Ambassador Financial Group, Inc.

Banks Flush with Cash can Rachet Up Performance

The current fixed-income investing environment feels like the one we had not too long ago. I'm referring to the environment in the early part of this decade from mid-2002 through mid-2004 when treasury yields hit historically low levels. Then and now are chock full of similarities. For starters, the Fed aggressively pursued an easing campaign by lowering short-term borrowing rates both times. Remember that back in early 2001, the Fed was already engaged in an easing cycle on the back of the bursting NASDAQ bubble. Nine months into the easy money campaign, the 911 terrorist attacks occurred, causing the Fed to continue to lower rates through June 2003 for a grand total of 550 basis points of easing.

In the current cycle, the Fed has aggressively lowered the overnight rate 500 basis points from 5.25 percent to 0.25 percent in an attempt to skirt another Great Depression. As was the case earlier in the decade, the Fed is trying to spawn growth by lubricating the economic machine with easy money. Unfortunately, the earlier easing campaign greatly contributed to the current crises, while the current easing campaign is trying to get us out of this mess. Isn't this ironic?

Another similarity is the impact of the easing campaign, one being the significantly lower treasury rates. In 2003, treasury rates bottomed in mid-June, which represented historically low rates across the curve. For the current cycle, the low in treasury rates occurred in mid-December of 2008 at levels well below those in 2003 (see Figure 1). Recall that it wasn't that long ago when yields on treasury bills were actually negative. Fast forward to today, treasury yields have moved up markedly since December, proving just how quickly volatility in rates can return.

Figure 1

Comparative Yield Curve

	6/13/2003	12/18/2008	5/4/2009
3 Month	0.846%	0.012%	0.150%
6 Month	0.837%	0.140%	0.287%
1 Year	0.959%	0.402%	0.452%
2 Year	1.080%	0.676%	0.891%
3 Year	1.314%	0.934%	1.348%
5 Year	2.030%	1.258%	2.001%
10 Year	3.112%	2.079%	3.140%
30 Year	4.173%	2.521%	4.064%

As a result of lower treasury rates fueled by the flight to quality and the quantitative easing initiative pursued by the Fed whereby they purchase both treasury and mortgage-backed securities, mortgage rates are at multi-generational lows. In the earlier cycle, lower mortgage rates precipitated a massive refinancing wave which ultimately exacerbated the housing bubble. While not nearly as many people qualify for mortgages today and lending standards have been prudently tightened, refinancing activity is up and we would expect this to continue as long as the government keeps mortgage rates artificially low. This 2009 refinancing boom continues to cause accelerated cash flows within the loan and mortgage-backed security portfolios.

In addition to accelerated cash flows through refinancing activity, this environment parallels the earlier cycle in that deposit inflows are also accelerating. Investors' flight to quality from riskier assets and depositors' exodus from riskier banks have been a boon to community banks as these shifts have given them the luxury of attracting lower-costing deposits. Anecdotally, our clients have been experiencing significant deposit inflows while aggressively lowering CD rates, and first quarter earnings reports support this claim across the banking sector. While liquidity remains a problem, specifically as it relates to collateral requirements with funding counterparties such as the FHLB, competitive pressures have abated. The likes of Washington Mutual, Wachovia, and Countrywide are no longer paying up for deposits, enabling community banks to generate lower-costing deposits, including non-interest-bearing transaction accounts. Coupled with refinancing cash flows, deposit growth is creating an abundance of cash on banks' balance sheets.

As bankers strive to optimize the use of their abundant cash, history helps show us what might be in store for us going forward. To gain some knowledge on what to expect, consider periods when the Fed embarked on a tightening campaign to curb growth and inflation. Going back to 1971, we identified seven such cycles when the Fed aggressively pursued a tightening policy (see Figure 2). We measured from trough to peak the severity of the rate increase as well as the length of time it took to achieve the increase. The results indicate that the median rate increase was 388 basis points extending over a 25-month period. Clearly the periods in the 1970s and 1980s represent the most severe moves occurring over the longest time frames, potentially skewing the data. However, it is important to include those data points to increase the size of the sample and to highlight environments defined by stagflation or runaway inflation. Because of the skew, median values are reported. While not trying to be an alarmist, given the record deficits, bailouts, and increasing U.S. dollar money supply, those periods in the 1970s and 1980s might better portend the outcome of the current cycle.

