AMBASSADOR FINANCIAL GROUP

Notes from the Ambassador Bank Vault **October 24, 2017**

Asset/Liability Management: The Barbell Strategy Can Optimize Your Bank's Performance

In 1530, Michelangelo hung mattresses on the outside walls of the bell tower of Florence to minimize damage from cannon fire during the war with Charles V and Medici Pope Clement VII. Although "going to the mattresses" is a wartime strategy and community banks are not at at war (at least not officially), we believe asset/liability officers should embrace a protective strategy to better control interest rate risk and maximize income given potential Fed short-term interest rate increases and the unwinding of its $4.5 trillion balance sheet. This article updates our August 7, 2017 publication "Asset/Liability Management: The Fed's Securities Portfolio Could Affect Your Bank's Performance".

The barbell strategy is simple to implement and can be implemented by investing excess liquidity or as part of a repositioning strategy. The premise is to avoid the middle of the curve by concentrating investments in very short securities (often linked to LIBOR) and in long-term maturities. Because LIBOR has been moving higher with Fed Funds, securities with a coupon tied to LIBOR have been resetting higher. The long end of the barbell is used as a yield anchor. For the long end of the barbell, longer-term municipals, corporates, and deep discount callable agencies are structures that exhibit positive convexity. These instruments often work best and stand to benefit as long as rates remain stable or move lower. If the Fed continues to raise rates, the yield curve could further compress, generating gains on securities that are on the long end of the curve.

- Ambassador Financial recommends that banks use a barbell approach as a conservative asset/liability strategy. This should facilitate profitability by taking advantage of higher shorter-term rates and mitigate extension risk through the use of variable-rate instruments tied to the short end of the curve and fixed-rate assets on the long end of the curve.

- The Federal Open Market Committee reiterated that it expected to start reducing its portfolio of bonds and mortgage-backed securities. This will be a long, multiyear process designed to lower the possibility of roiling capital markets.

- All other things equal, the Fed's policy to "roll off" its securities portfolio should (theoretically) produce higher rates, or have the opposite effect of quantitative easing, which was designed to promote economic growth by keeping long-term interest rates low.

- The Fed tailwind is subsiding as interest rates have been boosted four times since December 2015. Although rates were untouched at the Fed's two-day meetings in July and September, another interest rate hike in the fourth quarter may occur.

- As we go to press, the spread between 2-and 10-year Treasury bonds compressed to 79 basis points compared with 125 basis points at December 31, 2016. The spread was 95 basis points at the same time last year. Further compression could occur, particularly if longer-term rates decline if the economy softens.

- The economy remains in a steady, but relatively "slow growth," mode despite considerable Fed backing. If this support is lifted, is it logical to expect economic activity to accelerate meaningfully? We think not, and opine that the Fed's willingness to tighten and risk a "soft landing" is due to increased concerns regarding excessively higher valuations of other asset classes without a supportive fiscal policy.

Astute bankers recognize that fiscal reform may <u>not</u> offset the effects of Fed tightening, and funding and investment strategies should be adjusted to reflect greater macroeconomic uncertainties. Tax reform appears to be moving forward, but the Congressional process is maddening and there isn't much certainty regarding the timing or contents of the final product. Ambassador Financial continues to believe that risk asset valuations are generally rich, and longer-term Treasury yields could move lower or stay stable even if short-term rates increase due to Fed maneuvers. Economic activity should remain fairly steady for the foreseeable future, but we question if growth will exceed the pedestrian pace of 2% or so when the Fed unwinds its massive stimulus programs.

Based on the Fed's statement following its September 19–20 meeting and follow-up comments, the central bank's plans to raise short-term interest rates once more in 2017 appear intact. (The benchmark rate remained in a range between 1% and 1.25%.)

The Federal Open Market Committee reiterated on September 20 that it expected to start to reduce its portfolio of bonds and mortgage-backed securities. **Shrinking the balance sheet – another form of tightening – has not yet occurred in U.S. history and, therefore, it seems impossible to predict exactly what will happen.** The Fed purchased approximately $4.5 trillion in Treasury- and mortgage-backed securities during and after the financial crisis to temper longer-term interest rates and, in turn, to provide stimulus to the economy. Interest rates were cut to zero in 2008. Although the Fed stopped buying securities for its balance sheet in 2014, it has not pruned it by allowing securities to "roll off" due to lingering fears regarding the health of the economy. As the Fed purchased assets, it was able to temper yields on Treasury- and mortgage-backed securities, which made it cheaper for the U.S. government to finance its budget deficits and for homebuyers to finance mortgages.

The Fed has telegraphed its thinking in order to avoid surprising the market regarding its plans for the balance sheet. In May 2013, the market was spooked when then-Chairman Ben Bernanke suggested that the Fed was considering scaling back its balance sheet. Identified as the "taper tantrum," the U.S. housing market and emerging markets were punished as longer-term interest rates increased. Chairwoman Janet Yellen suggested it will take a few years to reduce the balance sheet. The balance sheet, ultimately, will be much smaller than it is today, but larger than it was before the Great Recession when it was "only" $1 trillion. We believe the Fed's intention is not to actively sell, but to allow a preset amount of holdings mature each month without reinvestment.

Expectations are that the Fed will have monthly reductions of $6 billion of Treasury debt and $4 billion of mortgage-backed securities and gradually increase that to $30 billion and $20 billion, respectively. **Rather than selling securities outright, it will pare its portfolio by allowing bonds to roll off, instead of reinvesting, the proceeds of the bonds as they mature. (The Fed presently reinvests proceeds by buying more bonds.)** Assets on the Fed's $4.6 billion balance sheet consist of U.S. Treasury securities of $2.5 trillion (55.1%), mortgage-backed securities of $1.8 trillion (39.5%), and other securities of (5.4%) consisting of swaps with foreign central banks, overnight loans of securities, and foreign currencies.

Ambassador Financial believes that the Fed will adjust its long-term program of unwinding its balance sheet as business conditions and the economy warrant. Balance sheet flexibility also makes sense for community banks, and financial officers should consider different economic and interest rate scenarios and potential outcomes when assessing asset/liability strategies.

Please feel free to contact your Ambassador Representative for more detailed analysis regarding your institution.

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