BANKERS' BANK

VIEW FROM THE TRADING DESK

Second Quarter 2024

The second quarter saw two FOMC meetings come to pass with the Fed opting to stay the course by keeping rates unchanged. However, the June meeting did result with the Fed acknowledging the intention to cut rates at least one time in 2024 if their economic projections of a cooling economy come to fruition. The Fed is anticipating a gradual improvement on their battle with inflation in 2024 with more rapid progress in 2025. While higher yields should translate into a gradually cooling economy, the tight labor market remains a sticking point and could extend rate cuts further into the future. There is little debate that the current policy is restrictive and should put downward pressure on aggregate demand, but what most cannot agree on is when the Fed will take action.

2024 FOMC Meetings: January 31st, March 20th, May 1st, June 12th, July 31st, September 18th, November 7th & December 18th

Key Indices Returns

	Q1 Returns	2024 Returns
Bloomberg Global Aggregate	**-1.10%**	**-3.16%**
US Treasuries	**+0.9%**	**-0.86%**
US Aggregate Bond Index	**+0.7%**	**-0.71%**
MBS	**+0.7%**	**-0.98%**
Municipal Bonds	**-0.02%**	**-0.40%**
Taxable Municipal Bonds	**-0.19%**	**-0.08%**
Corporate Bonds	**-0.09%**	**-0.49%**

OUR TAKE FROM A COMMUNITY BANK INVESTMENT PORTFOLIO PERSPECTIVE:

U.S. Treasuries – Yields finished the quarter slightly higher than where they began Q2 but intra-quarter activity was volatile. A strong GDP report in April surprised to the upside which led to yields on the 5YR and 10YR to rise by ~50 basis points before retreating lower. As the quarter progressed, additional economic data reflected some indication the economy may be slowing which brought some confidence back into the market. Existing housing sales and new construction dropped during the quarter and there is some indication that aggregate consumer demand is slowing. Counter to the slowing economy picture is a continually tight labor market that has the potential to prolong any rate cut further into the future. Yields are higher now than at the beginning of Q2 but remain range bound with a bias toward lower rates. The path forward is not likely to be smooth as we anticipate choppiness based on outlier economic and political events.

US Treasury Bond Yields			
Maturity	4/2/2024	6/28/2024	Shift (bps)
1YR	5.03%	5.13%	10
2YR	4.62%	4.75%	13
3YR	4.41%	4.53%	12
5YR	4.21%	4.34%	13
7YR	4.21%	4.31%	10
10YR	4.20%	4.31%	11
30YR	4.34%	4.45%	11

U.S. Agencies – As yields spiked in April, agency investors pivoted into US treasury purchases in an effort to lock in duration. Strategically, this was a sensible approach to the market given that agencies offer more yield than UST but at the cost of call protection. The nearly 50 basis point rise in treasury yields in April was an opportune time to move into call protected securities. Agency structures that did present some form of call protection (such as one and two year lockouts) were less frequently issued than in Q1, further leading investors to consider alternative assets such as UST, CD's and munis.

Further tightening of spreads on agency bullet (non-callable) structures continues in Q2. With supply lacking in this market, spreads have compressed to such an extent that there is very little benefit in the bullet agency market.

UST vs US Agency Bullet - 6/28/2024			
Maturity	UST	US Agency	Spread (bps)
1YR	5.13%	5.20%	7
2YR	4.74%	4.75%	1
3YR	4.53%	4.53%	0
5YR	4.33%	4.33%	0
7YR	4.31%	4.35%	4
10YR	4.31%	4.47%	16

Municipals Year-to-date, national municipal bond issuance (excluding notes and issues with maturities less than 13 months) has exceeded 2023's pace by an impressive 36%. Through June, 2024 issuance is $249.4 billion versus last year's $183.6 billion over the same time period. Regional issuance has been more varied. Focusing on Bankers' Bank's five state footprint of IA, IL, IN, OH and WI, total issuance has been relatively flat but notably uneven. Supply in Illinois outpaced 2023's issuance by $200 million resulting in a 61.63% increase. Removing Illinois from the calculation, the remaining four states saw a -26.22% decline in supply.

