues.

(Long-term) If there is any technological advancement in the space such as Google Chromebooks, new Android tablets, or products by Apple, there will be market share erosion, resulting in the loss of Microsoft's Windows licensing fees. Thus, this intense competition always puts Microsoft at risk, as the transitioning period and execution is not an easy task.

Conclusion of Report

Microsoft has evolved over the years to be a powerhouse technology company that has and continues to diversify their products and services through countless acquisitions and technological advancements. As an investor, their commercial cloud and productivity and business segments are very appealing, as growth in these sectors are expected to rise in the coming years. Some are hopeful that the new gaming console will be met with open-arms due to recent advancements that have been made, hopefully helping revenue growth in their Personal Computing segment, which has seen a lot of volatility and underwhelming growth in recent years. Microsoft faces strong competition in all of its sectors from notable giants such as Amazon, Apple, and Google, but their management has proven to be great at execution and capitalizing on ongoing trends.

The current drop in prices due to the underwhelming second quarter outlook presents a strong opportunity to buy, as the stock can be expected to rise back to its previous levels and surpass it in the years to come.

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Other figures from Capital IQ

Where Trump Stands on Key Issues

By Laura Chan, Market Research Analyst

What was Trump's tax plan in the past four years and what are the impacts?

Trump has passed the Tax Cuts and Jobs Act (TCJA) in 2017, which is a pro-growth reform, significantly lowering the marginal tax rates and cost of capital. For individuals, the TCJA lowered most individual income tax rates, including the top marginal rate from 39.6 to 37 percent, and increased standard deduction from $6,500 (single) and $9,550 (married) to $12,400 (single) and $24,800 (married). On the business side, the TCJA decreased the corporate income tax from 35 to 21 percent [1].

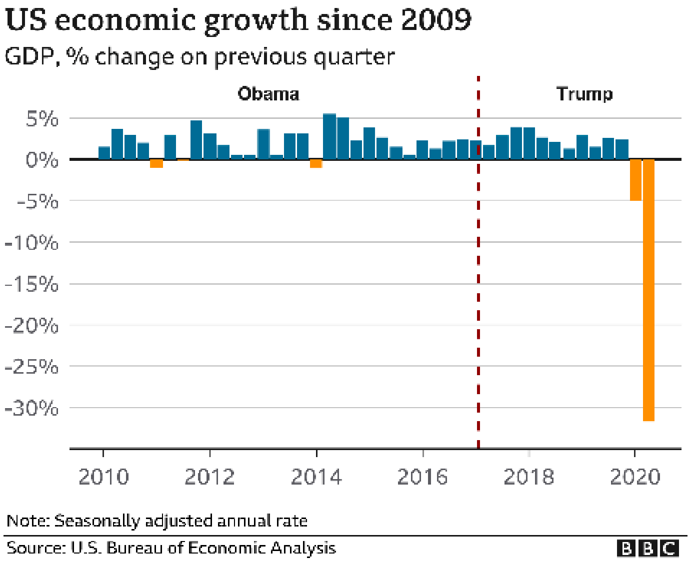


Fig.1 US economic growth under Obama and Trump [2]

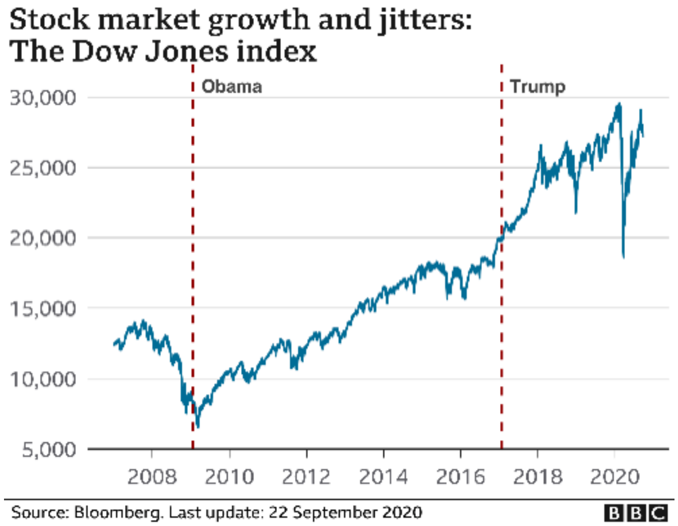


Fig. 2 Stock market growth: Obama vs. Trump [2]

