CREATIVE DESTRUCTION'S EVIL TWIN

Written By: Your First Bankers Trust Team

FIRST BANKERS TRUST COMPANY
A Division of Town & Country Bank and Trust Co.

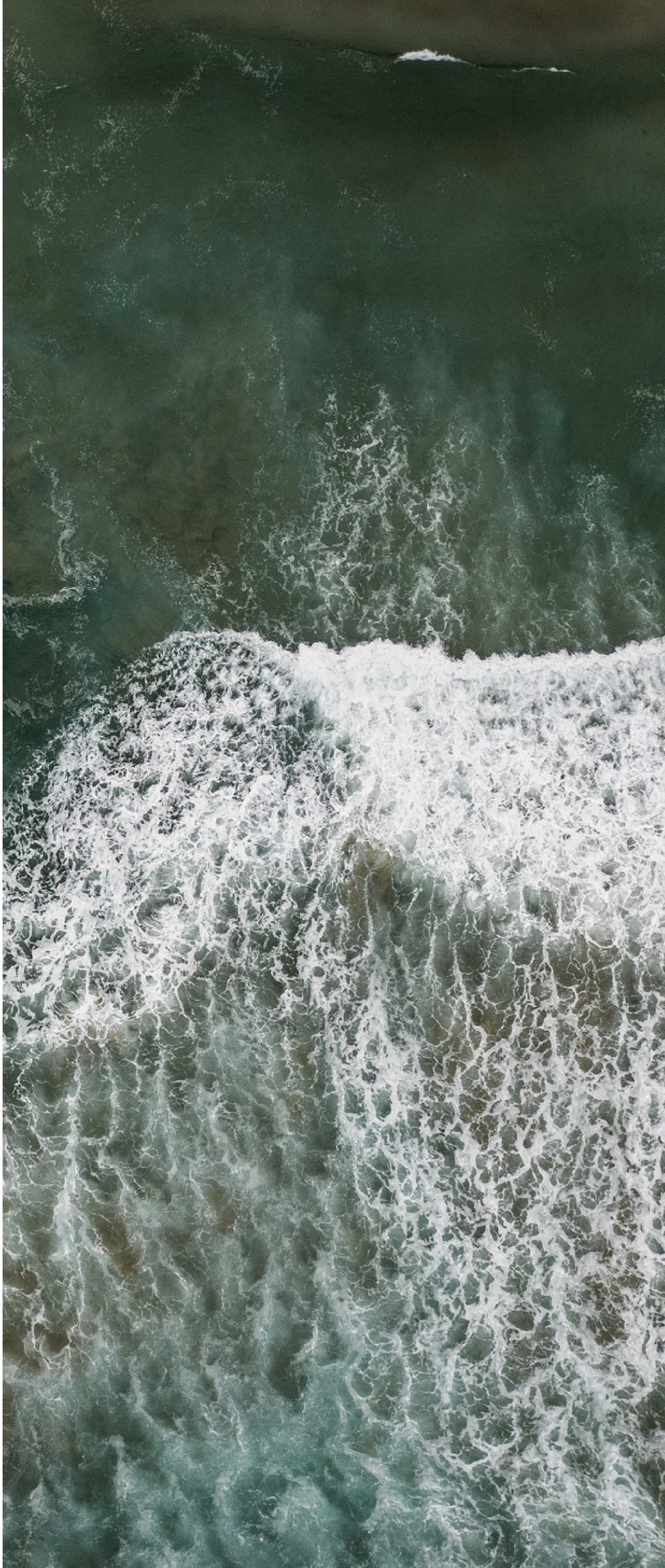
Innovation is the grease on the wheels of the economy. A beautiful byproduct of human ingenuity and persistence, innovation is also the lifeblood of companies. If a company fails to improve and innovate, it risks going out of business. The development by which new processes, products, and services disrupt existing incumbents is often referred to as creative destruction. This term was popularized by Austrian economist Joseph Schumpeter and remains common terminology in business today.

