
November 2022

**"Lags from interest rate policy are long and variable." – Fed Chairman Jerome Powell**

Powell's comment in the title is one sound bite from his last press conference that did not adequately get its day in the sun. During the conference, he goes on to elaborate that the actual inflationary impact felt from interest rate policy decisions takes, in some cases, one to two years to show up in the data. If we follow the Fed Chair's logic, then inflation data seen today is mostly representing 2020 and 2021 environment of low rates, fiscal and monetary stimulus, supply chain induced shortages, and a robust rally in equities. This also means the jobs and inflation data we see over the next two years will represent a regime of quantitative tightening, a historic rise in interest rates, a prolonged strong dollar, and a selloff in risk assets.

As we look to leading indicators, oil is starting to break out to the upside again, wage growth is accelerating, job openings continue to climb, and bank lending activity has been robust throughout the year. There is a case to be made for rates to remain at or near the current levels for some time after the hiking/tightening cycle ceases. As of this writing, the Fed forecasts project Fed Funds to be 4.50% by year end, eventually peaking at 5% in May of 2023.

**Next FOMC Meetings: December 14, February 1st, March 22nd, May 3rd, June 14th**

## OCTOBER IN-REVIEW

**Benchmark Treasury Yields:**

| | 01/03/22 | 09/30/22 | 10/31/22 | MoM Change (BPS) |
|---|---|---|---|---|
| 1M | 0.04 | 2.679 | 3.623 | +94.5 |
| 3M | 0.06 | 3.27 | 4.074 | +80.4 |
| 2Y | 0.77 | 4.281 | 4.485 | +20.5 |
| 5Y | 1.36 | 4.092 | 4.23 | +13.8 |
| 10Y | 1.63 | 3.832 | 4.05 | +21.8 |
| 20Y | 2.05 | 4.091 | 4.406 | +31.5 |
| 30Y | 2.02 | 3.779 | 4.167 | +38.7 |

**Key Indices Returns**

| | MTD Returns | YTD Returns |
|---|---|---|
| Bloomberg Global Aggregate | -0.69% | -20.44% |
| US Treasuries | -1.39% | -14.30% |
| US Aggregate Bond Index | -1.30% | -15.72% |
| MBS | -1.42% | -14.89% |
| Municipal Bonds | -0.83% | -12.86% |
| Taxable Municipal Bonds | -2.49% | -21.29% |
| Corporate Bonds | -1.03% | -19.56% |

## OUR TAKE FROM A COMMUNITY BANK INVESTMENT PORTFOLIO PERSPECTIVE:

**U.S. Treasuries / Agencies** – October proved to be an extremely volatile month with the benchmark 10YR TRSY rising 61 basis points in early October to its peak of 4.24% on October 24th. Yields quickly reversed course and within days surged to a 3.91% before settling around a 4% at month's end. In terms of shape, the yield curve remains inverted. An already inverted Treasury curve became more inverted by the end of the month, with spread +50 bps higher on 2-year vs. 10-year Notes. Last month the inversion was 45 basis-points. While an inversion doesn't guarantee a recession, there has never been a recession without an inversion first occurring. If the economy moves into recession territory, a more accommodative Fed would likely be the end result.

Spreads on callable agencies have ebbed and flowed along with TRSY volatility. As of late, investors can leverage call risk into substantial cash flow. For example, 5, and 10yr agencies with 6MO calls were coming to market with coupons in excess of 6%. Some in fact were approaching 7%. While incredibly attractive, the embedded call feature would lean one to believe this is a shorter, not longer, duration option. For those looking to lock in yield, non-callable agencies were scarce but remained constant as the month progressed. 5YR NC agencies were pricing at approximately 30 basis points over the 5YR TRSY throughout the course of the month. 10YR bullets were not frequently issued coming to market just 3 times during the month at around +65/10YR. Both options are attractive at this time and present a portfolio manager the ability to construct a portfolio with various characteristics to weather both up and down markets over the ensuing years.

**Municipals** – Muni returns continued to dip in October. The losses were (-0.83%) and continues to pile on an already historically bad year. October's losses bring 2022's returns to negative (-12.86%) which is the lowest year-to-date decline since 1993. The long end of the curve took the brunt of the damage underperforming short munis by a wide margin. In fact, short dates municipals managed to squeak out a slightly positive return in October while the intermediate and long end suffered. The short end benefitted from institutional money seeking out a safe harbor from long term volatility.

Looking at the bank qualified municipal yield curve, the results are similar but a bit more dramatic. Long munis declined by 31 basis points in October which is more than the 21 basis point decline experienced in "general market" municipals. The outsized decline in longer bank qualified munis was largely driven by factors not muni bond related at all. Over the course of 2022 bank loans demand has increased and deposits fell a bit as rate-sensitive customers moved money to capture higher rates elsewhere. In totality banks have shifted from having excess liquidity in 2021 to a liquidity shortfall in 2022. The end result is a reduction in demand for long municipals as all investment activity has declined.

