Notes from the Ambassador Bank Vault **November 6, 2018**

Mid-Atlantic Small and Mid Cap Banks and Thrifts
Third Quarter 2018 Volatility: Another Look at Investment Portfolios

SUMMARY:

"A good plan violently executed today is better than a perfect plan executed next week." Gen. George S. Patton. Third quarter 2018 earnings for mid-Atlantic community banks were generally good as most companies met or exceeded both expectations and results for the third quarter of 2017. Bank stock prices, however, fell sharply along with the overall equity markets as investors focused more on headwinds – both real and perceived – rather than reported results. Banking is an established industry, and therefore, tends to mirror the overall economy, which flashed enough signs of strength to convince the Federal Open Market Committee (FOMC) to raise interest rates following its September 2018 meeting. **The Fed also signaled additional rate hikes would likely occur through 2019, which challenges bankers to implement strategies to overcome rising funding costs.** Merger activity should remain, although a hiatus seems probable as pricing metrics adjust to reflect market volatility and lower valuations.

HIGHLIGHTS:

- Third quarter earnings generally met or exceeded market expectations. On a median basis, earnings per share for mid-Atlantic banks with assets between $2 and $10 billion increased 24.7% year-over-year and 2.1% above consensus estimates.

- Although attention spans were focused on equity markets, the yield curve continued to flatten. Many banks will look to reposition balance sheets in the fourth quarter when investors generally accept "kitchen sink" maneuvers and the stage is set to maximize performance in the upcoming year.

- As we go to press, the spread between 2 and 5-year Treasury notes shrunk to only 12 basis points vs. 14 basis points a month ago, 44 basis points a year ago, and 45 basis points two years ago. We regard 2 and 5-year Treasuries as proxies for funding costs and investment yields, respectively. See Figures 1 &2.

- 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.

- Anecdotal evidence suggests many banks plan to increase higher share buybacks due to lower stock prices. This usually helps boost earnings per share, but further analysis may show that repurchases may not be as helpful as strategic asset/liability maneuvers.

- Not all banks will be able to meet core funding needs organically, and therefore, the quest for core deposits will likely be an important merger and acquisition driver for the foreseeable future.

Contacts:

Rick Weiss	rweiss@ambfg.com	**Ryan Walker**	rwalker@ambfg.com
Matt Resch	mresch@ambfg.com	**Josh Albright**	jalbright@ambfg.com
Rob Pachence	rpachence@ambfg.com	**Eric Tesche**	etesche@ambfg.com

INVESTMENT THESIS

Opportunities exist to sell securities and use the proceeds to reposition the portfolio more profitably in the current interest rate environment. Fourth quarter 2018, earnings results, therefore, should include many more one-time charges as attention turns to 2019 earnings prospects. Many banks reposition balance sheets in the fourth quarter when investors are more accepting of one-time restructuring charges provided risk/reward metrics are enhanced for the upcoming year. Because credit quality remains quite strong and charge-offs have been minimal, it seems logical to infer that most repositioning charges will relate to investment securities and funding mixes.

As year-end 2018 nears, Ambassador Financial believes bankers will gain more visibility regarding the direction and degree of interest rate moves, however, some ambiguity always persists given the vast number of independent and uncontrolled variables. **This market uncertainty dovetails with our conservative approach regarding the role of investment securities, which is to help manage interest rate risk and support liquidity, with profitability as a lesser consideration.** This strategy has historically served both regulators and investors well, but tactics can be modified in the current operating environment. We doubt that banks with outsized investment portfolios will be accorded a higher trading multiple, but tangible capital (particularly retained earnings) matters and asset/liability officers should review portfolios to eke out more earnings without exposing the bank to undue credit or interest rate risk.

The graphs in Figures 1 and Figure 2 on the following page compare the yield curves from October 31, 2003 through 2006 (four years) with the current interest rate environment. Although the absolute level of interest rates are higher today, the changing slopes of the yield curves over the different time periods are eerily similar. The rising short-term rates that began in 2003 culminated with an inverted curve in 2006, which not so coincidentally proceeded the Great Recession. Although history does not repeat itself, sometimes the best strategy is to prepare for the worst, but hope for the best. (Particular attention should be focused on the green and purple lines within both graphs as the slopes look identical. It points to where we are going next year – the blue line.)