Everyone adores innovation, but creative destruction is a more succinct phrase to describe the way in which innovation affects the economy and its participants: the creators and innovators thrive and the stagnant incumbents suffer destruction. Despite some people experiencing pain, creative destruction is viewed positively because time after time, business cycle after business cycle, creative destruction delivers a net positive to society and improves our lives.

What is discussed far less in business, economic, and market circles is creative destruction's evil twin. As we've written about in multiple newsletters over the past year or so, the Federal Reserve is changing the cost of money. Our metaphors have ranged from the ocean currents to wrecking balls, but the complex and powerful actions taken by the Fed can be boiled down to that: the cost of money is going up via higher short-term interest rates. Despite the myriad of challenges businesses must overcome, perhaps none have as wide-ranging and unpredictable impacts as rising interest rates. This process is what brings about creative destruction's evil twin. Poorly managed businesses – even those that might have an "innovative" offering – fail during rising interest rates. We will quote Warren Buffet again - "only when the tide goes out do you discover who has been swimming naked." Creative destruction's evil twin is the riptide that removes froth or excesses from the economy. The riptide does not possess the positive connotations that creative destruction does, but unfortunately it is every bit as necessary for the economy to thrive longer term. Froth and excess destroys capital and distorts demand and supply responses – the riptide pulls it out of the system and allows for innovation to impact the places it is needed the most.

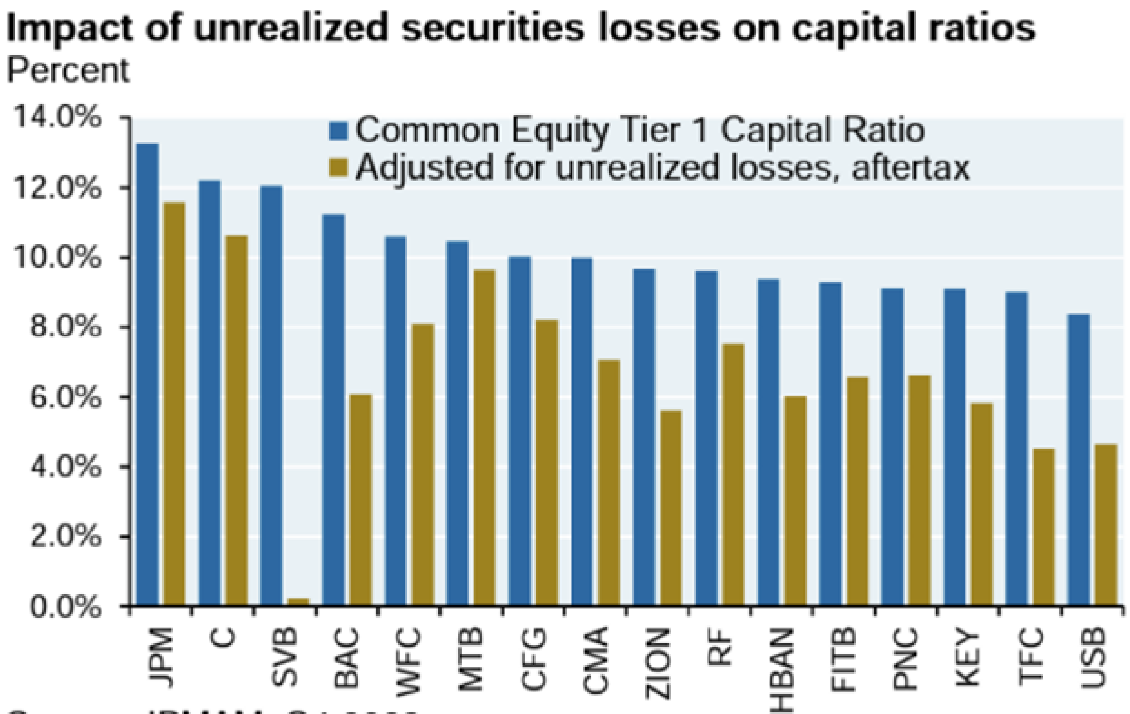
The riptide was certainly present in the financial markets last year, but the markets move faster than the real economy and bankruptcies were mostly limited to outright Ponzi schemes in the cryptocurrency sector, such as FTX. On March 10, 2023, the riptide pulled a much more meaningful victim out to sea: Silicon Valley Bank (SVB). There were two other banks that failed in March as well: Silvergate Bank and Signature Bank. Bank failures certainly cause intense phantom pains in the scar tissue from the Great Financial Crisis, but the economy will be better off longer term thanks to creative destruction's evil twin taking these three out to sea.