Figure 2

Federal Funds Target Rate Statistics

Cycle	Date	Trough	Date	Peak	Rate Increase from Trough to Peak	Months from Trough to Peak
1	2/26/1971	3.50%	5/31/1974	13.00%	950 bps	39 Months
2	1/30/1976	4.75%	5/29/1981	20.00%	1525 bps	64 Months
3	4/29/1983	8.50%	8/31/1984	11.75%	325 bps	16 Months
4	11/28/1986	5.88%	2/28/1989	9.75%	388 bps	27 Months
5	1/31/1994	3.00%	2/28/1995	6.00%	300 bps	13 Months
6	5/31/1999	4.75%	5/31/2000	6.50%	175 bps	12 Months
7	5/31/2004	1.00%	6/30/2006	5.25%	425 bps	25 Months
8	12/31/2008	0.25%	?	?	?	?
				Median	388 bps	25 Months

We also wanted to take a look at how the 5-, 10-, and 30-year treasury yields performed, trough to peak, during those tightening cycles (see Figure 3). Note that the trough to peak dates for the federal funds target rate don't match up with the treasury rates. Markets traditionally lead the Fed and move up in advance of what they believe the Fed will do. Interestingly, the results indicate that treasury rates, in most instances, didn't move as high as the fed funds rate, meaning that the curve flattened. Cycle 3 represents the only cycle that most closely exhibits a parallel shift in rates, whereby the entire curve moved in lockstep.

Figure 3

5-Year Treasury Bond Statistics

Cycle	Date	Trough	Date	Peak	Rate Increase from Trough to Peak	Months from Trough to Peak
1	12/31/1971	5.69%	8/31/1974	8.63%	294 bps	32 Months
2	12/31/1976	6.10%	9/30/1981	15.93%	983 bps	57 Months
3	4/30/1983	10.02%	6/30/1984	13.48%	346 bps	14 Months
4	1/31/1987	6.64%	3/31/1989	9.51%	287 bps	26 Months
5	10/31/1993	4.71%	12/31/1994	7.78%	307 bps	14 Months
6	10/31/1998	4.18%	5/31/2000	6.69%	251 bps	19 Months
7	6/30/2003	2.27%	6/30/2006	5.07%	280 bps	36 Months
8	12/31/2008	1.52%	?	?	?	?
				Median	294 bps	26 Months

10-Year Treasury Bond Statistics

Cycle	Date	Trough	Date	Peak	Rate Increase from Trough to Peak	Months from Trough to Peak
1	3/31/1971	5.70%	9/30/1975	8.43%	273 bps	54 Months
2	12/31/1976	6.87%	9/30/1981	15.32%	845 bps	57 Months
3	5/31/1983	10.38%	6/30/1984	13.56%	318 bps	13 Months
4	1/31/1987	7.08%	10/31/1987	9.52%	244 bps	9 Months
5	10/31/1993	5.33%	11/30/1994	7.96%	263 bps	13 Months
6	10/31/1998	4.53%	1/31/2000	6.66%	213 bps	15 Months
7	6/30/2003	3.33%	5/31/2006	5.11%	178 bps	35 Months
8	12/31/2008	2.42%	?	?	?	?
				Median	263 bps	15 Months

30-Year Treasury Bond Statistics

Cycle	Date	Trough	Date	Peak	Rate Increase from Trough to Peak	Months from Trough to Peak
1	-	-	-	-	-	-
2	6/30/1977	7.64%	10/31/1981	14.68%	704 bps	52 Months
3	4/30/1983	10.48%	6/30/1984	13.44%	296 bps	14 Months
4	1/31/1987	7.39%	10/31/1987	9.61%	222 bps	9 Months
5	10/31/1993	5.94%	11/30/1994	8.08%	214 bps	13 Months
6	10/31/1998	5.01%	1/31/2000	6.63%	162 bps	15 Months
7	-	-	-	-	-	-
8	12/31/2008	2.87%	?	?	?	?
				Median	222 bps	14 Months

So what can we infer from this data? They suggest that short-term rates, as measured by the fed funds rate, have the potential to move higher by a wide margin and that treasuries will also move higher, albeit not to the same degree. The data also suggest that prior to a tightening campaign the yield curve steepens, creating lots of positive slope. This is exactly what happened earlier this decade and is precisely what the curve is doing today. History cannot always predict the future, as each market environment exhibits its own unique qualities. This time around one might argue that the abundance of government bailout programs could cause significantly higher rates across the curve given the anticipated glut of forthcoming treasury supply. Nevertheless, learning from past interest-rate cycles can assist us in generating an investment strategy that prepares us for a probable outcome.