Trump has always claimed that his tax plan boosted the economy and prospered the stock markets. Fig.1 shows the average quarterly economic growth rates under Obama's two terms and Trump's three years before the COVID-19. The average quarterly economic growth rates are 2.3% under Obama's eight years and 2.5% under Trump's first three years. After COVID-19 hit the U.S., there is a 5% and 32.9% GDP decrease in the first and second quarter of 2020. It can be seen that the quarterly GDP growth rates under Obama and Trump are approximately the same before the pandemic. However, Obama took office after the 2008 financial crisis had already happened, while Trump inherited an economy that was recovered from 2008. Therefore, it is inappropriate to attribute recent years of economic growth on Trump's tax cut policy alone since there are not significantly greater GDP growth rates [2].

It can be seen from Fig.3 that the expectation of a major corporate tax cut in 2017 did give the market a lot of confidence and boosted the stock market. The Dow Jones Index increased 42.6% under Trump's presidency. However, there was a greater increase, by 63.7%, in Dow Jones Index under the first Obama's term, which completely beat Trump's record [3]. That being said, keep in mind that Obama did start during the Financial Crisis.

If Trump is re-elected in the November, the TCJA, which is set to be expired in 2025, will be extended. However, if Biden is elected, he will increase the corporate tax rate from 21% to 28%, which will impede the stock market growth momentum to some extent.