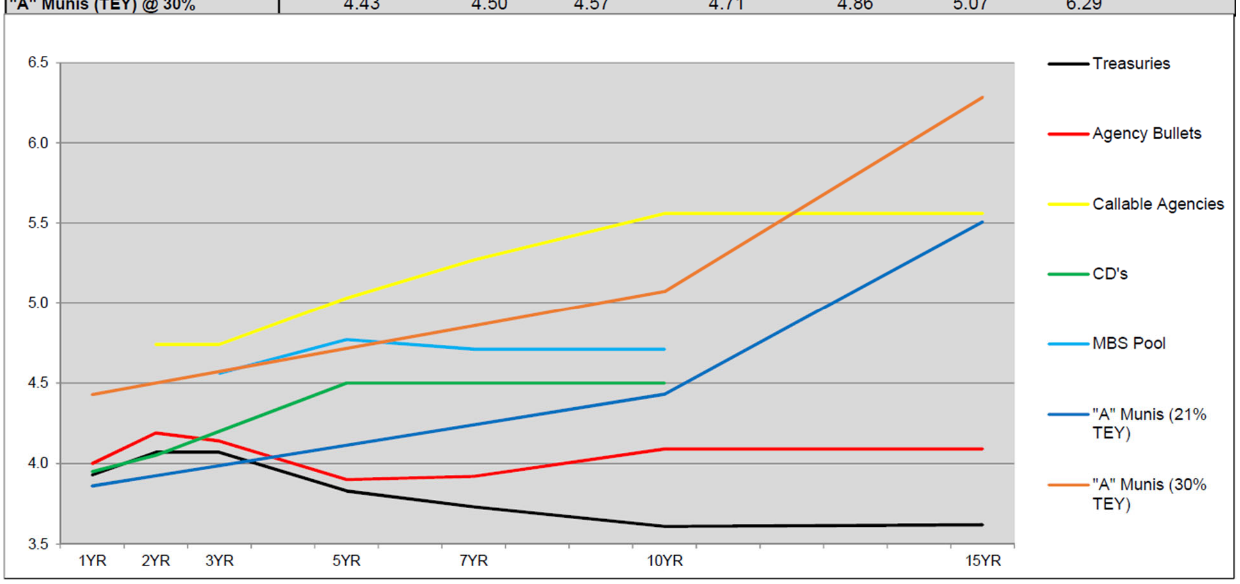
Ironically, the lack of liquidity has created a tremendous opportunity for bank portfolios. The 10YR BQ muni yield curve has risen 220 basis-points from one year ago. Currently, banks portfolios can lock in tax free BQ yields at/around 3.80%. This translates into taxable equivalent yields (TEY) ranging from 4.75% -5.45% depending on the bank's tax status. Banks that are able to source pockets of investable cash should take advantage of the current rate environment as yields this high were last seen in 2007. We have to keep in mind that the cyclical nature of the market leads one to believe that eventually, rates will move lower as the Fed begins to corral inflation and can once again move to a more accommodative policy to prevent recession.

**Mortgages** – The mortgage market, like all of fixed income, had a volatile month of October. Mortgage rates surpassed 7% (+100% YoY) while purchase applications are near the lowest levels in history. Last time home prices reached 7%, the average home price was nearly half of the current average. Also, it did not go unnoticed at the end of the month to see the Case Shiller Home Price Index show two consecutive months of declining prices, lead primarily by the West and Southwest regions. It may be sometime before that information shows up in inflation data, but rest assured it will show up eventually.

Despite the headlines, we feel it makes sense to carve out a section of the portfolio to invest in current rates pools or CMOs. Specifically, we feel there is value in the 5.5% and 6% Sequentials over VADMs, as the cash flow windows are narrower, while the Modified Duration and Average Life are also shorter at purchase. With nearly the entire mortgage market prepaying below the historical floor of 6 CPR, buying recent issues with a premium handle dollar price will potentially allow most investors to amortize the minimal premium and recognize the current income sooner than later. By looking for premium dollar prices, investors can hedge the effects of a prolonged slowdown in the mortgage market by adding a bond that will benefit from a slowdown in speeds and rates at current levels or higher.

**PRODUCT YIELD CURVE**

| Security Type | 1YR | 2YR | 3YR | 5YR | 7YR | 10YR | 15YR |
|---|---|---|---|---|---|---|---|
| Treasuries | 3.93 | 4.07 | 4.07 | 3.83 | 3.73 | 3.61 | 3.95 |
| Agency Bullets | 4.00 | 4.19 | 4.14 | 3.90 | 3.92 | 4.09 | 4.09 |
| Callable Agencies (NC1) | | 4.74 | 4.74 | 5.03 | 5.27 | 5.56 | 5.56 |
| CD's | 3.95 | 4.05 | 4.20 | 4.50 | 4.50 | 4.50 | |
| MBS Pool (average life) | | | 4.56 | 3.55 | | | |
| "A" Munis (TEY) @ 21% | 3.86 | 3.92 | 3.99 | 4.11 | 4.24 | 4.43 | 5.51 |
| "A" Munis (TEY) @ 30% | 4.43 | 4.50 | 4.57 | 4.71 | 4.86 | 5.07 | 6.29 |




Data as of 10/4/2022

## IN CLOSING

Portfolio objectives remain forefront in our discussions around potential investment strategies. With the rapid increases in Federal Funds rate in 2022, most portfolios have gone from a positive gain in January to a negative loss when marked to market. Conversely, many banks have lagged increases in their cost of funds during 2002, while seeing increased pressure to raise rates as the year progressed. The investment portfolio remains a significant tool in the bank's balance sheet to adjust liquidity, yield, and interest rate risk parameters. In regards to ability to lock in higher portfolio yields across maturities, consider the cash flow management and liability match benefits of bullet securities. As of this writing, it would appear the FOMC will continue its ratcheting of rates into 2023 and holding rates higher until sustained reduction in inflation levels. When conditions change, market participants will be looking for locked-in protection of yield as liquidity levels increase. Please reach out to our team if you would like to discuss your investment portfolio objectives and how we may assist. Thank you.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