It may seem harsh to bid adieu nonchalantly to these three banks, particularly Silicon Valley Bank. SVB was a strong, 40-year-old franchise that did a lot of good for the tech startup and venture capital ecosystem. However, we believe we are in the midst of a regime change in the economy and capital markets. SVB and its customers were beneficiaries of low interest rates, especially relative to the rest of the economy. Low inflation and low interest rates enable investors and managers to think long-term and be more tolerant of pushing profits further into the future – a frequent attribute of tech startups. High inflation and higher interest rates do the opposite, as investors can generate more cash quickly in fixed income, and either offset the cost of high inflation personally or redeploy into high inflation sectors to encourage bringing needed supply to the economy. The promises of future profits do not suffice in this environment.



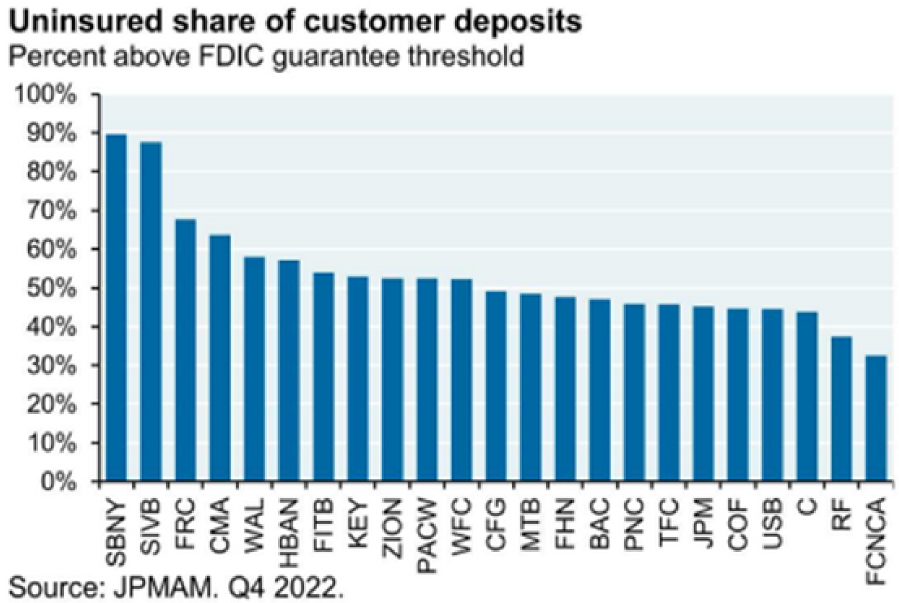
A QUICK LOOK AT THE PARTICULAR WEAKNESSES OF SILICON VALLEY BANK

Herein lies the need for the riptide to pull SVB and its fallen brethren into the sea. Inflation gained steam in the summer of 2021. Yes, elements were transitory and disinflation is finally occurring but there was absolutely no reason for the 10 year Treasury yield to be bouncing around 1.5% when core inflation measures punched through 4% in June 2021. This was the warning shot: interest rates must go up and everyone, especially banks, must reduce interest rate exposure. To be clear, banks are in the business of interest rate risk: they borrow short via accepting deposits and loan longer-term to customers. And the speed and magnitude of the interest rate shock was historic. Nevertheless, there were many prudent actions a bank could take to reduce the magnitude of interest rate risk inherent in the business model. SVB, in order to avoid taking a reduction in profits in the short term, failed to reduce interest rate risk in their securities portfolios (if banks don't have enough lending opportunities, they will often buy bonds to earn an interest spread). All banks were guilty of this to varying degrees (and remember, interest rate risk is a feature of the business), but SVB took it to dangerous levels, as seen in the chart below.



