BANKERS' BANK

VIEW FROM THE TRADING DESK

Second Quarter 2023

Looking back to the beginning of the second quarter, we had a robust rally in the Treasury market, a widening of investment spreads, and expectations of multiple rate cuts priced into the futures curve. As we put the second quarter in the rearview mirror, it appears those pressures not only faded, but completely reversed course. Throughout Q2, we saw investment spreads tighten for investment grade and high yield securities, despite treasuries selling off, and expectations of 1-2 more 25bps hikes from the FOMC. The reason for this abrupt 180 is twofold; the data remained strong and fears of a larger bank contagion related to recent bank failures gradually subsided. Both inflation and jobs data gave the Fed the green light to continue the hiking campaign, especially given the stubbornly high services inflation which is centered on the housing market.

Next FOMC Meetings: July 26, September 20, November 1, December 13

Key Indices Returns

	Q2 Returns	2023 Returns
Bloomberg Global Aggregate	-1.53%	+1.43%
US Treasuries	-1.38%	+1.59%
US Aggregate Bond Index	-0.84%	+2.09%
MBS	-0.64%	+1.87%
Municipal Bonds	-0.10%	+2.67%
Taxable Municipal Bonds	-0.43%	+4.75%
Corporate Bonds	-0.29%	+3.21%

OUR TAKE FROM A COMMUNITY BANK INVESTMENT PORTFOLIO PERSPECTIVE:

U.S. Treasuries – In Q2, the UST curve experienced a curve shift to higher yields as persistent inflation and Fed Rate hikes have not yet been able to contain a strong US economy. The Fed has bumped rates in 10 of the past 14 months and at the fastest rate in 40 years. Despite the aggressive policy by the central bank, the economy remains strong and traders are pricing in at least two more rate hikes this year with a very low probability the central bank will be in a position to lower rates in 2023. In fact, the latest comments by Chairman Powell have extended the projected target date of the Fed to meet its 2% inflation target an additional year to 2025.

Maturity	4/1/2023	6/30/2023	Shift (bps)
1YR	4.61%	5.40%	79
2YR	4.03%	4.83%	80
3YR	3.79%	4.46%	67
5YR	3.58%	4.09%	51
7YR	3.54%	3.94%	40
10YR	3.47%	3.80%	33
30YR	3.65%	3.86%	21

Actionable Idea: With US T-Bills currently generating the highest yields on the curve (6-month yields nearly 5.50%), purchasing 6-month ladders provides pledging securities, while potentially increasing yield and lowering aggregate duration of the portfolio. Banks experiencing higher than anticipated liability sensitivity on their balance sheet may benefit.

U.S. Agencies – The market being efficient, absolute yields on new issue callable agencies have risen along with UST yields. In Q1 of 2023, 5% was the most favored coupon/yield but with rates higher in Q2, it's not unusual to see 5.50% - 6% coupons (with limited call protection) in the current market. Due to bank portfolio liquidations in Q2, there has been an influx of secondary market callable agencies. Many of these agencies were issued in 2020-2021 and carry coupons in the 2% and lower range and with investor demand typically interested in higher current coupons, spreads in the secondary have widened. This has created the opportunity to purchase secondary market discounted priced bonds with above market yields. A barbell approach pairing up new issue (short call) current coupon positions with older secondary agencies is a strategy worth exploring. In summary, over the past quarter competition for investor dollars remains stiff and agencies are not immune to the ebbs and flows of supply and demand trends. Agency issuers and dealers alike need to continually price offerings with coupons or yields that can draw interest.

Actionable Idea: Utilize current coupon agencies for short call yield portfolio enhancement, while adding deeply discounted callable agencies or bullets for maturities longer than 2025.

Municipals – Earlier this year, the muni market experienced considerable outflows from both mutual funds and from separately managed accounts (SMA's). More recently, those outflows have slowed and in some weeks reversed completely which created more demand in the market. While banks have slowed their purchases in Q2, the largest investors of muni's (SMA's and direct retail investors) have stepped back into the market to take advantage of higher yields. Due to the volatile nature of the market over the past 12-18 months most buyers have stayed at the front end of the curve and when you consider year-to-date issuance being down 19%, it's not a surprise that shorter duration bonds have seen their yields driven lower. The strong interest in this part of the curve has created a spillover effect into the bank qualified space.