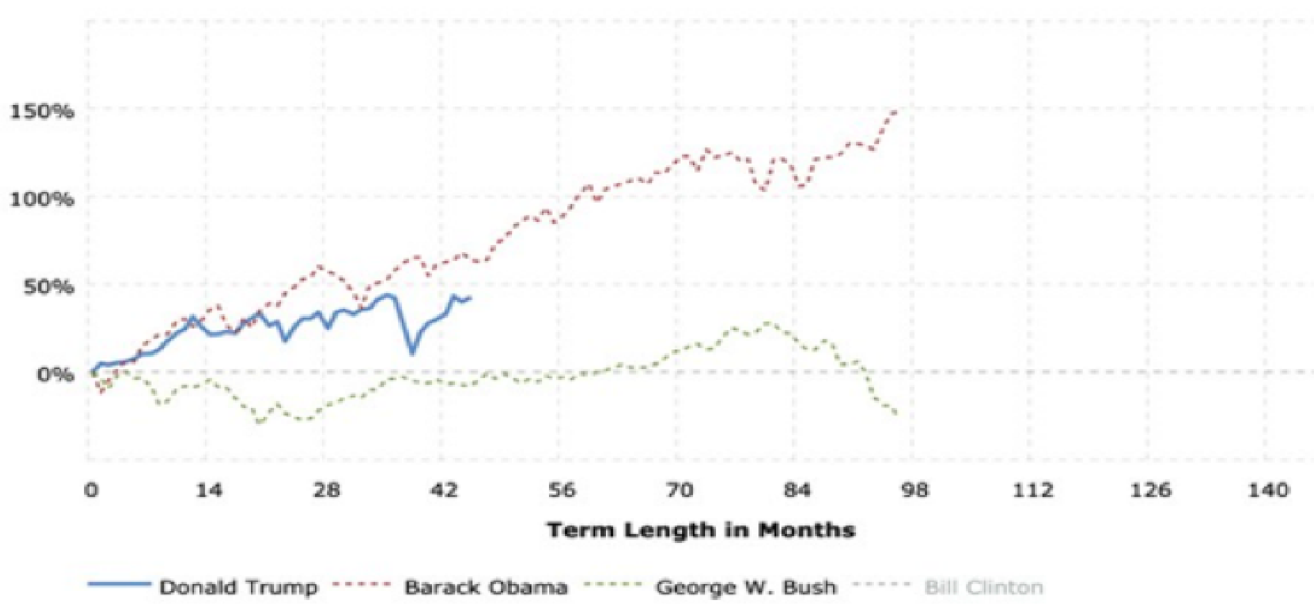


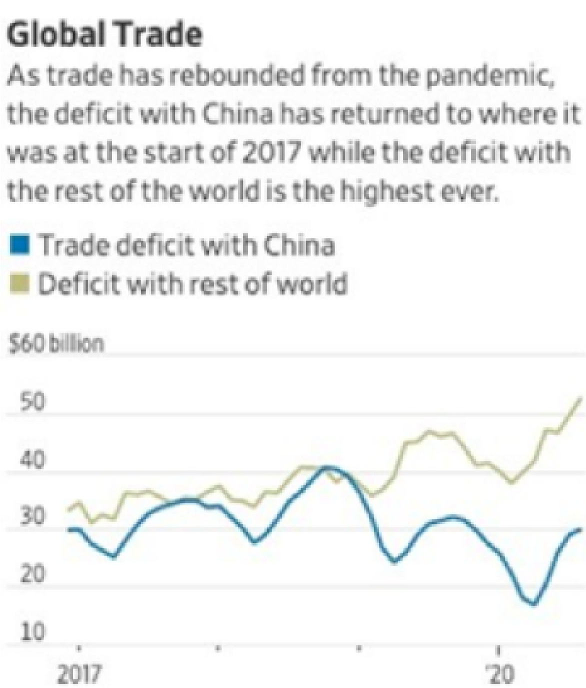
Fig.3 Stock Market Performance by Presidents [3]

Trade War with China

The trade war with China is one of the most important policies of Trump's government. Beginning in 2018, Trump announced a series of trade policies with China aimed to decrease the U.S.' trade deficit and boost American manufacturing.

Opponents of the trade war claim that U.S. manufacturing has not been much impacted by the trade war positively.Fig.4 shows that after the Chinese tariff began, the rate of increase in U.S. manufacturing jobs slowed down, and this was even before the pandemic. Fig.5 shows that the U.S manufacturing index peaked around December in 2018 and maintained roughly the same level in 2019. Neither graphs show much impact of the trade war on U.S. manufacturing.

After the U.S. imposed tariff on Chinese goods, the U.S. consumers soon switched to other countries' imports, like southeast Asian countries. From Fig.6, it's shown that U.S. trade deficit with China has decreased to some extent, but U.S. trade deficit with rest of the world has increased a lot. However, one can certainly argue that it is usually beneficial to import from different countries rather than to be overdependent on one or a few countries' exports.



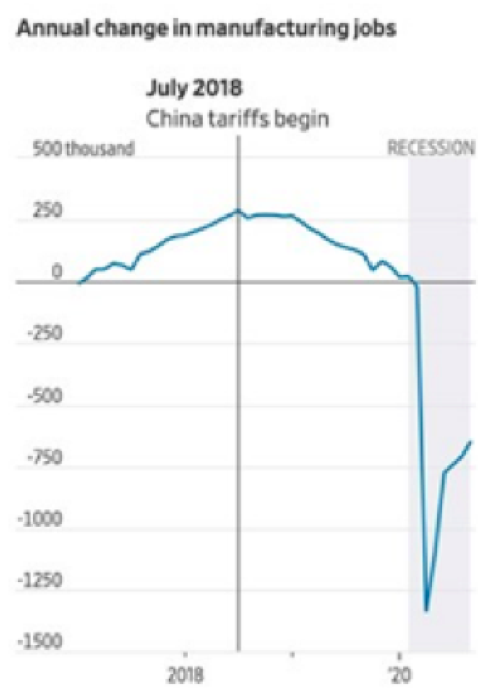


Fig.4 Annual change in U.S. manufacturing jobs [5]

Fig.5 U.S. Trade deficit [5]

Proponents of the trade war argue that it did have a certain amount of impact on the economy of China. From Fig.7, the GDP growth rates of China gradually decreased after the tariff had taken effect. Although it has a relatively minor negative impact on the Chinese economy, in the long term, high leverage in the economy could foster a negative spiral where slower growth leads to business failures and defaults which in turn leads to even slower growth and more failures and defaults. This could potentially drag the economy of China down in the long term [7].