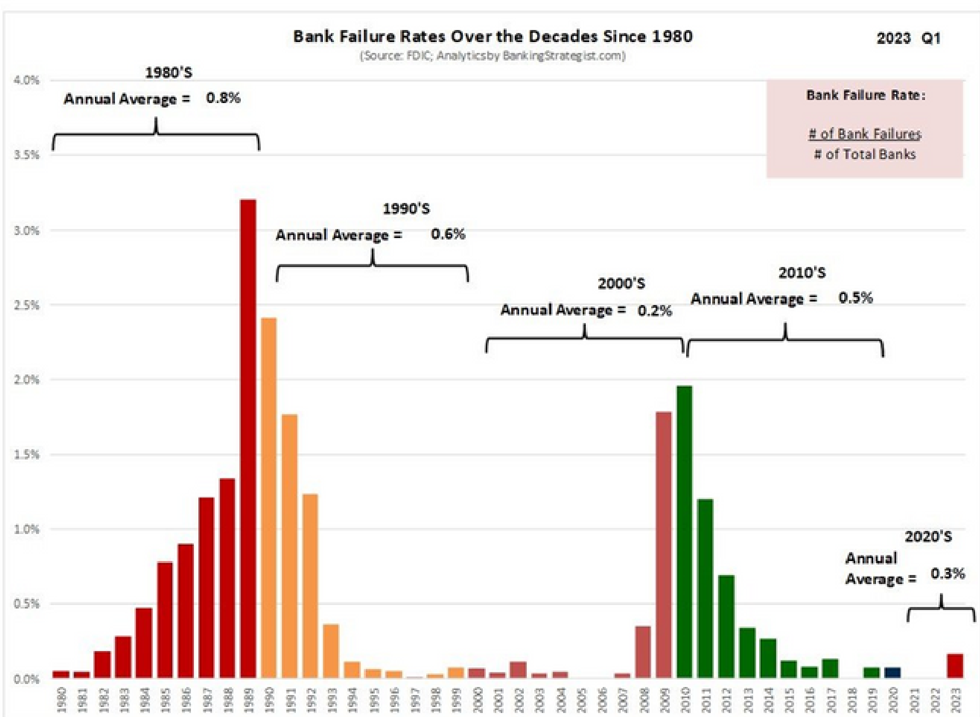
Source: JPMAM. Q4 2022.

That is just the left side of the balance sheet (assets). SVB committed a cardinal sin of finance on the right side (liabilities) of the balance sheet as well: a failure to diversify. SVB's long-standing reputation in the tech industry inevitably led its deposit base to be fairly concentrated in one industry (an interest rate sensitive industry we might add). However, SVB not only failed to diversify by industry (and likely geographic) exposure, but they also failed to diversify by depositor: the top 10 accounts held $13.3 billion in deposits!



That was over 7% of their deposit base, with the average account size being estimated over $4 million. There are vehicles to protect deposits over the FDIC insurance amount of $250,000, but most of SVB's customer base apparently failed to utilize these options.

As more reports come out, it's clear SVB had some other questionable business practices too. And SVB management is on record deciding to avoid taking losses up front in the name of sound asset liability management (i.e. interest rate risk management). A failure to adapt to the new interest rate environment, and a long-standing failure to diversify are signs of excesses, in our opinion, and the management teams needed to be removed by the riptide. This will push SVB customers to more soundly managed banks and increase the resiliency and productivity of the banking system longer term.



