AMBASSADOR FINANCIAL GROUP

Notes from the Ambassador Bank Vault **August 16, 2018**

Asset/Liability Management: Find the Optimal Trade as the Yield Curve Flattens

"My dear, here we must run as fast as we can, just to stay in place. And if you wish to go anywhere you must run twice as fast as that." — Lewis Carroll, Alice in Wonderland

Community banks generally produced strong earnings for the quarter ending June 30, 2018, with only a handful of adverse surprises. On a national basis, the median earnings per share growth rates for banks between $500 million and $20 billion were 25.0% on a year-over-year basis and 4.8% (not annualized) on a sequential quarter basis. The outsized 12-month growth rate was due in large part to lower corporate tax rates in 2018, but linked quarter growth was also impressive as most banks grinded out higher net interest margins and controlled noninterest expenses. Despite the flattening yield curve, net interest margin improvement was achieved mainly through moderate loan growth along with higher yields while rates paid on interest-bearing funds were dampened. Some banks used cash flows from investment portfolios to help fund loan growth. Overall asset quality remained very good and credit costs remained subdued.

Figure 1

Net Interest Margin

Banks with assets between $500M and $20 billion

	Q217	Q118	Q218
	%	%	%
Northeast	3.22	3.14	3.13
Mid-Atlantic	3.43	3.45	3.50
Southeast	3.70	3.69	3.75
Midwest	3.64	3.66	3.74
Southwest	3.72	3.79	3.90
West	3.94	3.81	3.94
All U.S.	3.63	3.65	3.69

*Represents medians

Source: S&P Global Market Intelligence

- As we go to press, the spread between 2-year and 10-year Treasury notes was only 25 basis points compared with 54 basis points at January 2, 2018, and 89 basis points a year-ago.

- Developing an effective asset/liability strategy is company-specific and should include board policies regarding liquidity and capital. For instance, institutions with strong loan demand and/or terrific core funding will have different asset/liability strategies than banks without these attributes.

- Corporate issues with shorter final maturities (often floaters) and community bank debt often have attractive risk-return profiles.

- Ambassador Financial believes the majority of investors favor conservative investment policies. We, therefore, recommend A/L managers deploy a barbell approach with regard to investment portfolios.

- Portfolio managers should consider selling short tax-exempt/BQ munis as this sector is overvalued compared to other alternatives.

As of June 30, 2018, investment securities represented between 15-20% of total assets and spread income represented approximately 75-85% of operating earnings for most community banks with assets below $20 billion. Funding – particularly core deposits –has regained more importance due to rising short-term rates along with the flatter yield curve. Please see *Notes from the Ambassador Bank Vault –July 9, 2018* for detailed information regarding deposits and core deposit premiums. Regarding the other side of the balance sheet, **Ambassador Financial believes proactive asset/liability managers can take measures within the investment portfolio to help mitigate the effects of the flattening yield curve.**

Investment Portfolio Strategy

Opportunities exist to sell securities and use the proceeds to reposition the portfolio more profitably in the current interest rate environment. We like to take advantage of market movements that allow us to sell securities out of an overvalued sector and reinvest into an undervalued sector. Presently, short, well-rated tax-exempt/BQ munis have been trading with TEY's at or below the yield on comparable maturity Treasuries. This can be attributed to both the decrease in corporate tax rates, which effectively lowered TEY's, and relatively strong retail demand for short munis. Given this phenomenon, we have been analyzing strategies that center around selling munis with 1-4 year maturities. In addition to taking advantage of the exuberant market pricing, this part of the curve is most exposed to price declines due to rising short term rates, given the Fed's quest to normalize Fed Funds.

We have executed this type of strategy for many clients and are often able to pick up 30 to 50 bps over the taxable equivalent yields we sold by reinvesting into 15yr 4% MBS. This type of paper has offered spreads near +60, yields near 3.30%, and base case durations of only 4 years. **The shorter amortization schedule helps minimize extension risk in a rising rate environment, while providing significant cash flows.** If rates push lower from here, there is potential for significant price appreciation given where this paper had been trading in the last several years. Many times, the sale candidates have a duration around 3 years while the reinvestment is around 4 years. Interestingly, however, in the Treasury curve there is only a three basis point difference going from a 3 to a 4 year duration. In this strategy, we are able to increase this differential by more than 10 fold. By moving into the MBS we can also improve credit quality, help prevent margin compression, and generate monthly cash-flow to help fund loan growth.

