VIEW FROM THE TRADING DESK

December 2022

November provided fixed income investors with a welcome reprieve from a historically tough year. November also marked a starting date for a change in sentiment. To start the month, the Fed hiked 75 basis points, however shortly after the hike, CPI data came in softer than expected leading investors to recalibrate inflation and further rate hike expectations. As a result of the events from the month, two different camps of thought have emerged.

The first camp, sees rates climbing modestly and staying at or near 5% for the entirety of 2023, with a moderate chance to cut rates in 2024. The first camp still sees sticky inflation, especially in areas like housing, energy, and food prices, which will keep those metrics above the Fed's desired range. The second camp thinks the Fed has already gone too far and we are more likely to end 2023 with a lower Fed Funds rate than at the start of the year. The second camp expects the recent trend of cooling inflation to amplify in the coming months/quarters as the delayed effects of tightening start to show up in the data. The arguments for both sides are sound, and very realistic in the conclusions being drawn based on the data. At Bankers' Bank, we are not in the business of speculating, which is why we continue to think taking a well-rounded risk management approach to your fixed income portfolio is the only way to persist a challenging time.

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

NOVEMBER IN-REVIEW

Benchmark Treasury Yields:

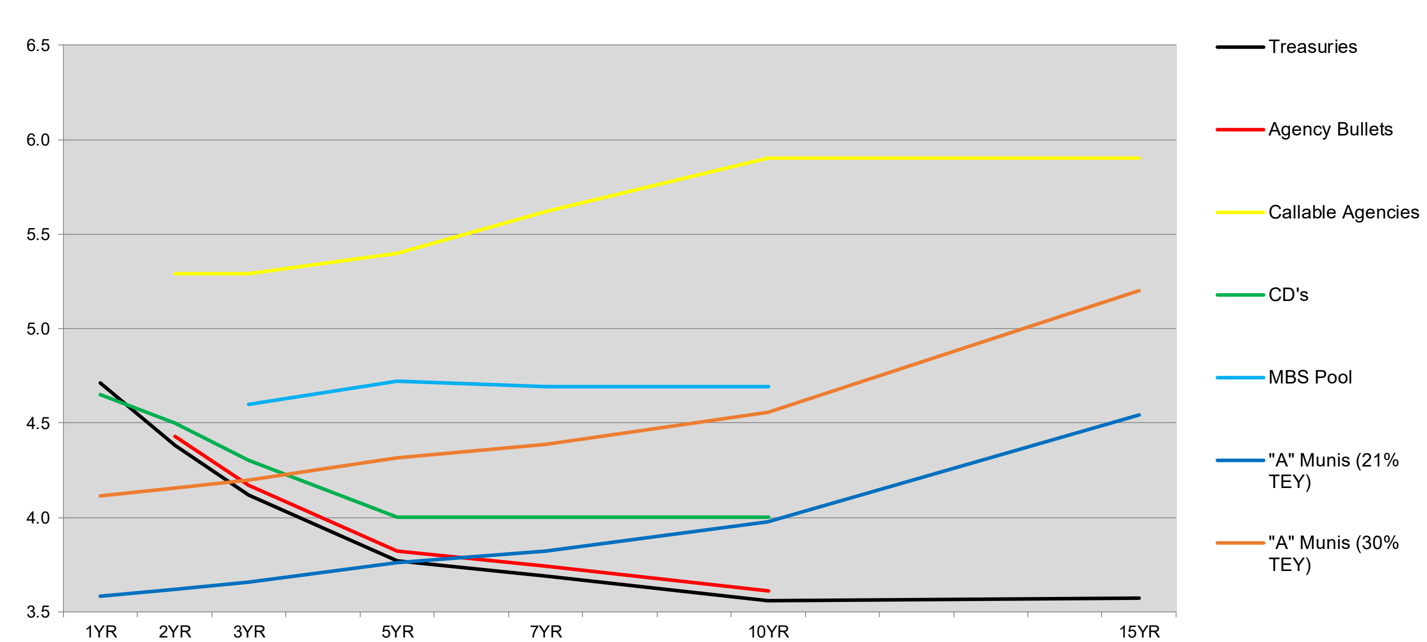
	01/03/22	11/01/22	11/30/22	MoM Change (BPS)
1M	**0.04**	**3.604**	**3.947**	**+34.4**
3M	**0.06**	**4.126**	**4.349**	**+22.3**
2Y	**0.77**	**4.548**	**4.312**	**-23.6**
5Y	**1.36**	**4.269**	**3.738**	**-53.0**
10Y	**1.63**	**4.044**	**3.607**	**-43.7**
20Y	**2.05**	**4.360**	**3.931**	**-42.9**
30Y	**2.02**	**4.094**	**3.738**	**-35.6**

