FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Ed Depenbrok
DATE: August 30, 2019
SUBJECT: The *Summer* of Our Discontent

It was none other than the Bard himself who, speaking through Richard, Duke of Gloucester, in *Richard the III*, Act 1, Scene I in London as he began his soliloquy, "Now is the winter of our discontent. . ." That opening has been repeatedly penned (in various forms) throughout the last four hundred twenty-five years.

It is the title of John Steinbeck's novel, *The Winter of Our Discontent,* written nearly 60 years ago.

We are certain that we have heard or seen Shakespeare's opening from *Richard the III* morphed into the seasons of Spring and Fall.

So what does it mean—*The (Winter, Spring, Summer, Fall) of our discontent?* The discontent is misery or unhappiness which seems to describe the mood in which investors find themselves as we end this Summer 2019.

What the heck is going on?

Trade negotiations with China seem to have fallen off the tracks; the yield curve inverted, became flat and then inverted again, if ever so modestly—two basis points and is believed to signal the onset of a recession; many of the EU countries are in recession or close to it; the European Central Bank, the ECB (not to be confused with the England and Wales Cricket Board) has rates at *zero* percent--$17 trillion of bonds around the world are at negative rates (led by Germany, France and Japan); depositors are, in effect, paying the banks to take their funds on deposit; the economic pundits on cable news are bringing on fears of negative rates in the US, we believe unduly frightening folks living on fixed incomes and are thoughtlessly talking up recession without any thought as to the possibility that their fear mongering could, in fact, trigger an economic slow-down leading to recession. Not possible?

Well . . . last December as these nattering nabobs of negativity began recession talk, the savings rate in this country jumped from 7.2% in November to 8.8% in the final month of the year![1] In December, a month of historically low savings, our savings rate, triggered by recession talk jumped over 22% on consumer fears caused by these comments.

Then on Monday, August 19 we received an article from one of our readers (thank you sir!) entitled "The Last Thing Banks Need Is Even Lower Rates" by Robert Burgess of *Bloomberg*; and, from a regular source, Banks Street Partners/Performance Trust, we found in our inbox an article entitled "Buckle Up", from the inimitable Nancy Bush of *Bush On Banks*.

We think (not seriously) that Robert Burgess did some "appropriating" of our Fortress Partners mantra and we are flattered: ***The foundation of a strong, free economy is a diverse and competitive banking system. We believe interested, proactive shareholders promote efficiency and good performance, while fostering a healthy banking and economic system*** as he opened his piece with "It's generally accepted that one of the keys to a healthy economic system is a robust banking system." With that opening line we were hooked. Of course, he was right but let's go on.

He points out that banks make their money borrowing short and lending long but as yield curves invert

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[1] Source: TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

throughout the world, including periodically in the US over the past several weeks, even days and hours, banks do struggle to earn a profit when the cost of short term funds (deposits in particular) becomes greater than the rate on longer term funds, we banks find ourselves between a rock and a hard place.

Burgess cited a recent report from Morgan Stanley which noted that "[t]he lower the ECB pushes rates, the more difficult it will be for [EU] banks to remain profitable." We assume that would apply here in the US as well. Also, the *National Bureau of Economic Research*, the organization that identifies when US recessions start and end presented a paper at the Chicago Fed stating that "a cut in the policy rate into negative territory is actually mildly contractionary." Why? "[T]he negative impact on the banking system outweighs the benefits of lower rates" according to Burgess. This is applicable where the central bank's balance sheet is as large as it is at the ECB ($5.2 trillion in assets). We think the Fed's balance sheet at $3.5 trillion in assets is still too big.

In addition, economists, according to Burgess are concerned of another effect of low or negative rates: "the unintended consequence of boosting savings rates" (not interest rates) as consumers put more of their earnings away to make up for lost interest income. In fact the personal savings rate for the month of June 2019, the latest reading available, was 8.1%, double what it was heading into the Great Recession/Financial Crisis in 2008.