Historically, BQ issuers have offered more yield than non-BQ (general market) bonds due BQ deals being smaller in size, less liquid, and often non-rated. These bond issuers were structured for bank investors but with the lack of bonds available in the front end of the curve we have seen interest in BQ bonds from cross-over investors increase dramatically in Q2. In early April, the spread between BQ and Non-BQ issuers was just over 40bps on average with BQ bonds providing more yield. Today, that spread differential has compressed to just 20 bps in the 1-10YR range. The SMA and retail investors that have spilled over from general market into the BQ market seeking short duration supply has put pressure on the market driving down BQ yields. In most cases, C Corporation banks are priced completely out of the market in the 1-5YR range and while S Corporations can still find value, it's not readily available in every new issue.

General Market GO's vs Bank Qualified GO's		
Maturity	Spread Difference 4/1/2023	Spread Difference 6/30/2023
1YR	43	22
2YR	43	21
3YR	43	20
5YR	44	20
7YR	43	23
10YR	43	28
30YR	39	40

Actionable Idea: Banks looking for short term paper should explore secondary offerings as the trading desk is able to source bonds that provide a meaningful return over fully taxable alternatives.

Actionable Idea: Investors should also continue to look at BQ bonds in the 10YR and longer range as they still offer strong relative value as the demand on that part of the BQ curve remains mostly exclusive to bank investors. With demand being more normalized as you extend, long-term bonds currently yield 90% or more of their UST counterpart. Factoring in the tax advantage nature of municipals, banks can see taxable equivalent yields in excess of 6%.

Mortgages – The mortgage market, and by extension the housing market, has displayed resilience in the face of higher rates. Record low supply colliding with record high rates has shown that supply and demand factors prevail. According to Redfin, the number of US homes for sale in May fell to 1.37 million, the lowest on record going back to 2012. Couple that with 62% of US Mortgage holders have a rate below 4% and 92% have a rate below 6%, it is not surprising why 7% mortgage rates are not driving buying activity.

For banks looking to add a cash flowing security, we recommend looking into 15yr pass-throughs or CMOs near current coupon, which as of this writing is a 5.5% coupon. Currently, 15yr pass-throughs are trading at spreads which are historically wide. Given 15yr paper is less likely to refinance given a drop in rates due to its lower loan balance, 15yr paper should perform in rates level, slightly higher, and lower from here. In the CMO space, finding good structure is critical. Since most of the underlying collateral in new issue deals are 30yr loans, finding a structure that can cushion some prepay volatility if rates drop would be ideal. Front SEQ offer the most opportunity in terms of available new issuance. SEQ with coupons in the 5.5% range are being issued with 5% yields, average life and modified duration below 5, and principal windows that are narrower than pass-through alternatives.

Actionable Idea: The ideal way to participate in the CMO space would be through VADMs at or near par. VADMs, or Very Accurately Defined Maturity, CMOs offer just that, a defined WAL with less extension risk, shorter stated finals, and unlike most mortgage bonds, positive convexity. Please reach out to the desk if you would like to learn more.

Community Bank Debt – The bank debt market has cooled off since March, with most of the new issuance coming from large regional or money center banks. The shock to the system from SIVB and SBNY shelved several community bank debt offerings in the second quarter. As we look ahead to the second half of the year,

we are seeing more banks open to issuing. If you are interested in issuing debt during the second half of the year, please reach out to the desk to learn more about pricing and structure.

Funding – If there has been a topic that has dominated our conversations in Q2, it has been bank funding. Ongoing liquidity needs and the cost to support balance assets has compressed margins for many banks in the quarter. Banks have been exploring the following with our team:

Deposits:

- Reciprocal deposits
- DTC CDs
- Repurchase Agreements
- Pledging

Borrowings:

- Federal Funds
- Federal Home Loan Bank Advances
- FRB Discount Window
- FRB Bank Term Funding Programs

In regards to utilizing the investment portfolio for liquidity, discussions with banks have centered on bond swap ideas, optimal pledging strategies, and portfolio positioning for potential future rate environments. Please call your investment officer to discuss.

IN CLOSING

The first half of 2023 continued to challenge banks for funding and for compressing margins. When considering different options, it is important to consider short-term and future needs across the balance sheet. Likely, it is a mix of strategies and funding sources that will need to be utilized. Please call your Bankers' Bank investment team to discuss.

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