Key Indices Returns

	MTD Returns	YTD Returns
Bloomberg Global Aggregate	+4.71%	-16.70%
US Treasuries	+2.68%	-12.01%
US Aggregate Bond Index	+3.68%	-12.62%
MBS	+4.08%	-11.42%
Municipal Bonds	+4.68%	-8.79%
Taxable Municipal Bonds	+4.50%	-17.75%
Corporate Bonds	+5.18%	-15.39%

PRODUCT YIELD CURVE

Security Type	1YR	2YR	3YR	5YR	7YR	10YR	15YR
Treasuries	4.71	4.33	4.10	3.77	3.69	3.56	3.57
Agency Bullets	0.00	4.43	4.17	3.82	3.74	3.61	0.00
Callable Agencies (NC1)		5.29	5.29	5.40	5.62	5.90	5.90
CD's	4.65	4.50	4.30	4.00	4.00	4.00	
MBS Pool (average life)			4.60	3.55			
"A" Munis (TEY) @ 21%	3.58	3.62	3.66	3.76	3.82	3.97	4.54
"A" Munis (TEY) @ 30%	4.11	4.16	4.20	4.31	4.39	4.56	5.20



Data as of 12/6/2022

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OUR TAKE FROM A COMMUNITY BANK INVESTMENT PORTFOLIO PERSPECTIVE:

U.S. Treasuries / Agencies – The 10YR TRSY 2022 YTD peak occurred on October 24th at a 4.24%. Rates tested that peak again on November 7th which was just a few days before a key CPI release on the 10th. This inflation report was widely viewed as a strong indicator as to what impact (if any) Fed hikes have had on the economy as well as what the market could expect future rates hikes would look like. The report showed CPI cooled by more than expected in October and as a result, the TRSY market immediately began a month long rally. Post CPI release, various Fed officials suggested that while rate hikes will continue, the rate of those hikes may diminish. The result speaks for itself with the 10YR having moved from a 4.21% on the 10th of November to ending the month at a 3.61% - a 60 basis point rally.

In terms of curve shape, the 2-year vs 10-yr TRSY curve has inverted further which is an indication that investors are counting on a slowing economy and one that may end up in a recession. If the economy moves into recession territory, a more accommodative Fed would likely be the end result and such, is also the root cause of strength in the intermediate to long end of the curve. The inverted curve presents investors with the opportunity to lock in high coupon, short duration securities paired up with longer term bonds with call protection.

In November, spreads on callable agencies have compressed. The month saw fewer bullets being issued and shorter call structures becoming dominant. Still, despite market compression, investors can still purchase 5% or better cash flow by accepting limited call protection. While attractive, the embedded call feature would lead one to believe this is a shorter, not longer, duration option. Non-callable agencies became scarce as issuers were reluctant to print without a redemption clause. Like TRSY's, investors should pair short term callable structures with longer term securities such as TRSY's, CDs, and municipals to mitigate reinvestment risk.

Municipals – Municipal state and city debt (this excludes revenue projects such as airports, hospitals, special tax, etc. bonds) gained 4.6% in November which is the biggest monthly rally since 1986. Intuitively one would assume that municipals simply followed the US GOVT market shift to lower rates and while true, it doesn't fully account for the strong performance. In November, Treasuries gained 2.1% which is less than half of what munis did. The cause of the muni market's outperformance is highly correlated to two significant factors. First, the broader interest rate market has stabilized at levels that are near multi-year highs. This breeds confidence and leads to the second factor which is demand. For the first time since August 2021, there were inflows into the muni bond mutual fund market. At $730 million, these inflows was a clear sign of demand from both institutions and investors alike that are frantically trying to lock in yield.