State	BQ Issuance Q2	2024 YTD Issuance	Year over Year Change
Wisconsin	235.515	358.165	-13.09%
Iowa	214.681	269.721	5.55%
Illinois	106.534	306.755	61.63%
Indiana	72.661	103.595	-17.95%
Ohio	22.421	45.231	-34.55%
Totals	651.812	1083.467	2.91%
In millions			
Excludes BANS (short term securities)			

The attractiveness of a municipal bond investment is not entirely decided by their absolute yield. Calculating their tax efficiency (based on tax brackets) to generate a true yield can then be measured against alternative, fully taxable bonds to determine their relative value. In the first quarter of 2023, municipals were outperforming other taxable products and did not offer much in the way of value to C Corp banks. As supply increased in the second quarter, municipal yields came under pressure and rose much higher than their US Treasury counterparts during the second quarter.

Using the 5YR range as an example, municipal yields rose 37 basis points in Q2 while UST rose just 13 basis points. Despite the significant rise in municipal yields, headwinds still exist for C Corp investors focusing on the 1-10 year part of the muni curve. S Corps are in better position to take advantage of the municipal bond tax benefit throughout the curve.

"A" Rated Bank Qualified Municipal Yields			
Maturity	4/2/2024	6/28/2024	Shift (bps)
1YR	3.73%	3.67%	-6
2YR	3.54%	3.63%	9
3YR	3.38%	3.54%	16
5YR	3.14%	3.51%	37
7YR	3.17%	3.52%	35
10YR	3.23%	3.52%	29
30YR	4.55%	4.49%	-6

Mortgages – With the Fed seemingly behind its tightening cycle, both yields and volatility have been effectively capped in the MBS market. This recent period of stability and confidence in future interest rate cycles has resulted with inflows in US bond funds that focus on MBS. Bond fund MBS holdings are up 31% while banks as holders are down 17% as liquidity needs continue to detract from the investing process. As the Fed shifts toward easing, bank participation may pick up and secondly, if the yield curve were to lose its inversion more fuel to the investing option would be added as a positively sloped curve could improve bank net asset margins.

Effective MBS net supply, which includes both Fed running off its portfolio as well as organic supply, may reach a five year high in 2024. Factors driving supply are the Fed runoff, a firm new-home market, more assistance for first time home buyers and rising loan size. Organic issuance of MBS is on pace to exceed 2023's supply by $50 billion, a 23% increase. Fed runoff may add an additional $200 million to the market by year end bringing the total to $460 billion.

<u>DTC Brokered CD's</u> – Banks continued to utilize the brokered (DTC) CD market to fund liquidity needs in Q2. Unlike 2023 which saw issuance increase throughout the first half of the year, the rate of utilization is lower than 2023 and has stabilized.

DTC CD - Issuance thru Bankers' Bank (in millions)			
Category	Q1 2023	Q2 2023	Total
DTC CDs	22.056	36.587	58.643
Category	Q1 2024	Q2 2024	Total
DTC CDs	17.125	17.265	34.39

The volume of overall investing activity at Bankers' Bank is flat versus 2023 but CD purchases are down. This drop in CD purchasing activity can largely be explained by technical factors affecting the market. As supply declined in the CD market, so did the variety of structures available to banks who were looking to deploy cash. Secondly, because of the diminished amount of issuance, CD's were (on occasion) able to be issued at low yields. Historically, an investor would see a CD yield with spread over and above a comparable UST. However, for some extended periods during 2024 CD's have been trading with yields very close or lower than those on a comparable UST. With relative value in CD's questionable during those time periods, investors were less active in CD's and became more active in UST, MBS and other higher yielding securities.

IN CLOSING

Some quick takeaway ideas for banks:

1. Determine strategic balance sheet allocation to investment portfolio in 2024. In the first half of 2024, banks have for the most part utilized portfolio runoff to pay off higher price borrowings and support balance sheet loan growth. Talk with the Bankers' Bank team on ideas for adding yield to the portfolio, managing cash flows, and strategic repositioning.
2. Many banks are hoping for rate cuts in the second half of 2024 – maybe September and maybe November/ December. We recommend analyzing impacts from those potential changes on the portfolio to identify opportunities. Our Portfolio AdvantEdge reports model interest rate changes impact on securities level cash flows and market values. Depending on your portfolio, there may need to be large interest changes to impact the cash flows. Using tools to model where can better manage cash flow changes will be useful to banks if we are indeed moving into lower rates in 2024 and 2025.
3. Banks considering selectively repositioning the portfolio may hesitate selling bonds due to realizing losses. As you look into remainder of 2024, there may be opportunities to take gains elsewhere in the bank and offset losses when strategically restructuring investments. Examples include selling MSR portfolios or one-time transaction gains. Other banks have considered selling variable rate MBS at a gain and netting out longer holdings at loss. These opportunities may allow for putting the portfolio into better position for future cash flow and yield needs.

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