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VIEW FROM THE TRADING DESK

June 3, 2022

May 2022 Recap:

Rates bucked the trend for the year in May, as the front end rose with the Fed hiking rates 50bps, while the 3-7 year “belly” of the US Treasury yield curve had a meaningful rally. The narrative for the outperformance in the belly of the curve is based on investors re-setting inflation expectations, with many thinking May or June will be the peak of inflation. The counter to peak inflation is being tested as oil continues to climb to record levels. The Fed officially begins Quantitative Tightening on 6/1.

Benchmark Treasury Yields:

	01/03/22	05/02/22	05/31/22	MoM Change
1M	0.04	0.38	0.72	+33.7
3M	0.06	0.78	1.06	+27.1
2Y	0.77	2.73	2.56	(-17.5)
5Y	1.36	3.00	2.82	(-18.6)
10Y	1.63	2.99	2.85	(-13.8)
20Y	2.05	3.25	3.26	+0.7
30Y	2.02	3.04	3.05	+1.1

Key Indices MTD/YTD Returns

- Bloomberg Global Aggregate: +0.27% / (-11.06%)
- US Treasuries: +0.18% / (-8.33%)
- US Aggregate: +0.64% / (-8.92%)
- MBS: +1.11% / (-7.29%)
- Municipal Bonds: +1.49% / (-7.47%)
- Taxable Municipal Bonds: (-0.70%) / (-13.79%)
- Corporate Bonds: +0.93% / (-11.92%)

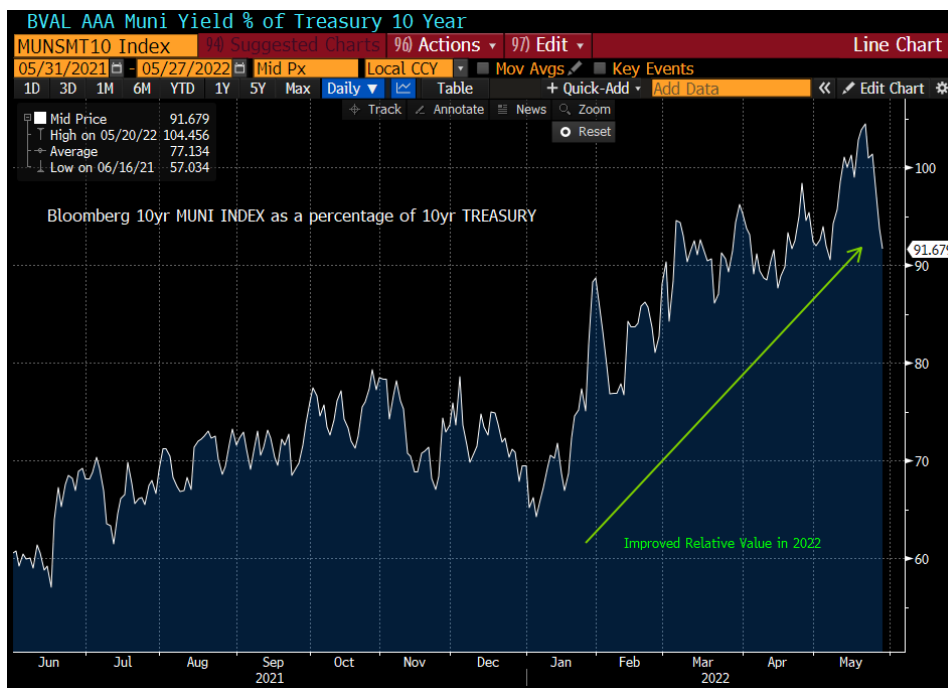
Next FOMC Meetings: June 15, July 27, and September 21

Our take from a community bank investment portfolio perspective:

U.S. Treasuries / Agencies – In May, we saw continued interest in Treasury securities as nominal yields looked more attractive to purchasers looking for bullet options. Non-callable agencies provided little spread over comparable Treasuries until invested past 5 years. Callable agencies started to show relative value, but that required some extension and giving up call protection. In general CDs tend to lag Treasuries up and down – and in May lagging Treasuries downward moves in the 2-5 year range meant CDs had additional spread until rate adjustments.

