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Notes from the Ambassador Bank Vault **December 14, 2018**

Small and Mid Cap Banks and Thrifts
Asset/Liability Strategy: Still Time to Position for 2019

SUMMARY:

"It's no exaggeration to say that the undecideds could go one way or another." George H.W. Bush. **Opportunities exist to sell securities and use the proceeds to reposition the portfolio more profitably.** Fourth quarter 2018 results, therefore, should include more one-time charges as attention turns to 2019 earnings prospects. Banks typically 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 strong and charge-offs have been minimal, it seems logical to infer that most repositioning charges will relate to investment securities and funding mixes. Not all banks will be able to meet core funding needs organically, and therefore, the quest for core deposits should be an important merger and acquisition driver for the foreseeable future.

HIGHLIGHTS:

- You wouldn't know it by judging the equity markets, but fourth quarter bank earnings should generally be okay and meet most expectations. We believe investors have already looked past 2018, and are focused on potentially slower earnings growth in 2019 due in large part to the flat yield curve and margin pressure.

- As we go to press, the spread between 2 and 5-year Treasury notes inverted to <u>negative</u> three basis points from 11 basis points a month ago, 34 basis points a year ago, and 70 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 that although there is somewhat more visibility regarding the direction and degree of interest rate moves, bankers should favor prudent investment policies given that the economy appears to be at an inflection point regarding future growth rates.

- Many banks will 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. A recent example is Investors Bancorp (NASDAQ: ISBC), which announced a securities portfolio restructuring on December 11, 2018.

- 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.

- Ambassador continues to recommend A/L managers to opportunistically deploy excess liquidity and selectively add duration, which makes sense at this point in the economic cycle.

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INVESTMENT THESIS

As year-end 2018 nears, Ambassador Financial believes bankers gained a bit 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 enhance profitability while effectively managing interest rate risk and liquidity considerations.** 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 in search of opportunities to eke out more earnings without exposing the bank to undue credit risk.

The Fed's interest rate hikes and mixed signals regarding additional rate hikes challenges bankers to implement strategies to overcome rising funding costs. The implied probability of a rate hike at next Wednesday's Federal Open Market Committee (FOMC) meeting has fallen to 72.4%. We still believe the Fed will raise at the December meeting while offering a dovish policy statement to ease market tension. The policy statements have already begun to evolve. At the beginning of October, Chairman Powell stated rates are "a long way from neutral" while at the end of November he said rates are "just below neutral". If there is a 25 basis point increase in Fed Funds next week, it is possible the Fed says rates are "at neutral".

Arguments for the yield curve staying relatively flat include the growing view that economic growth will slow. If the economy falters, the longer end of the curve has little cause to rise, particularly if inflation remains tame. On the flip side, if the Fed perceives strong economic growth will continue, there is a greater probability for further rate hikes, which will cause the shorter-term rates to rise all other things being equal.

The wildcard is the Fed's shrinking balance sheet – another form of tightening – has not yet occurred in U.S. history, and therefore, it seems nearly 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. After 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 home buyers to finance mortgages. The Fed is expected to allow approximately $400 billion and $600 billion to "roll off" in 2018 and 2019, respectively. At $4.5 trillion, the Fed's balance sheet was about 25% the size of the U.S. annual gross domestic product and equal to about 18% of the government debt held by the public.

The graphs in Figures 1 and Figure 2 on the following page compare the yield curves from November 30, 2003 through 2006 (four years) with the current interest rate environment. Although the absolute level of interest rates is lower 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 always 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