Given the potential for significantly higher rates in the future, how can we invest today without mortgaging the future (pun intended)? We find ourselves flush with cash at a time when treasury and mortgage rates are near historically low levels, and prudent loan growth opportunities are limited, making today's investment choices paramount to successful longer-term performance. Remember that investments made back in 2003 ultimately resulted in AFS losses as rates moved higher, putting pressure on equity book values. While unfortunate, this is the dilemma when investing during a period of historically low rates. However, despite the similarities between the current and prior cycles, there are some distinctions that make this cycle more opportunistic.

In general terms, risk premiums on all asset classes, including fixed-income assets, were at or approaching historically low levels. Pervasive risk-taking pushed up asset prices to inflated levels. This contributed to the current mess. Consequently, the universe of traditionally conservative fixed-income investments, such as mortgage-backed securities, agencies and corporate bonds, were offering unusually low returns. The one exception was tax-exempt municipal bonds, which did offer nice yields further out on the curve. In contrast to then, in today's market we find that there are some compelling opportunities within the mortgage-backed securities arena, corporate securities, tax-exempt municipals, and taxable municipals. The goal is not to purchase the highest-yielding securities today, but rather select investment opportunities and structures that position the balance sheet for the long term. Below are some opportunities we see for taking advantage of this environment, avoiding some of the pitfalls from earlier this decade, and preparing the balance sheet for the future.

1. In the mortgage-backed security arena, we continue to favor seasoned agency paper, particularly 15-year collateral. These pools perform really well in either a rising- or falling-rate environment. Extension risk is marginal in an up-rate environment as the seasoned pools put them well into their amortization schedule. Even at extremely slow prepayment speeds, these pools will generate significant cash flows to reinvest into higher-yielding loans or securities as rates rise (see Table 1). Conversely, in a falling-rate environment, cash flows remain stable as the underlying weighted average coupon is low and will mitigate accelerating refinancing activity. Said differently, lower underlying collateral coupons are less susceptible to wholesale refinancing. Seasoned structures inherently generate a lower level of refinancing as the underlying borrowers typically don't wish to extend the term of existing loans unless the incremental savings is substantial. When purchasing seasoned MBS pools, it is extremely important to focus on larger pools with geographic dispersion. Larger pools backed by many loans improve the predictability of future cash flows due to the greater diversification.

Table 1

Cash Flow Analysis: 15-year 4.5% MBS

Assumptions

Modified Duration	3.18	Coupon	4.50%	WAM	123
Average Life	3.60	Original Balance	17,707,019	WALA	51
		Current Balance	10,000,000	WAC	5.01%

Year	Date	Principal Balance	Interest	Regular Principal	Prepaid Principal	Net Cash Flow	% of Cash Flow Recovered	Cumulative Recovery
1	5/15/2010	$ 8,488,155	$ 418,257	$ 744,690	$ 767,155	$ 1,930,102	19.30%	19.30%
2	5/15/2011	$ 7,120,603	$ 353,248	$ 720,267	$ 647,285	$ 1,720,799	17.21%	36.51%
3	5/15/2012	$ 5,885,036	$ 294,474	$ 696,645	$ 538,923	$ 1,530,041	15.30%	51.81%
4	5/15/2013	$ 4,770,154	$ 241,403	$ 673,797	$ 441,085	$ 1,356,285	13.56%	65.37%
5	5/15/2014	$ 3,765,586	$ 193,545	$ 651,699	$ 352,869	$ 1,198,114	11.98%	77.35%
6	5/15/2015	$ 2,861,813	$ 150,452	$ 630,326	$ 273,446	$ 1,054,225	10.54%	87.90%
7	5/15/2016	$ 2,050,103	$ 111,713	$ 609,654	$ 202,056	$ 923,423	9.23%	97.13%
8	5/15/2017	$ 1,322,443	$ 76,948	$ 589,659	$ 138,001	$ 804,608	8.05%	105.18%
9	5/15/2018	$ 671,481	$ 45,811	$ 570,321	$ 80,641	$ 696,773	6.97%	112.14%
10	5/15/2019	$ 90,475	$ 17,985	$ 551,616	$ 29,389	$ 598,991	5.99%	118.13%
10	7/15/2019	$ -	$ 508	$ 90,161	$ 314	$ 90,983	0.91%	119.04%