Figure 1 – A picture is worth a thousand words

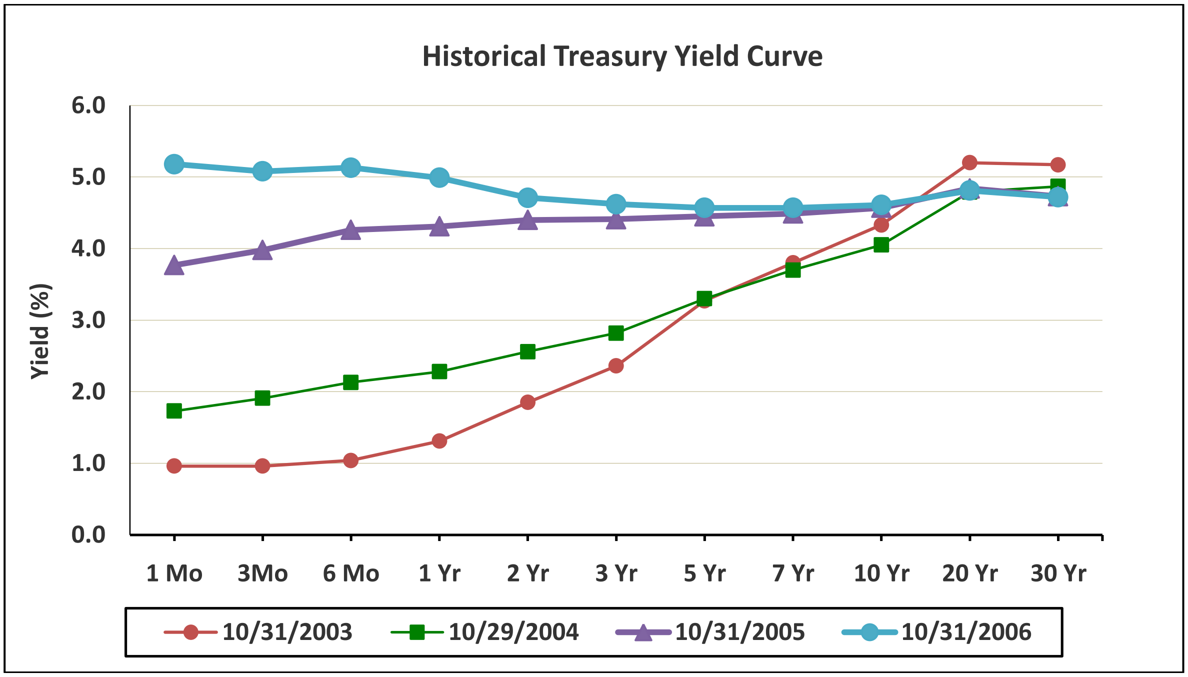
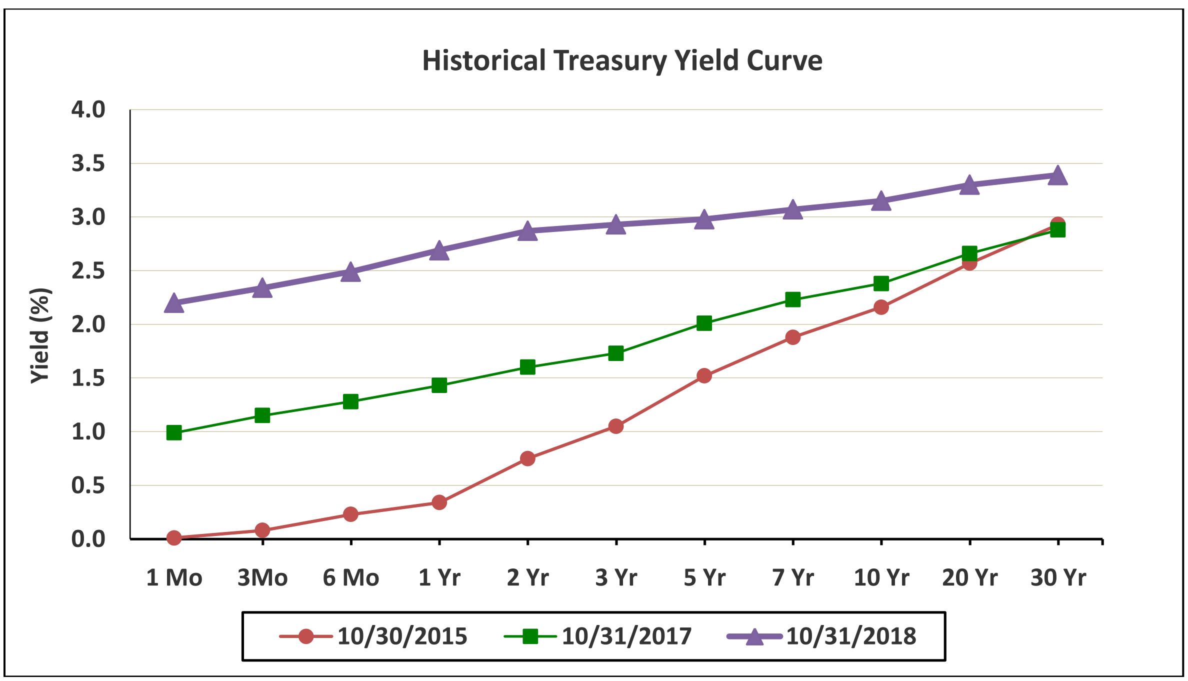