The second strategy that we continue to implement focuses on increasing floating rate securities or "barbelling" the portfolio. The move in the 2-year Treasury closely follows FOMC decisions, which makes it difficult to invest in this part of the curve. Floating-rate assets tied to LIBOR, or similar indices such as Prime, have performed well. Prime and 1-month LIBOR trade at the highest level in almost 10 years and this trend should continue for the foreseeable future if the Fed opts for additional rate hikes. At the same time, longer term rates could move lower in anticipation of the end of the interest rate and economic cycles. **Over the past 30 years, when the Fed is lowering Fed funds, the curve generally steepens, and when the Fed raises rates, the curve generally flattens.** Once a FOMC tightening campaign ends, long rates often begin to fall in anticipation of the next Fed easing cycle. Consequently, the longer duration assets on the opposite side of the barbell will lock in higher yields and provide significant price appreciation potential.

Ambassador Financial believes each incremental FOMC rate increase will hasten the end of both the interest rate and economic cycles. An inverted yield curve historically forecasts an economic recession in the next 18-24 months; and the probability is growing that the yield curve will invert before the end of the year, suggesting we could enter a recession in late 2019 or 2020. Some market participants believe an inverted yield curve won't spell recession this time around because rates have been artificially low for so long. We can't predict if this time will be different but, a recent study published by the Federal Reserve Bank of San Francisco determined that an inverted yield curve has predicted the last nine recessions, dating back to 1955. In the final analysis, it is important to take a hard look at the portfolio to ensure that it is optimally positioned to take advantage of rising rates in the near term and to confirm there is not undue credit risk in case of an economic slowdown.

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AMBASSADOR FINANCIAL GROUP

Our experienced executives have been advising clients for three decades with an aggregate deal value in excess of $10 billion. Our recent transactions include a subordinated debt offering and several acquisitions.

M&A Advisory
July 2018 | Pineville, West Virginia

Peoples Bankshares, Inc. has agreed to be acquired by Summit Financial Group, Inc., of Moorefield, West Virginia.

Announced deal value was $25.5 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Peoples Bankshares, Inc.

M&A Advisory
June 2018 | Warren, Pennsylvania

Northwest Bancshares, Inc. has announced the acquisition of Donegal Financial Services Corporation, of Marietta, Pennsylvania.

Announced deal value was $85.0 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Northwest Bancshares, Inc.

M&A Advisory
May 2018 | Mercersburg, Pennsylvania

Mercersburg Financial Corporation has agreed to be acquired by Orrstown Financial Services, Inc., of Shippensburg, Pennsylvania.

Announced deal value was $32.4 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Mercersburg Financial Corporation.

M&A Advisory
January 2018 | Scottdale, Pennsylvania

The Scottdale Bank & Trust Company has been acquired by Mid Penn Bancorp, Inc., of Millersburg, Pennsylvania.

Announced deal value was $59.1 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, The Scottdale Bank & Trust Company.

M&A Advisory
December 2017 | Belleville, Pennsylvania

Kish Bank has acquired Benefits Management Group, Inc., of Lewistown, Pennsylvania.

Ambassador served as financial advisor to Kish Bank.

M&A Advisory
October 2017 | Harrisburg, Pennsylvania

Riverview Financial Corporation has merged with CBT Financial Corporation, of Clearfield, Pennsylvania.

Ambassador served as financial advisor to, and prepared the fairness opinion for, Riverview Financial Corporation.

M&A Advisory
July 2017 | Bowie, Maryland

Old Line Bancshares, Inc. has acquired DCB Bancshares, Inc., of Damascus, Maryland.

Announced deal value was $40.7 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Old Line Bancshares, Inc.

Capital Markets
June 2017 | Livingston, New Jersey

Regal Bancorp, Inc. has completed a $10.0 million subordinated debt offering.

Ambassador served as placement agent to Regal Bancorp, Inc.

M&A Fairness Opinion
June 2017 | Monona, Wisconsin

Monona Bankshares, Inc. has acquired Middleton Community Bank, of Middleton, Wisconsin.

Ambassador provided the fairness opinion for Monona Bankshares, Inc.

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