Beyond our Monday morning quarterbacking and Darwinian diatribe, we think it's important to point out the banking system as a whole is in far better shape than 2008. Capital ratios, a measure of buffer against losses, are significantly higher and credit losses are not even remotely close to where they were during the Great Financial Crisis. This latter point is pertinent when it comes to the general health of the economy too. It's easy to forget that during the economic boom of the 1980's (also a time of interest rate volatility), bank failures were more common than they are now.

WHAT DOES THIS MEAN FOR PORTFOLIOS?

We strongly suspect the riptide is still churning and more excesses will be taken out to sea. There could even be another bank or two to fail, and there are numerous unprofitable young companies with questionable unit economics – even some popular consumer technology companies. Those without the evidence of current or future profitability will see funding dry up and be carried out to sea. Bankruptcies are already on the rise (please note they are coming off extremely low levels – this is just normalization), so 2023 may be a year of volatility and minor panics.

First Bankers Trust clients should rest assured that our strategy focuses heavily on high quality companies, and a lack of profits has never interested us – even in low interest rate environments. While stock prices whipsaw as market participants debate recession and inflation, the management teams of companies in which we invest are adapting to ever changing dynamics in their industries and the economy as a whole and generating strong returns on capital.

Inflation risk remains, and at the time of this writing, cash pays more than the rest of the Treasury curve. While the rate of inflation is coming down, we disagree with the market's current pricing of interest rate cuts in July. The Fed has no reason to cut without job losses – they too know how much excess money supply is still in the system. Could unemployment pick up between now and then? We think it would take an exogenous shock to accelerate that quickly. Could we see interest rate cuts next year? That's more reasonable in our opinion. Thus, cash is king until the bond market accepts regime change. We believe Treasury yields for maturities beyond a year must be 4% or higher for consideration. The time for extending duration may be getting closer, however.

