September 2022

Jumbo Hike on the Horizon? –

August was full of angst as the market was repeatedly exposed to strong economic data. As the month progressed, market participants succumbed to the inevitability of the Fed continuing to make jumbo hikes to fight inflation and cool the economy. The Fed has raised rates 75bps each time at their last two meetings and as of this writing, investors are betting they will do the same in September. However, with the latest Jobs report showing a surge in the available labor force (so much for the Great Resignation) traders pared their bets a touch as more available workers could be the relief valve the tight labor market needs right now. The Fed will get one more important report before their meeting Sept 20-21. The consumer price readout for August will be released on Sept 13th. An August review/Sept preview by sector follows.

Next FOMC Meetings: September 21, November 2, and December 14

AUGUST IN-REVIEW

Benchmark Treasury Yields:

	01/03/22	08/01/22	08/31/22	MoM Change (BPS)
1M	0.04	2.172	2.258	+8.6
3M	0.06	2.331	2.925	+59.4
2Y	0.77	2.873	3.495	+62.2
5Y	1.36	2.637	3.353	+71.6
10Y	1.63	2.576	3.195	+61.9
20Y	2.05	3.109	3.571	+46.2
30Y	2.02	2.915	3.294	+37.8

Key Indices Returns

	MTD Returns	YTD Returns
Bloomberg Global Aggregate	**-0.92%**	**-16.33%**
US Treasuries	**-0.58%**	**-10.50%**
US Aggregate Bond Index	**-0.59%**	**-11.28%**
MBS	**-0.41%**	**-9.44%**
Municipal Bonds	**-0.49%**	**-9.08%**
Taxable Municipal Bonds	**-0.69%**	**-15.43%**
Corporate Bonds	**-0.87%**	**-14.95%**

OUR TAKE FROM A COMMUNITY BANK INVESTMENT PORTFOLIO PERSPECTIVE:

U.S. Treasuries / Agencies – As the summer pushed toward fall, the TRSY market pushed toward higher interest rates. While not a complete rout, the 10YR TRSY benchmark performed poorly. The Benchmark opened August at a 2.57% and closed up 62bps at a 3.19%. Not unlike an equity rally during a bear market, the strong positive July move reversed in August as the overall consensus was for inflation to continue to overpower recent Fed hikes. While higher, it's a good time to put the interest rate shift in perspective. The closing August yield was still below its YTD peak of a 3.47% in mid-June.

August's drift to higher rates was driven almost exclusively on headline risk and economic announcements. The Fed last FOMC decision was July 27th and their next is Sept 21st. With no hard action being taken by the Fed in August, speeches by Fed governors, economic data releases and some speculation were market drivers. The first days of September has mostly followed that trend but at a more muted pace as the Fed announcement approaches.