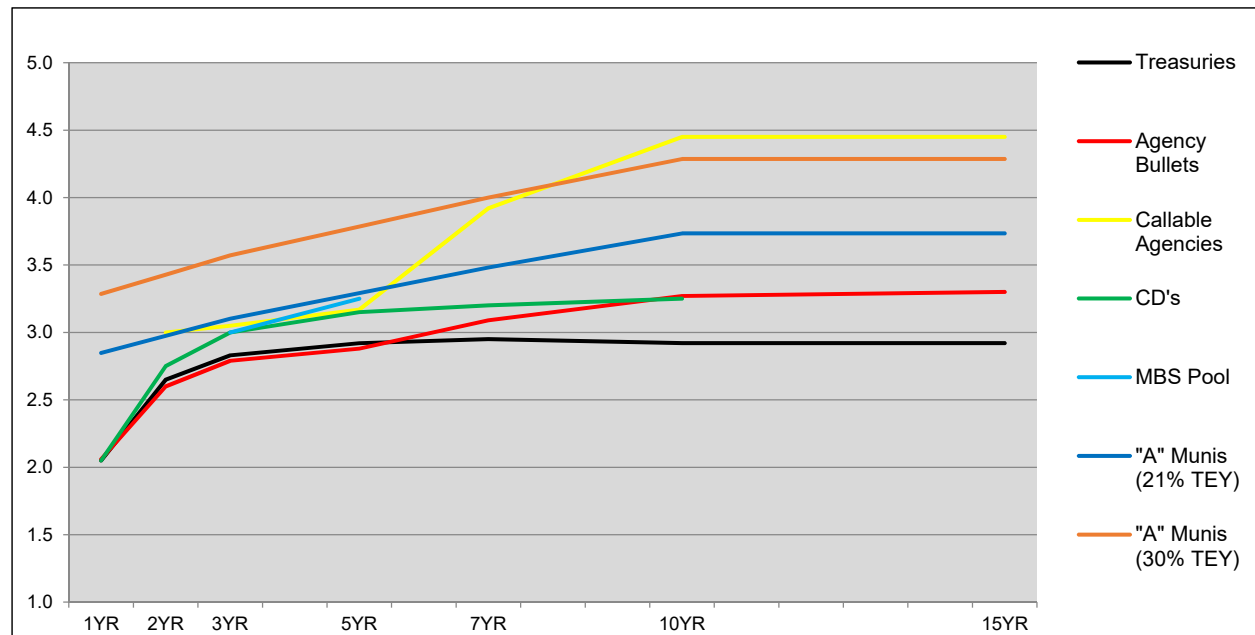
Municipals – Since January, the market has been under a significant amount of stress. The contributing factors started with inflation pressure and the subsequent hawkish fed outlook. These rising rate fears forced mutual funds and other money managers to sell bonds to raise cash in order to satisfy customer outflows. Selling created more selling which put an enormous amount of pressure on the dealer community to provide liquidity. As the pressure built, the bid side of the market faded resulting in a rapidly rising rate environment.

Due to the rapid rise in municipal yields, the current relative value of municipals is quite strong. Investors can source bank qualified municipal bonds that yield well over their treasury counterpart before adding in the tax advantage benefit. Not to be overlooked but municipals as a whole has an improving credit profile post pandemic whereas other markets can't say the same.



Mortgages – MBS had the best monthly return since October 2010, even outperforming both corporate bonds and treasuries for the month of May and on an YTD basis. Mortgage purchase applications are -14.2% YoY; refinances are -75.2% YoY. The average fixed rate mortgage rate is 5.33% compared to 3.17% a year ago. Mortgage investments have seen noticeable extension with the slowdown in activity, but we still feel the sector offers opportunities to pick up ample cash flow, allowing banks to participate in future higher rates

Quantitative Tightening and Mortgage Backed Securities – The Fed’s current stance for their MBS holdings is to have \$17.5 billion per month roll off for the first three months, eventually increasing to \$35 billion per month in September. These roll off amounts are based on expected prepayments for their holdings. Since a majority of Fed MBS holdings are in 30 year pools with 2%, 2.5% and 3% coupons, which are out of the money by a sizeable margin, which may prove to be difficult to accomplish. The Fed has indicated their desire to not disrupt markets, however if prepayment speeds are not fast enough for the FOMC to reach their targets, we may see outright selling.



In Closing

Community bank investment portfolios have had a volatile year so far. It would be ideal to say that the volatility is behind us and it will be smooth sailing from here, but that does not appear to be the case. It is in this light that we recommend blending a mix of income generating securities with a mix of bullet-like (positive convexity) securities to protect your portfolio in rates down/unchanged/or higher from current levels. If you think this strategy would be a good fit for your portfolio, please reach out to our desk to talk specifics and implementation.

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