Sincerely,

Your First Bankers Trust Team

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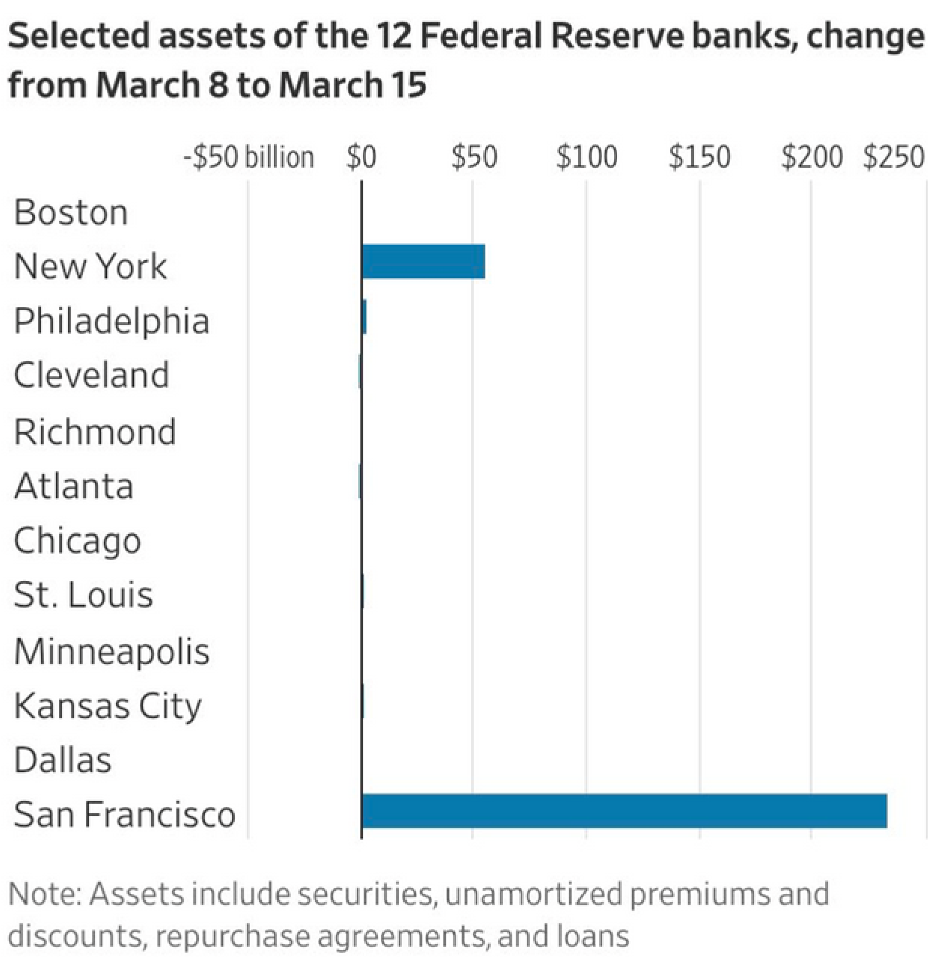
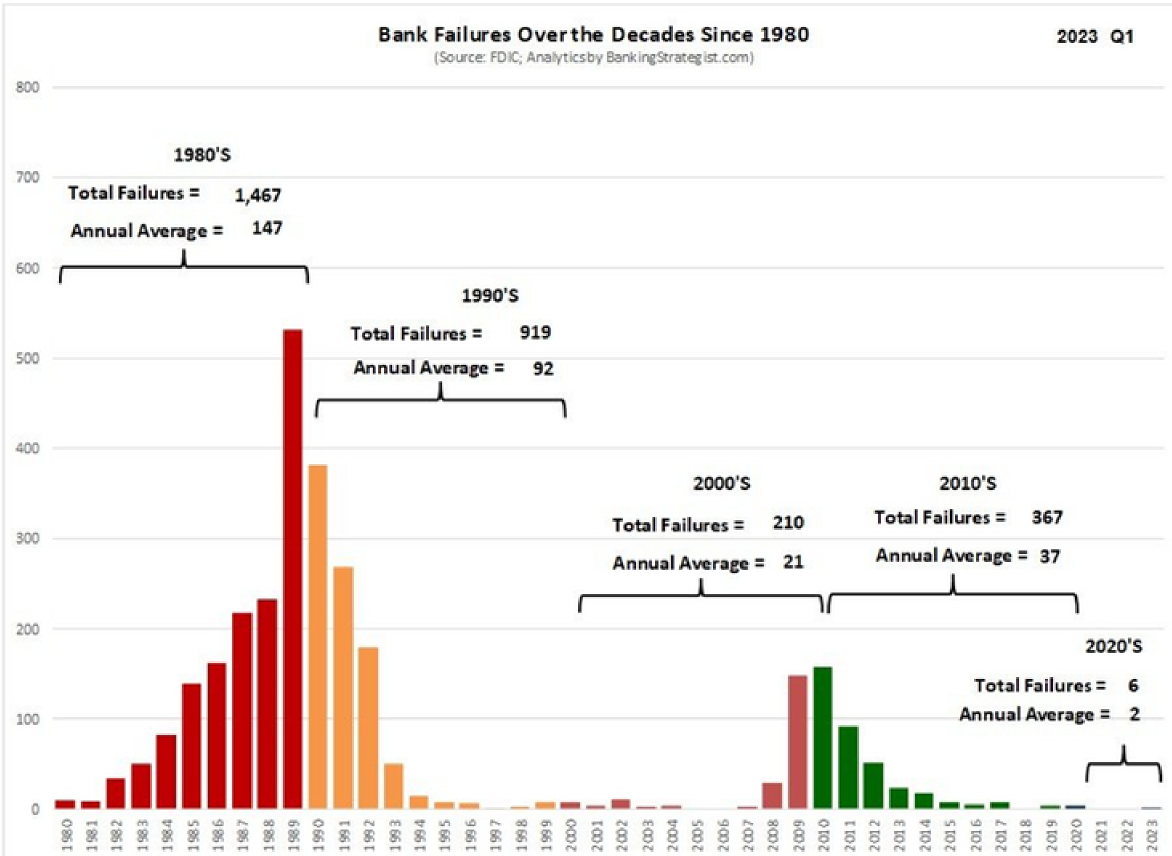
Chart Appendix