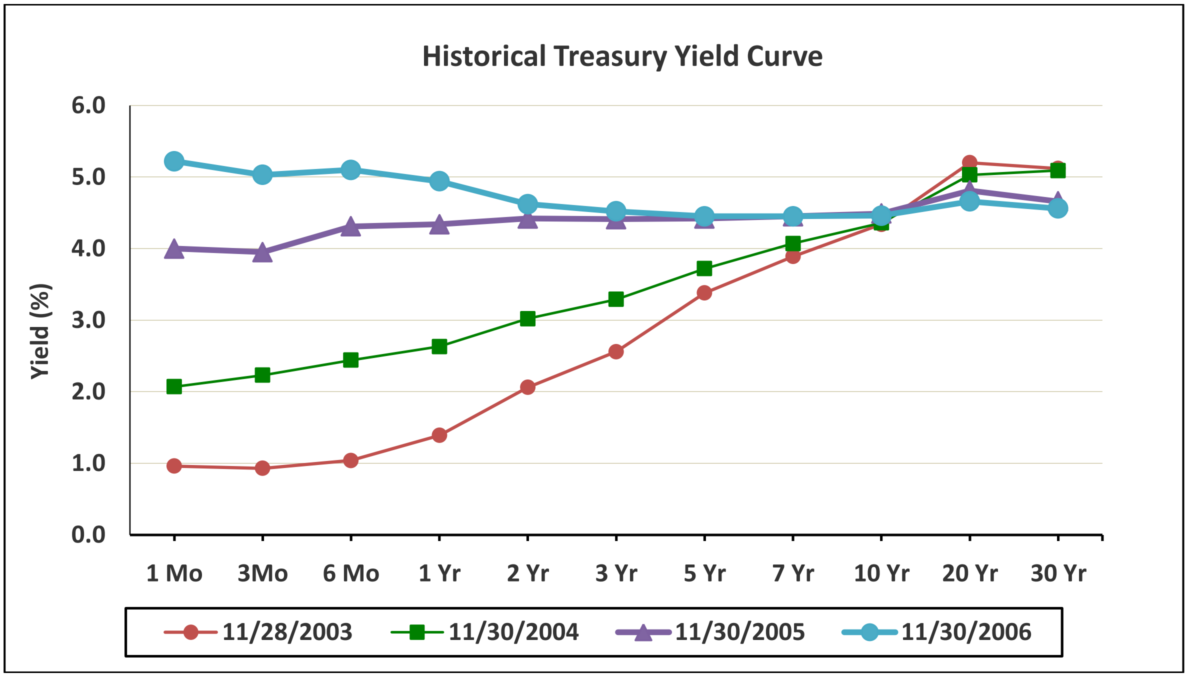
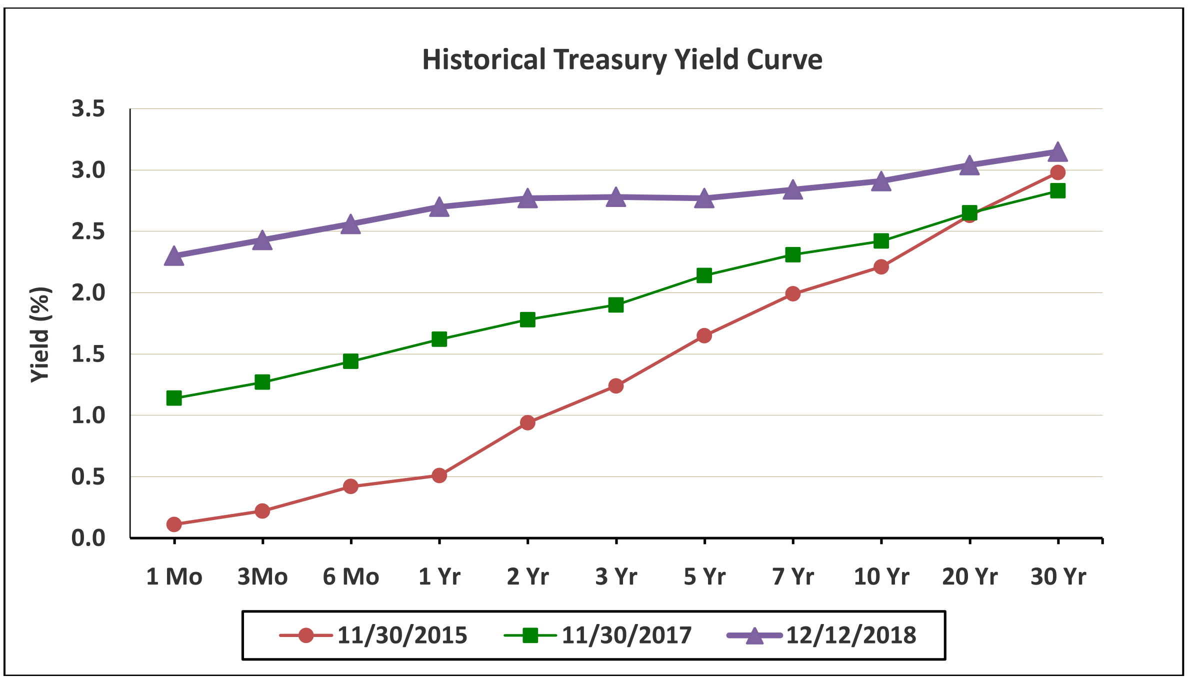