2. In the corporate world, we believe there is an opportunity to selectively add shorter duration (three years or shorter) corporate securities to the portfolio given their current yields. Spreads have tightened considerably since the third quarter of 2008, but remain at levels that offer tremendous value. While there is value in all sectors within the corporate spectrum, the financials clearly offer the most compelling yield opportunities given the negative sentiment that continues to affect prices. However, given massive

government support through the litany of acronym-labeled government programs (such as TLGP, TAF, TALF, TARP, CAP, and PPIP), we believe the financials are oversold and that the yield compensates one for the assumed risk. In addition, Paul Volcker recently stated that no systemically important banks will fail, reiterating similar comments made by the Fed chairman, Ben Bernanke, and Treasury secretary, Timothy Geithner. As such, a focus on the 19 banks that the Treasury has promulgated as being systemically important seems like the logical choice within the financial space. In addition, it is important to build a diversified corporate portfolio in order to mitigate security-specific risk.

3. On the tax-exempt front, yields remain at levels above their historical mean relative to treasuries across the curve. While yields have tightened significantly over the past few weeks on the back of less supply and increased demand, they remain at attractive levels. Keep an eye on 20-year bank-qualified municipal levels at the 4.00 percent yield level. A research piece we issued a few years ago suggested that the 4.00 percent level is a floor level for 20-year municipals. Therefore, adding duration at those levels probably doesn't make sense as they will most certainly go to a loss if history repeats itself.

Remember to focus on the "cleanest" general obligation structures with solid stand-alone credit ratings. Few insurers carry the AAA-rating these days and underlying ratings are the key factor in evaluating municipal credits. A further focus on school district bonds with state specific school enhancement programs can add another level of credit protection. Also remember that the new stimulus package allows for banks to purchase non-bank-qualified municipals representing 2 percent of their total assets. The bonds must be issued in 2009-2010, and consulting with your tax accountant makes sense.

4. On the taxable municipal bond front, we have seen a glut of supply in Build America Bonds (BABs). BABs are taxable municipal deals that carry a 35 percent subsidy by the government in the form of interest payments or tax relief. The deals have been extremely well received by the market as large institutional buyers are absorbing supply. While the BAB deals have more concentration longer on the curve, some deals have shorter maturities. We believe there is value across the curve for both BAB deals and other taxable municipal deals. Once again, portfolio managers should focus on the cleanest general obligation structures with solid stand-alone credit ratings.

Implementing one or all of the above opportunities can make sense, but each investment decision depends greatly on one's asset-liability position, risk appetite, and investment policy. Within the above mentioned investment opportunities, there is a lot of flexibility. Building a shorter duration ladder utilizing shorter corporates and taxable municipals, along with seasoned 15-year MBSs can provide an excellent cash flow stream to fund higher-yielding loans and/or investments as rates rise. Those same cash flows could also be used to selectively deleverage the balance sheet to pay off borrowings or let high-priced hot money CDs walk. Adding intermediate and longer-duration tax-exempt and taxable municipal bonds can spread interest-rate risk across the curve and enhance yield.

In addition to the above attractive alternatives for excess cash and liquidity, this environment offers some other balance sheet opportunities. In regards to the investment portfolio, we believe that prepays will continue to accelerate within the mortgage space; therefore, selling MBSs prone to those prepays at gains might make sense. Higher coupon structures, hybrid arms, and smaller pools fall into that category, and the gains can help to offset expenses associated with higher FDIC premiums and loan provisioning.

On the liability side of the balance sheet, we continue to recommend tapping into the Term Auction Facility (TAF) through the Fed. The TAF is a biweekly auction through the Fed to borrow short-term funds. The earlier monthly auction is for a term of 28 days, while the later monthly auction is a term of 84 days. The borrowing rate has consistently come in at 25 basis points, representing the cheapest source of short-term funding. Obviously the ability to borrow at 0.25 percent creates some phenomenal leveraging opportunities as reinvesting into the most conservative investments can offer attractive spreads. We also like the TAF program as another source of liquidity. Counterparty risk is minimal as the Fed is on the other side and collateral requirements are favorable. Liquidity contingency planning remains at the top of the list for many institutions, specifically given the recent developments at some of the FHLBs.

In summary, this environment offers many opportunities. While many of you are experiencing sticker shock with declining asset yields and growing cash, a proactive approach to navigating this environment can pay off. Develop an investment strategy to take advantage of this environment. Knowing that cash will most likely continue to build, don't attempt to time markets. Rather, steadily put excess liquidity to work over time so cash flows remain manageable. The opportunity cost of sitting on the sidelines is too great and there is value to be found.

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