AMBASSADOR FINANCIAL GROUP

Asset Liability Management: Flexibility and Defense Are the Keys to 2019

"Cheers to a New Year and a chance to get it right." – Oprah Winfrey

The combination of Fed tightening along with a decline in longer-term interest rates over the past three months has flattened the yield curve and complicated community bankers' investment strategies. Concerns that economic growth is slowing has generated more conviction that the Fed will not raise interest rates in 2019 as Fed funds futures recently indicated a 91% chance that central bankers will finish 2019 with interest rates at or below their current level. At the last Fed meeting on December 19, 2018, interest rates were raised 25 basis points to range between 2.25-2.50% with two more rate hikes projected in 2019.

Sensible action can be taken to offset some of the net interest margin pressure that will likely occur if the yield curve stays flat or inverts for a lengthy period. **As discussed below, Ambassador Financial continues to recommend prudent approaches regarding the role of investment securities, which is to enhance profitability while effectively managing interest rate risk and liquidity considerations.** These tailored strategies have historically satisfied both investors and regulators, but tactics should be modified given the unique characteristics of today's interest rate environment. Banks with outsized investment portfolios are not typically accorded higher trading multiples, but tangible capital (particularly retained earnings) matters and asset/liability officers should review portfolios for opportunities to eke out more earnings without exposing the bank to undue credit or interest rate risk.

- The yield curve is flat. As of January 3, 2019, the spread between 2-year and 10-year Treasury notes was only 16 basis points, compared with 51 basis points a year ago and 133 basis points two years ago. (The last time the yield curve inverted was in June 2007.) Please see Figures 1 and 2.

- One size does not fit all. 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.

- Optimize the risk/reward ratio. Most banks have a securities portfolio with a duration of 3-5 years. Depending upon an individual bank's financial condition and risk tolerance, today's interest rate conditions may merit consideration of a slightly more aggressive strategy that selectively layers in some assets with durations of 5-7 plus years. We believe this approach comfortably fits within acceptable risk/reward ratios of both investors and regulators.

- An opportunity to selectively sell municipal bonds at attractive prices. This seasonal strategy arises because the new issue, tax-exempt municipal bond supply is typically light from New Year's Day through mid-February. Demand, however, is generally quite strong despite the light supply as buyers (high net-worth individuals, mutual funds, hedge funds, etc.) actively need to buy bonds. Consequently, secondary muni prices tend to move higher on this seasonal supply/demand dynamic that is unique in January.

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Unless your bank enjoys strong loan demand and investment securities are used primarily to provide liquidity, investing strictly at the short end of the curve is probably too conservative given shareholder demands for a higher return on equity. **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.

The flatter yield curve should encourage bankers to analyze investment portfolios and consider repositioning through the sale of lower-yielding securities. The decline in longer term rates over the past three months may allow repositioning opportunities, but securities purchased prior to 2018 generally yield less than comparable securities do today. (The yield on a 10-year Treasury note was 3.24% on November 8, 2018, compared with 2.66% on January 2, 2019, and 2.45% on January 3, 2017.) Balance sheet restructuring is not for everybody, but Ambassador recommends this approach on a company-specific basis. **Banks that are willing and able to absorb an immediate loss can deliver higher future earnings (assuming all other things equal), as those proceeds are reinvested at higher yields, thus improving net interest margins.** This strategy need not increase interest rate risk, as proceeds can be reinvested in securities with similar durations. Corporate treasurers, moreover, may elect to buy shorter-duration securities to reduce extension risk and/or pay down higher costing borrowings, depending upon individual circumstances.

Banks with strong capital levels and investment portfolios that are accounted for as AFS securities are the prime candidates to reposition. Under generally accepted accounting principles (GAAP), net unrealized gains or losses are excluded from earnings, but rather are reported in other comprehensive income until they are realized. Unrealized losses are not included in regulatory capital, although they reduce book value and GAAP capital levels if accounted for as AFS.

The graphs in Figure 1 and Figure 2 below compare the yield curves from December 31, 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. (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.)

When the curve flattened in 2005 and then inverted by mid-2006, net interest margins compressed and eventually credit soured from pristine levels as banks tried to boost earnings through higher-yielding, but dicey loans and investment securities. Although credit quality generally remained steadfast through 2018, future losses and problem loans might increase significantly in the next credit cycle. **History may not repeat itself but merger and acquisition activity picked up considerably when the yield curve inverted in 2005-2006.**

