BANKERS' BANK

# VIEW FROM THE TRADING DESK

**Third Quarter 2023**

A resilient labor market led to a near constant rise in rates over the entire third quarter. This was a surprise to many bond market participants as earlier in the year, many believed an economic slowdown would take hold as the year wore on. Those early 2023 predictions of lower rate and Fed cuts have fallen by the wayside. The 10YR UST broke through the psychologically important 4.50% barrier and closed the quarter at a 4.61% which is 81 basis points higher than at the beginning of the quarter.

While the broader market declined, short duration investors weathered the storm quite well. The Fed opting to hold rates steady in September meant limited volatility in US Bills and other short duration assets.

**Next FOMC Meetings: November 1, December 13, January 31, March 20**

**Key Indices Returns**

| | Q3 Returns | 2023 Returns |
|---|---|---|
| Bloomberg Global Aggregate | -3.59% | -2.21% |
| US Treasuries | -3.06% | -1.52% |
| US Aggregate Bond Index | -3.23% | -1.21% |
| MBS | -4.05% | -2.26% |
| Municipal Bonds | -3.95% | -1.38% |
| Taxable Municipal Bonds | -3.70% | +.88% |
| Corporate Bonds | -3.09% | +.02% |

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

**U.S. Treasuries** – The UST market was under constant duress during the third quarter with rates surging to 16 year highs. The third quarter performance was the worst of the year with long Treasury bonds leading the way down with a negative 11.8% return. The mantra of "higher for longer" has led the charge to persistently higher rates as hawkish comments by multiple Fed presidents and governors remain abundant.

The yield curve remains inverted for the sixth quarter in a row. The quarter ended with 2s to 10s at a negative 45 basis points. While inverted, the yield curve is beginning to normalize with the inversion narrowing significantly from its negative 108 basis point slope at the end of the second quarter.

The Fed did raise rates by 25 basis points in July and hinted that future rate hikes were probable. However, in September, the Fed held rates steady wanting to let some time pass to see the effects of previous rate hikes on the economy. Despite the pause, market players still feel at least one more hike later this year or in early 2024 is likely.

| US Treasury Bonds | | | |
|---|---|---|---|
| Maturity | 7/3/2023 | 9/29/2023 | Shift (bps) |
| 1YR | 5.40% | 5.46% | 6 |
| 2YR | 4.83% | 5.04% | 21 |
| 3YR | 4.46% | 4.80% | 34 |
| 5YR | 4.09% | 4.61% | 52 |
| 7YR | 3.94% | 4.61% | 67 |
| 10YR | 3.80% | 4.57% | 77 |
| 30YR | 3.86% | 4.70% | 84 |

Actionable Idea: With currently available yields last seen in 2007, consider building a UST ladder adding duration when possible. UST are a pledgeable asset which may be useful when sourcing liquidity.

**U.S. Agencies** – Absolute yields on new issue callable agencies have risen along with UST yields. The favored agency coupon/yield in Q2 was 5.50% - 6% (with limited call protection). Q3 saw the introduction of coupons as high as 7% which was needed to compete against the higher yields available in UST. Agencies are not immune to the gravitational pull of higher UST yields and should be viewed as viable short and long term additions to your portfolio.

Actionable Idea: Match high coupon, short call agencies with longer term "one time" call structures. The short call agencies will generate a significant yield. Paired with longer call structures reduces reinvestment risk while also providing yield over UST.

**Municipals** – Municipals have performed poorly with the Bloomberg Municipal Bond Index sitting at a minus 1.38% through the first three quarters of 2023. Unlike short term UST, short duration municipals experienced yield increases much like their long term counterparts. This can be explained by muni yields as a percentage of UST. For much of the year this ratio was outside of historical norms with short term municipals being excessively "rich". That is there was very little (if any) relative value of 1-7 year municipals versus UST. As an example, at the beginning of Q3 high grade municipals with a 2YR maturity yielded just 60% of the 2YR UST. Adjusting for the tax advantage that municipals offer, the return was still lower than a comparable UST. Ultimately, the lack of value in municipals caused a much needed rise in yields re-instating the traditional relationship of municipal to UST. At the end of Q3, a 2YR muni yields 73% of UST putting it back inside of a more traditional band.

Through the first three quarters of 2023, bank qualified supply sits at $8.6 billion. This is a 16% decline from 2022 and is the culmination of the high cost of issuance in the current market. Municipal infrastructure still needs to occur regardless of interest rates but if a deal could be postponed or downsized, it was.

| "A" Rated Bank Qualified Municipals | | | |
|---|---|---|---|
| Maturity | 7/3/2023 | 9/29/2023 | Shift (bps) |
| 1YR | 3.56% | 4.18% | 62 |
| 2YR | 3.46% | 4.14% | 68 |
| 3YR | 3.31% | 4.03% | 72 |
| 5YR | 3.16% | 3.94% | 78 |
| 7YR | 3.11% | 3.95% | 84 |
| 10YR | 3.17% | 4.03% | 86 |
| 30YR | 4.31% | 5.12% | 81 |

Actionable Idea: With the muni curve's dramatic shift in Q3, investors who can tolerate interest rate volatility should consider extending duration with this portion of their asset allocation. Older secondary bonds now trading at a substantial discount present longer term capital gain potential.

**Mortgages** – 2023 has been challenging for the MBS market. The third quarter was no exception for several reasons including an inverted yield curve (which favors short term investments), extreme market volatility as yields continued to rise and severely curtailed bank demand.

Despite recent hurdles, the relative value of MBS remains strong. Credit is generally high in MBS. Bonds issues by Ginnie Mae are backed by the US government and bonds issued by Freddie Mac and Fannie Mae have been implicitly backed by the full faith and credit of the US Treasury since 2008.

Taking a small look, technical market conditions for MBS should continue to stabilize and even improve. Fund flows in MBS remains positive, most believe the Fed is near then end of its rate hike policy, new issue supply is just 16% of its trailing 3YR average and the yield curve has steepened providing excellent yield opportunities. With new MBS coupons in the 5.50%-6% range the pick-up we continue to recommend high quality, high coupon MBS for maximum cash flow generation.

## IN CLOSING

With three quarters of 2023 in the books, banks continue to focus on funding needs while managing margin compression. Funding diversification and interest rate risk management can be complemented with participating in these higher rates. The top of the rates market is hard to predict – but banks that continue to invest regularly will see opportunities to boost overall portfolio yields. Please call your Bankers' Bank investment team member to discuss portfolio strategies.


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