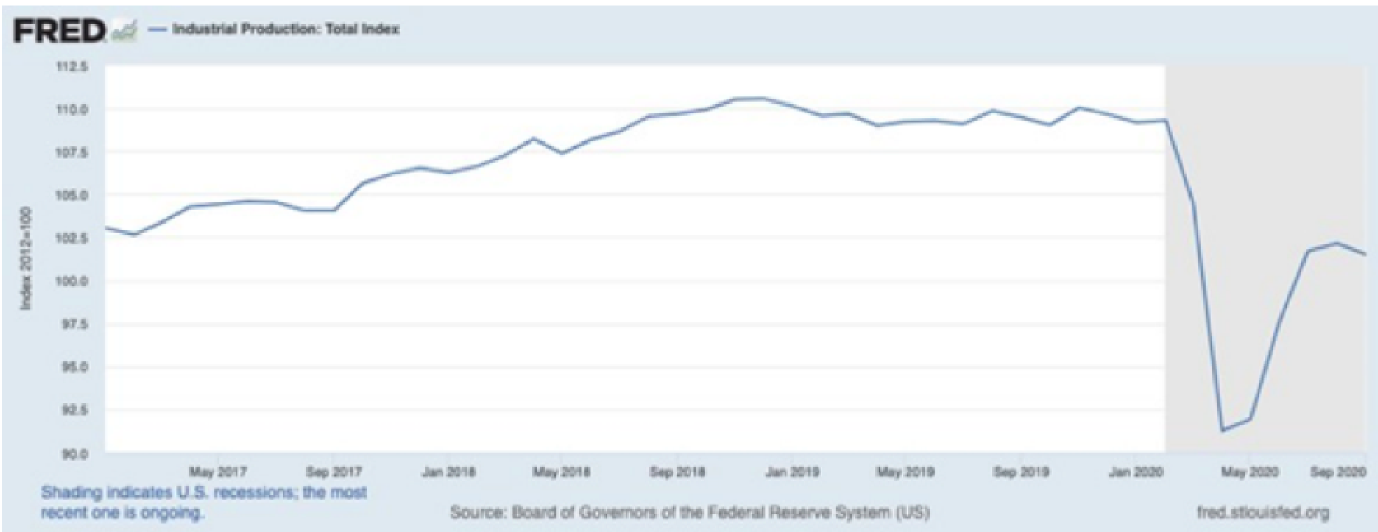


Fig.6 U.S. Industrial Production Index [6]

Although the damage to the Chinese economy has been done, there are not many benefits for the U.S. economy. The U.S.-China Phase 1 trade deal has been signed in January 2020. Phase 1 deal includes enforcement of intellectual property, currency agreement and agreement to open up China’s financial sector to more foreign investors. It is more of a compromise for China than the U.S. However, it is expensive for the U.S. government to bailout the industries such as farming. It is definite that Trump will maintain the tough attitude towards China, but it is hard to say what he will do in the future about the trade war if he gets re-elected, in terms of protectionist measures.