Looking at the bank qualified municipal yield curve, the results are similar but not quite as strong as there seems to be a lag effect. That is, while the BQ muni market has rallied impressively, it has underperformed vs the general market space. For example, 10YR Non-BQ munis rallied by 61 basis points in November. The A-rated BQ curve rallied 50. An 11 bps difference. Throughout the yield curve, it's the same story. Why the lag in BQs? Quite simply the demand factors in the BQ space are unique and don't always trend with the rest of the market. Much of the buying in BQs is limited to bank portfolio managers and retail investors whereas the larger muni market has a broader investor base to pull from. This includes mutual funds, ETFs, insurance companies, professional money managers as well as retail investors. Recently, the bank buying component has faced some headwinds in the 3rd and 4th quarter with regards to liquidity curbing demand a touch. With loan demand growing (along with projected loan demand) coinciding with flat to declining deposit rates, many banks were faced with limited resources that could be allocated for their portfolio. It is unknown how long before BQ munis gap up to their general market brethren, but with limited supply through year-end it may not take long. Investable cash should be deployed sooner rather than later as the demand for BQ munis will likely continue to improve as we move into 2023 while supply remains limited.

Mortgages – The mortgage market enjoyed a relief rally in November, largely in part to softer inflation data coupled with growing sentiment of the Fed pulling back on the tightening cycle. November's MBS performance represented the best calendar month returns for the sector in more than 30 years. For MBS investors, this was a welcome reprieve after September's returns were historically bad.

Looking ahead, mortgage rates have dropped from 7% at the start of November, to 6.49% to end the month. Forward looking indicators, such as building permits, new home sales, mortgage applications, refinancing activity and home price data, point to a slowdown in the market overall for next year. With a majority of the existing mortgage market having been originated in 2020 and 2021, it makes sense to see homeowners apprehensive to selling a 3% rate to take on another loan of 6%+. This leads us to believe there will be a dramatic decrease in issuance next year, which is positive for spreads overall.

For banks looking to boost their current income, we recommend looking into new issue CMOs at, or slightly above current coupon. The reason we favor premium priced bonds is simple, with the entire mortgage market prepaying below the historical 6 CPR floor, and issuance expected to dwindle next year, we are likely to see slower speeds for longer. Because of this, adding high coupons, with minimal premium to amortize, will provide higher current income over the discount, lower coupon options. Also, given the shape of the curves, higher coupon bonds are shorter in principal window and modified duration than the lower coupon options, and even exhibit better cash flow profiles than similar pass-through securities.

Subordinated Debt – We continue to see strong interest in subordinated debt issues of bank holding companies. Where Bankers' Bank has acted as placement agent on new issues, the issuer credit and structure have been attractive portfolio considerations. Please reach out to your investment officer if interested in learning more how these securities may be utilized.

IN CLOSING

Portfolio liquidity conversations took center stage with community bankers in November. The rapid increases in Federal Funds rate throughout 2022 has put pressure on some cost of funding strategies. Our discussions have focused on using the investment portfolio to manage liquidity, yield, and interest rate risk. In addition, many banks have opened discussions around pledging strategies for municipal depositors – let your Bankers' Bank team know how we may assist. For those looking to continue to lock in higher portfolio yields, we continue to promote the cash flow management and liability match benefits of bullet securities.

Early December FOMC predictions are that there will continue to be increases to the Federal Funds Rate Target on December 14 and rates held higher in 2023 until sustained reduction in inflation levels. Please let us know if you would like a copy of our 2023 Interest Rate Forecast. We anticipate December activity will focus on portfolio restructuring, particularly when can opportunistically sell lower yielding investments and reposition into higher yields. 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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To close as we finish 2022, your Bankers' Bank team is extremely appreciative of our relationship with your bank as a partner. As a bank built to work with banks, our team remains focused on your long-term success. We look forward to introducing many new initiatives to our customers in 2023. Happy Holidays and best wishes for a successful close to 2022!

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