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Special Economic Commentary

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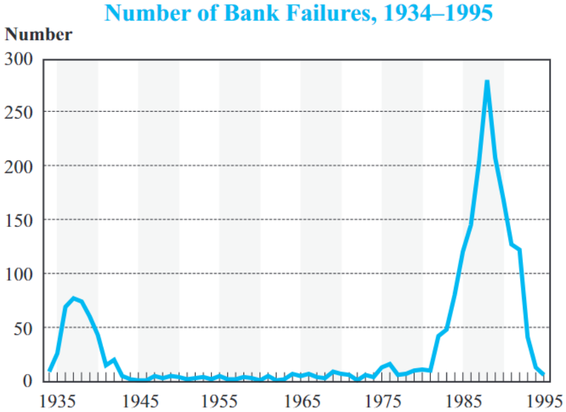
While most banks are experiencing strong selling pressure this looks more like a buying opportunity than widespread contagion. While it is fun to discuss and make comparisons to previous disasters using hyperbole, the demise of Signature Bank and SVB are garden variety bank failures. Both banks were poorly run and held exotic loan books. Their loans funded speculative and nascent areas of the market such as block chain and venture capital. The proceeds were used to purchase long dated treasury bonds with the hope that a sufficient percentage of their loan book would continue performing to prevent a sale of the government bonds. An increase in interest rates rendered many speculative businesses uninvestable when cheap money was no longer available. Even the most far-fetched business ventures are investable when funding costs are near zero. Now that interest rates have returned to historically normal levels business ideas that would have never received start-up and/or mezzanine funding have run out of capital. The lesson of these bank failures is part of the debate among investors since rates went to zero during the Great Recession: low interest rates encourage unnecessary risk taking. It has been very easy for banks to throw large sums of money at entertaining elevator pitches when interest rates are at or near zero. However, when people are forced to use critical thinking during an evaluation of a new business opportunity the Shark Tank style presentations become much harder to judge when an investor is forced to consider the cost of funding.

Number of Bank Failures, 1934–1995



Note: Data refer to FDIC-insured commercial and savings banks that were closed or received FDIC assistance.

When we zoom out and attempt to understand these events in the broader context of banking history it becomes more apparent that these events are unlikely to spiral into widespread financial contagion. Banks have failed since the practice of lending was created yet our economy has fared quite well. During the last seven years ending 12/31/2022 the worst year for bank failures was 2017 when eight bank failures occurred. This translated to a failure rate of 0.16% of the 4,918 chartered banking institutions. Furthermore, since 1934 the highest bank failure rate was 4.17% in 1989 during the throes of the Savings and Loan crisis that occurred from 1982 to 1995. This period is the most applicable comparison since rapidly rising interest rates were also the proximate cause of failures. Not only did the fair value of loan portfolios decline, interest paid out to depositors eclipsed interest derived from loans issued during a period of significantly lower interest rates. When scanning the headlines, we see a plethora of lazy comparisons to the Great Recession and Great Depression. These periods have little connection to what is happening now. The Great Recession was sparked by a combination of loose residential real estate lending standards and a public policy push among lawmakers to expand home ownership, while the Great Depression occurred due to the complete absence of regulation. Unfortunately, much of the news cycle is drawing these comparisons to drive click-bait and increase viewership. You will not hear that bank failure peaked during the Great Depression at 0.54% in 1937 and 1938. You also will not hear that the 157 bank failures of 2010 was far lower than the depths of the S&L crisis which happened to precede one of the strongest bull market equity periods in history. When we look past the headlines, we believe well-established banks with differentiated business models appear attractively valued after the intense sell-off. Moreover, the fundamental logic for further interest rate increases remains intact. We view these failures as largely episodic events with no major impact to our outlook for the remainder of the year.

Image Source: History of the Eighties : Lessons for the Future An Examination of the Banking Crises of the 1980s and Early 1990s, FDIC, 1997