Fig.6 U.S. Industrial Production Index [6]

Repeal the "Obamacare"

During the second term of Obama's administration, the Affordable Care Act (also known as Obamacare or ACA) was passed to reduce the cost of health insurance coverage for more American people. All ACA compliant health insurance plans—including every plan that is sold on the Health Insurance Marketplace—must cover "essential health benefits". Trump has always been attacking the Act and tried to repeal it after he took the office but was unsuccessful. The reason he gave is that ACA is unaffordable to the economy and for a lot of people. However, he was never able to announce a new "Trump health care plan". Though it is unclear how Trump can impact the healthcare industry earnings, it is clear that it is good news to the healthcare stocks if Biden wins the presidency. A government sponsored universal healthcare plan would make the national spending on healthcare continue to increase, and thereby boost the healthcare companies' earnings. On the contrary, the insurance industry's earnings are capped by the ACA. A Trump victory, meanwhile, means little change to the current markets, since everything will be like in the past four years [8]. Another important factor is whether the Republicans or Democrats will control the Senate.

[1] https://taxfoundation.org/tax-basics/tax-cuts-and-jobs-act
[2] https://www.bbc.com/news/world-45827430
[3] https://www.macrotrends.net/2481/stock-market-performance-by-president
[4] https://www.forbes.com/sites/forbes-personal-shopper/2020/10/22/home-office-upgrades-working-space/#299654ac163a
[5] https://www.wsj.com/articles/china-trade-war-didnt-boost-u-s-manufacturing-might-11603618203
[6] https://fred.stlouisfed.org/series/INDPRO
[7] https://www.ft.com/brandsuite/cme-group/trade-war-costs-consumers-companies-nations/index.html
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Lebanon's Economy; the Implosion Followed by the Explosion.

By Jashveer Reesaul, Vice President of Market Research

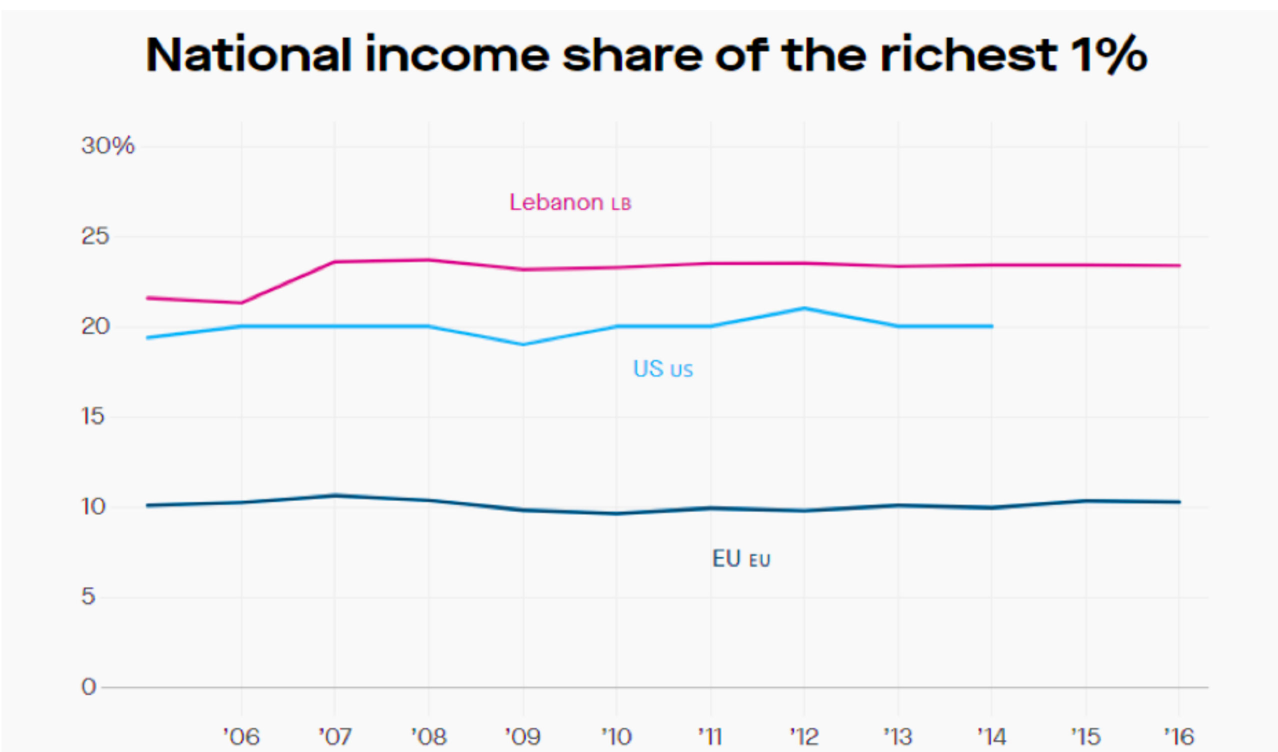
Lebanon takes serious damage as a result of a currency crisis followed by a chemical explosion leading to a shortage of food amidst political unrest.