Sources: Bloomberg, First Bankers Trust Research, JP Morgan Asset Management, Wall Street Journal, Banking Strategist, Arbor Data Science, S&P Global




Bank Failures Over the Decades Since 1980
(Source: FDIC; Analytics by BankingStrategist.com)
2023 Q1
1980'S
Total Failures = 1,467
Annual Average = 147
1990'S
Total Failures = 919
Annual Average = 92
2000'S
Total Failures = 210
Annual Average = 21
2010'S
Total Failures = 367
Annual Average = 37
2020'S
Total Failures = 6
Annual Average = 2
0
100
200
300
400
500
600
700
800
1980
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2022
2023


Corporate Bankruptcies at Two Decade Low
Bloomberg Corporate Bankruptcy Index (100 = 2000 to 2012 Medians)
ARBOR DATA SCIENCE
2000-2012 Median
0
100
200
300
400
500
600
700
800
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
Data Source: Bloomberg LP
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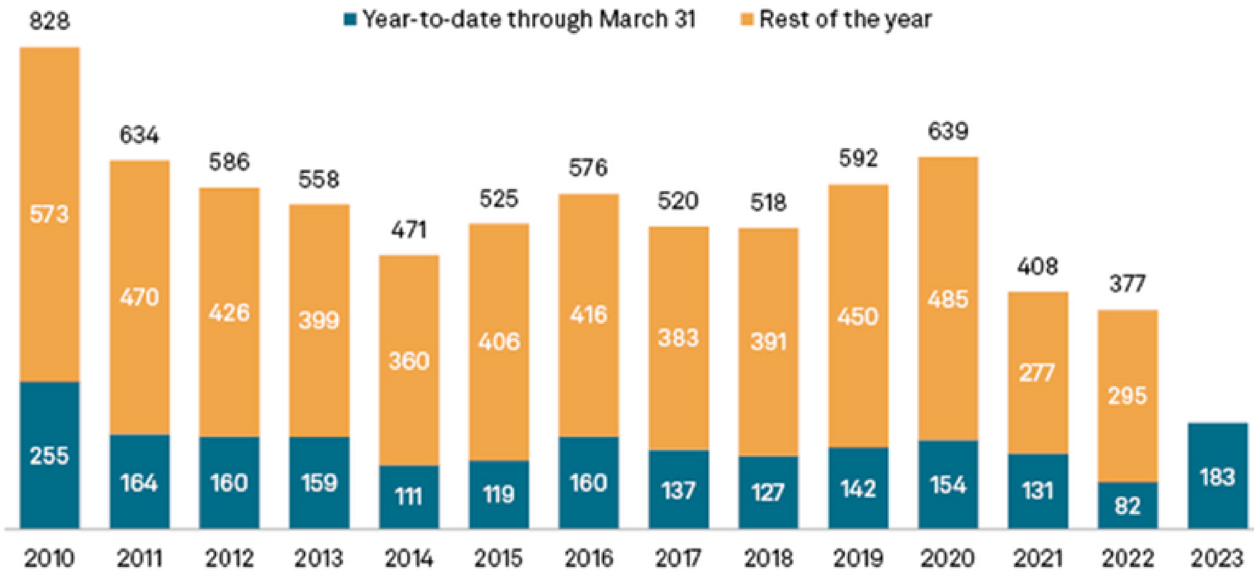
US bankruptcy filings by year



Includes S&P Global Market Intelligence-covered US companies that announced a bankruptcy between Jan. 1, 2010, and March 31, 2023.