Figure 2 – Will next year's yield curve resemble that of 2006?



Source: S&P Global Market Intelligence

Rising short-term rates provide openings for many community banks to put excess liquidity to work through the investment securities portfolio rather than through marginal loans. Banks need to consider whether originating loans with a 100% risk weighting makes sense when funded with higher cost, non-core, funding. The alternative to deploy funds into assets with a 20% risk weighting should be given more consideration in the late stages of a credit cycle. Loan growth was fairly modest for mid-Atlantic banks for the quarter ending September 30, 2018, as the median loan growth rates were 8.0% on a year-over-year basis but only 0.8% (not annualized) on a sequential quarter basis.

(Cont'd)

Core deposits, which we define as all deposits other than certificates of deposit and other time deposits, are especially prized in a rising rate environment due to their greater stability and relatively lower cost of funds. Core deposits also imply customer relationships that can be used to cross-sell other products and services and reduce interest rate risk. As part of a comprehensive asset/liability strategy, financial officers need to determine the expected run-off, or decay, rate of deposit products that lack a defined maturity date; the costs associated with gathering and maintaining core deposits (i.e., branch network, advertising); and how profitably and quickly these funds can be deployed into interest-earning assets. Obtaining core deposits through a merger may be preferable versus organic growth, but potential buyers must consider the possibility of unintentional deposit run-off from acquired institutions.

As the cost of deposits rise, more banks will have to depend on time and brokered deposits along with borrowings to fund interest-earning asset growth. To a certain extent and depending upon the specific institution, the bank has better optionality on the liability side of the balance sheet versus the asset side. Ambassador Financial suggests bankers need to develop tailored strategies rather than rely on "off the rack" asset/liability models.

That said and, without getting too specific, Ambassador Financial generally recommends the sale of securities out of an overvalued sector and reinvestment into an undervalued sector. Short-term, well-rated tax-exempt, bank qualified municipals trade with tax-equivalent yields at or below the yields on comparable maturity Treasuries. This can be attributed to both the decrease in corporate tax rates, which effectively lowered tax-equivalent yields, and relatively strong retail demand for short municipals. Given this phenomenon, we analyze strategies that center around selling municipals with one-four 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.

Outside of portfolio restructuring, clients looking to put excess liquidity to work have been able to find opportunities. 15 and 20 year mortgage-backed securities ("MBS") pass-throughs with coupons from 4% to 4.50% offer attractive yields ranging from 3.60% to 3.75% with reasonable duration profiles. In addition, the monthly cash-flow can be used to fund future loan growth or reinvested into higher-yielding securities if rates move higher from here. Floating rate securities continue to be popular as either part of a barbell repositioning or as standalone purchase. The coupon on these securities should reprice higher as the Fed continues down the path of normalizing rates. With the 10-year Treasury note moving higher, taxable municipals in the 10-15 year part of the curve offer yields nearing 4%. In addition to offering an attractive yield, these longer duration securities could outperform as we near the end of the current economic cycle. **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 which provides significant price appreciation potential.