What was once highly regarded as the "Switzerland of the East" back in the mid 1960s, now finds itself trapped at the very center of political and economic unrest. Lebanon's socioeconomic conditions never regained the same lustre since the Arab-Israeli war caused a mass movement of about 100,000 Palestinians to Lebanon. The religious divides became the additional burden the country could not carry and until today the effects are felt by the Lebanese people. Since the exodus, Lebanon witnessed a civil war, massacres and revolutions, all of which created hostile differences in the Lebanese army and the government. The late 2000s showed hope for the economy as it took significant strides to recover from the war of 2006. Lebanon experienced GDP growth averaging at 9.1% between 2007 and 2010 until the figure dropped to an average of 1.7% between 2011 and 2016 because of the Syrian Civil war. [1] Scarred Lebanon became the third highest indebted country in the world in terms of debt-to-GDP ratio and government expenditure towards the provision of merit and public goods was severely compromised. [2] Having shown proclivity towards a laissez-faire approach, the Lebanese population could only hope to follow the westerners' capitalist tendencies and realize the Lebanese dream. All until 2020, a year marked by a global pandemic, third world war threats, oil and gold shocks, when the "Paris of the Middle East" suffered a hyperinflation, a failed cover-up of a Ponzi scheme and an act of arguable negligence that caused an explosion in Beirut.

Currency Peg

Lebanon is experiencing an average monthly inflation growth rate of 56% and the figure was 89% in June alone. [3] This hyperinflation pushes the Lira away in the same bucket as the Zimbabwean Dollar. Unable to rely on tourism which has been one of the key drivers of the Lebanese economy, the multiplier effect of the increase in general prices is severely harming the economy. Food and non-alcoholic beverages account for 20% of the CPI and prices increased by about 109% leading to shortages and daunting signs of a coming famine. Interest payments on the debts initially taken to heal the economy from lengthy political instability are now becoming greater liabilities in the middle of a pandemic. The opportunity costs are high, and choices are few.

The fixed exchange rate was set at 1507 to 1 for the Lira against the Dollar. The market forces ensured that the balance between these two currencies was maintained. However, the first sign of trouble could be noticed when looking at the over-dependence of the Lebanese population on the Dollar. Roughly 80% of Lebanon's products come from imports, spending from tourists is in US Dollars and Lebanon depends heavily on remittances and loans in the western currency. Soon, the overall exchanges from Lira to the Dollar created large income inequality where the top 1% owned 25% of the country's GDP. [3]



Central Bank's Ponzi Scheme and the Lira Crash

The spillover effects of the Syrian Civil war caused funds in Lebanon to flow away. The Lebanese banks pushed interest rates as high as 14% to portray the Lira as an attractive currency. Central banks could not hide the fact that they were starting to pay interest payments using most deposits. It was only a matter of time that people started to realize the oncoming crash of the Lira. Riad Salameh, the governor of Lebanon's central bank ordered that offices such as Western Union and MoneyGram should make payments in Lira only rather than Dollars even in cases where there were specific requirements for payment in the latter currency. This was yet another warning sign for the Lebanese population signifying the erosion of the Lira.