Figure 2 – Will next year's yield curve resemble that of 2006?



Source: S&P Global Market Intelligence

Rising 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.

Given the economic warning signs that are beginning to flash, we have been recommending adding duration and convexity. This has produced excellent returns over the past month as the 10-year Treasury yield dropped by almost 35 basis points. For the technical analysts, the 10-year has now dropped below the 200 day moving average which could signal a further move lower in yields. A similar move has occurred in the 2-year where rates dropped 20 basis points over the past few weeks. This move lower has come at an opportune time as it creates greater flexibility for clients to rebalance the portfolio before yearend.

With the Treasury curve inverted on the short end and flat on the long end, we focus on strategies that increase interest income while maintaining or reducing credit risk. The most popular strategy involves selling baskets of securities that offer little spread to Treasuries (such as short tax-exempt munis) and rotating into more attractive sectors. Typically munis offer a cyclical buying opportunity as spreads widen towards yearend on increased supply and then tighten in the new year as supply is constrained for the first few weeks. We are beginning to see this play out, especially on the taxable muni front. Taxable muni spreads have widened significantly over the past couple weeks, moving spreads on the 10-year part of the curve from around +100 to around +130 basis points. **Due to the lower federal tax rate and thus lower taxable equivalent yields, swapping out of tax-exempts into taxable munis is an attractive trade given the current market dynamics.**

Many banks are using the majority of their liquidity to fund loans and those that are adding to the investment portfolio have largely remained short on the curve. Staying short has been challenging as the Fed has applied upward pressure to yields on the short end. Something that is often overlooked is the reliance on gains in the investment portfolio to assist during challenging economic times. Our clients frequently used their investment portfolio to harvest gains to offset loan losses and allow for portfolio repositioning during the last market downturn. The propensity for clients to invest short, coupled with investment portfolios rolling down the curve the last few years, could limit the amount of outsized gains available during the next recession. This will alter the amount of flexibility management teams have to use the investment portfolio as a necessary life boat during challenging market conditions.

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. For these reasons, we continue to recommend adding duration when Treasury sell-offs provide attractive entry points. It is important to purchase longer duration issues with positive convexity. We recommend buying bullets or issues where the optionality is far out of the money, such as discounted callable agencies, or munis with lengthy call protection. If rates do move lower, these types of structures will offer the greatest opportunity for price appreciation.

A recent example of a balance sheet restructuring tied to the securities portfolio was announced by Investors Bancorp on December 11, 2018. Investors, a $25.5 billion company based in New Jersey, sold approximately $665 million of lower-yielding mortgage-backed debt securities at an estimated loss of $25 million, or $0.09 per share (after-tax), to be recognized in the fourth quarter of 2018. The proceeds were reinvested in debt securities with an average yield of about 160 basis points higher than the securities that were sold. Investors estimated that the restructuring will result in annual earnings accretion of about $0.03 per share. Because the securities sold were classified as available for sale (AFS), the losses were previously recognized in capital through accumulated other comprehensive loss (AOCI) and is expected to have a minimal impact on tangible book value. Investors's stock price had little reaction immediately following the restructuring announcement: the stock was up slightly on December 12.