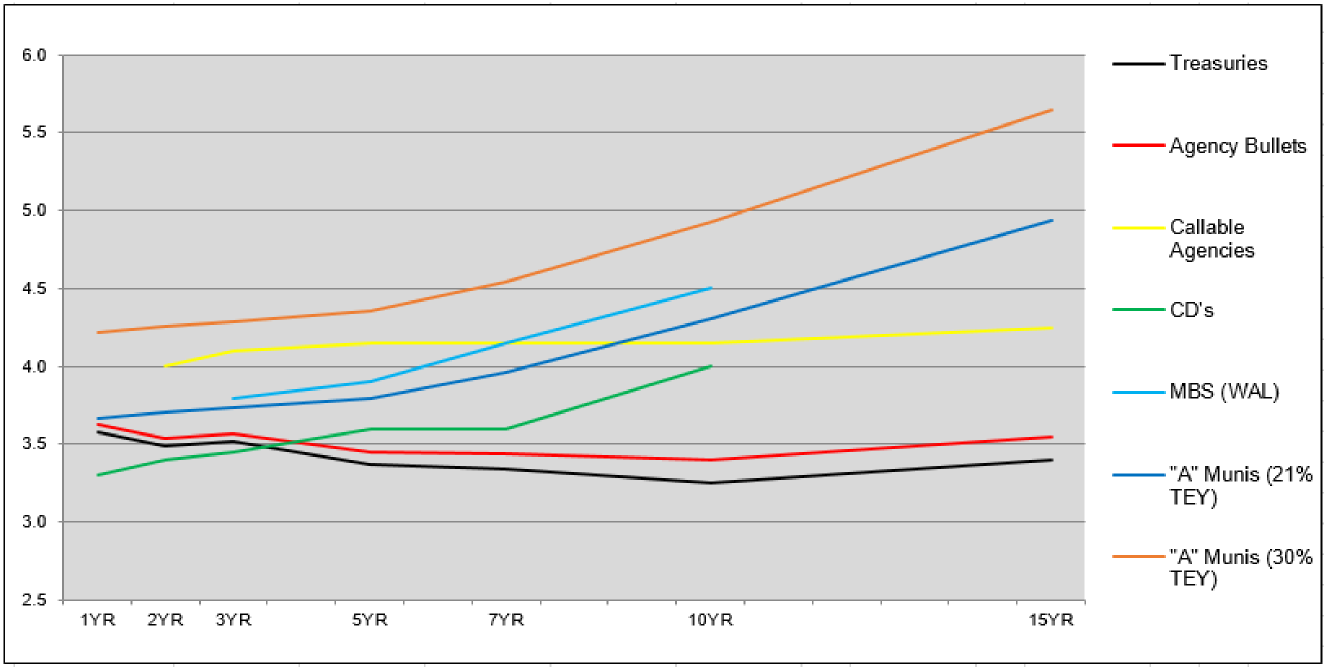
Municipals – August was a bit of a reversal in rates with yields shifting higher. After seeing a large push in the shorter dated maturities (see last month's comment), the front end of the curve reverted back to more traditional spreads. The 3YR "A" rated Bank Qualified yield curve rose from a tax free 2.10% to a 2.80%. This 70 basis point change was logical and not much of a surprise. For municipals to make financial sense tax-free yields need to be in a range of 65bps (C Corp) to 95bps (S Corp) of their taxable counterparts. After a short period of being "rich", the market adjusted accordingly.

Out on the curve, the Bank Qualified market wasn't suffering from overbought conditions and outperformed in August as a result. Rates did drift in tandem with rising US TRSY yields (down 10.5% YTD) but didn't quite feel the same downdraft in valuation as the front end. 10YR BQ yields now reside in the 3% camp and extending further you can find 4% at this time.

Supply tends to peak in September & October before easing as we approach the fall/winter holiday cycle. Considering the recent rise in rates, the next two months might be an opportune time to add to your portfolio should the appropriate credit come to market. In some instances, taxable equivalent yields now exceed 5.50% (and possibly 6% for S Corps out on the curve). These are levels the market hasn't seen in 4 years.

Mortgages – The MBS market, coming off of a strong July, had its second worst monthly total return performance in more than 30 years. That being said, the sector still has not surpassed double digit negative returns for the year. The underperformance in August was a direct result of both the 2yr and 10yr treasuries selling off 60bps respectively, and market participants anticipating the Fed's increased balance sheet roll off starting in September.

Mortgage investments have seen noticeable extension with the slowdown in purchase/refi activity. In fact, data on housing sales and turnover from the National Association of Realtors suggests pure turnover CPR has recently dipped below its historical floor of 6 CPR, or 100 PSA. Due to this, we feel certain corners of the mortgage market offer great opportunities for banks to add strong cash flow generating securities and boost current income. Specifically, we see value in 4.5-5% coupon VADM CMOs that add 75-100bps of incremental spread, and in some cases have shorter stated finals than comparable pass-thrus or Sequentials. For anyone looking to add positive convexity, DUS/K bonds offer attractive yields over bullets, with the benefit of monthly interest.



Data as of 9/8/2022

IN CLOSING

We have observed a number of banks effectively using the cash flow portion of the investment portfolio to support loan portfolio liquidity needs. Banks that structured the portfolio with a cash flow ladder have been able to use those funds for loans and reinvestment. Please give our team a call if you would like to discuss the objectives of your portfolio and how we may assist. Thank you.

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