Figure 1 – A picture is worth a thousand words

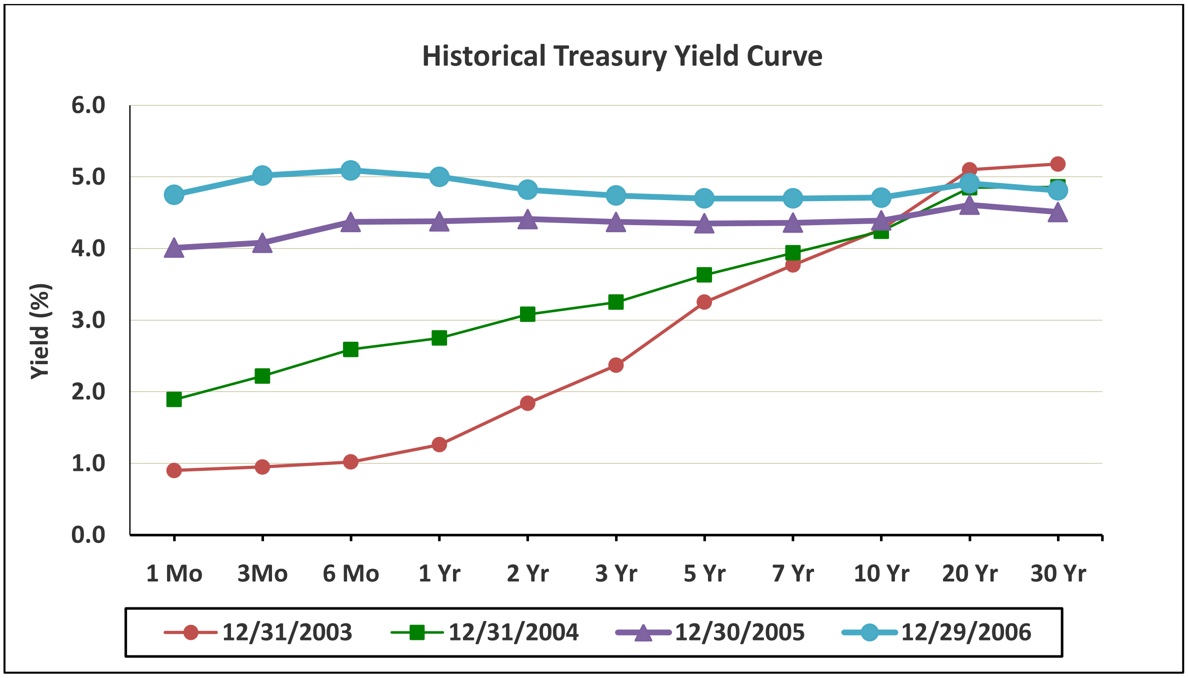
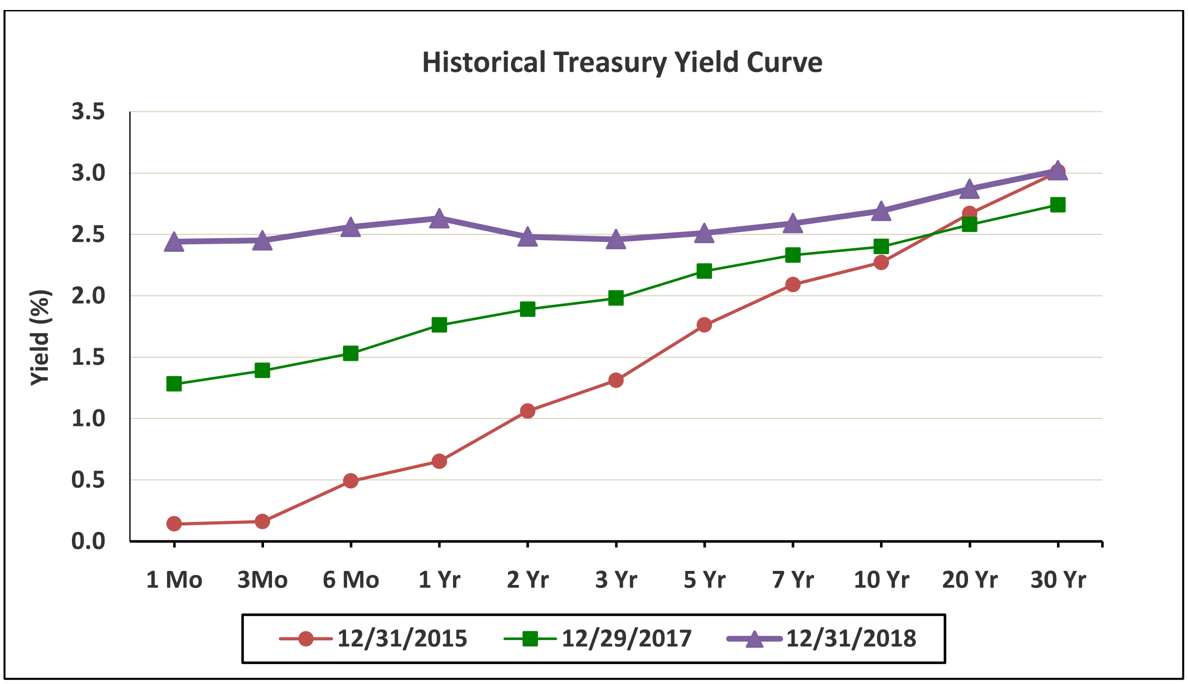


Figure 2 – Will next year's yield curve resemble that of 2006?



Source: S&P Global Market Intelligence