We agree with Burgess's final statement/understatement ". . . there's something to be said for setting monetary policy in a manner that promotes a healthy banking industry rather than hinders its growth."

So is Burgess warning us away from lowering rates? It sure appears that way but he and others of his stripe will be unable to stop the Fed if it is bludgeoned into a further lowering of rates.

But Nancy Bush points out, as we contemplate the economic and capital markets landscape each morning on Fox Business News or CNBC, "we scarcely know where to start with that day's litany of woes." Where does the issue of lowering rates rank? She caught Carl Weinberg, Chief Economist of High Frequency Economics, on August 12 on *Bloomberg Survellience TV.* Weinberg is, according to Bush, an old hand on the subjects of the yield curve and on China.

So where does Weinberg stand on the matter of lowering rates and, ultimately, negative rates? According to Bush, he "expressed great discomfort with the idea of any prolonged regimen of negative rates. . . [which] would inevitably lead to systemic failure as 'money dies' (i.e., is seen to have no value) and holders of money turn to consumption instead."

This sounds like our old (50-60 years-old) college economics text books. We are close enough to that possibility for it to be spooky.

He went on to say that we are in an environment he'd not experienced before. Here's the punchline. He went on to say "you don't know what you don't know when you're off the grid with interest rates." He further made a comparison with 2008 and nationally falling house prices saying that today's environment is similar, "in that no one knew what that meant until the meaning became suddenly and painfully clear."

Ms. Bush also points out that bank stock markets are as confused and angst-filled "with this idea of 'we don't know what we don't know.' As this was being written, the yield curve again inverted, if ever so little and she states "that the collective memory of the events of 2008 is leading to an exodus from financial services stocks."

But our industry is well prepared! We believe the industry we serve is far better prepared to weather a recession or even a storm like the one with which we were stricken in the last decade. While most observers of financial services and community banking would agree with that statement, there are a

number of others who, in a panic, have grabbed the microphone on cable business news saying that the Fed must act immediately on the inverted yield curve—even though it is inverted at this moment today but may not be inverted in a few minutes or tomorrow or the next week—and that it "can't fight the markets." To those latter, Bush says "Get a grip." And we agree.

So what should community banks be doing in response to the past few days or weeks? That's easy, continue straight blocking and tackling just have we have been doing for the past number of years. While "community banks are often judged to be at a disadvantage to the larger banks in these times as they have fewer revenue sources and are more exposed to moves in the yield curve." That's bunk! We agree with Nancy Bush that the conventional wisdom may not fully grasp what we believe is a "unique and important advantage—[community banks] know their customers, they can have conversations with them to clarify their situations, they can convey the need for a collegial and mutually advantageous relationship in times of turmoil. . ."

So what should community bank *investors* be doing in response to the past few days or weeks? We have been through this before and we arrived at the end alive—battered and bruised but nonetheless alive. And since then, the economy has rebounded, US industries have thrived and millions of our fellow Americans found jobs and bought homes. Sure, today there are a few things we have not experienced before, that are not normal and that stand in front of us, the yield curve inversion (or is it inversion *perversion?*) among them. <u>But community bank stocks are available at bargain prices!</u>

- The SNL Microcap Bank Index (of 468 banks with market capitalizations of $250 million or less) price change index is down over **-10%** since September 20, 2018—the most recent peak in prices. What is even more dramatic is:
  - The **price to tangible book ratio dropped from 154% to 128%** (they're really building capital), and
  - The **price to earnings ratio has declined from 19X to 13X!**
- The NASDAQ Bank Index (an index of 337 NASDAQ component banks including several in the largest 50) has declined over **-18%** since September 20, 2018.
- An August 14 report from Ricardo Diaz at Janney (FIG) Bank Research noted, "Banks trade at 61% of the S&P 500's forward P/E, the lowest relative level over the past six (6) years…Banks have routinely traded at 80% to 85% of the S&P 500's multiples.

This then is Our *Summer* of Discontent, fraught with misery and unhappiness due to uncertainty but not unlike a movie we've seen before. Community banking survived and thrived.

And today community banks are available at sale prices!

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