Further into 2019, the demand for the US Dollar kept rising in exchange booths as traders needed to satisfy the local need with the usual imports. These applied greater pressure on the peg which ultimately led to a breeding ground for highly priced Dollars in the underground economy. Since October, the Lira has lost 75% of its value and dealers even say they were buying Dollars for 6000 Lira, each. [3]

The Calm Before the Storm

The end of 2019 was marked by a unified Lebanon and some even say that October 17th was the true end of the Civil war. The imposition of taxes on WhatsApp usage led to protests on Martyr Square, Beirut where people had their hopeful eye set on reinforcing the idea that the Lebanese diaspora deserves the right to have their own soil free of corruption and social divides. The protests continued for months and the government attempted to tame the spirits of the protesters by cutting power daily. This could not harm the celebratory crowd as the protestors sang and danced in the streets of Beirut. The Lebanese Prime Minister Saad Hariri resigned but this was not enough for the protestors who wished for more impactful and sustainable change.

The protests were halted by Covid-19 which was followed by a long period of famine and unemployment. Coupled with a shortage of Dollars to purchase grains, animal produce, oil and other supplies, Lebanon quickly ran out of fuel and the citizens experienced power shortages up to four days each week.

The hungry population showed their anger towards the establishment on July 11th, 2020 when petrol bombs were thrown at the Central Bank while the shouts “down with the bank’s rule” and “down with Riad Salameh” were heard. [4] Protestors were heard on the streets of Beirut, Tripoli, Natabieh, Saida and other Lebanese areas demanding a solution for the harsh conditions the Lebanese population was living in. Just as one could start thinking that it was the end of the suffering for Lebanon, there was yet another challenge creeping up.

Beirut Explosion

The 4th of August will be forever remembered in the scarred hearts of the Lebanese people. A devastating explosion approximately 140 metres wide killed more than 200 people and injured more than 5000. The unemployment rate sat above 25% and about 1/3 of the country have been living below the poverty line. Roughly 300,000 people have lost their homes and total damage to the region has been estimated at billions of Dollars. [5]

The cause behind the terrible incident was an act of negligence that is not being shouldered by anyone including the local authorities claiming that the port was beyond the area of control and investigation. There is no evidence yet for the ignition of the 2.7 tonnes of ammonium nitrate that was stored in the Beirut port for 6 years, a similar incident to what happened in Tianjin, eastern China, in 2015 which killed 173 people. [6]

Beirut’s explosion caused greater turmoil in the already destabilized country and being trapped under such political and economic stress, the government of Lebanon stepped down amidst which, Hassan Diab, the Prime Minister resigned too.

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Aftermath

The anger in the hearts of the Lebanese people has reached immense heights. New elections will not be enough to soothe the accumulated pain caused by blows since the Syrian Civil war. The Lebanese population needs transparency and accountability. They need to know why those events are taking place and they need to be shown that there could be a light of hope in the darkness. On September 1st, 2020, President Emmanuel Macron visited the Lebanese soil on the country's centenary. [7] He voiced out the need for a new political reform based on non-sectarianism and transparency. Amidst the upheaval, the French President seemed to have said all the right things. What this means for Lebanon is unclear. The road that lies in front of the Lebanese people eerily resembles the same roads of 1948 during the Israeli-Lebanese war. For now, the spirits behind a unified Lebanon during the end of 2019 should not fade away as this might be another chance for the Lebanese people to make careful choices in terms of who they place into power.

[1]. https://tradingeconomics.com/lebanon/gdp-growth-annual
[2]. https://www.bbc.com/news/world-middle-east-50183895
[3]. https://www.forbes.com/sites/tatianakoffman/2020/07/09/lebanons-currency-crisis-paves-the-way-to-a-new-future/#37805a426a17
[4]. https://www.trtworld.com/magazine/why-the-central-bank-and-the-government-are-at-war-in-lebanon-37943
[5]. https://www.bbc.com/news/world-middle-east-53720383
[6]. https://www.independent.co.uk/news/world/asia/tianjin-explosion-photos-china-chemical-factory-accident-crater-revealed-a7199591.html
[7]. "The sultan et le president", The Economist, September 5th, 2020