The long and grinding road

Interest rates are slowly working their way higher.

To many bond market analysts, the snapshot of interest rates in mid-2018 displays many of the characteristics of a mature rising-interest-rate cycle. The most obvious feature is the flattening of the yield curve, which is of no surprise to anyone. The table, opposite, recaps recent changes.

Depending on whom you ask, we could see some continued flattening as the Federal Reserve executes its monetary game plan, including the wind-down of its still-swollen balance sheet. This is especially true if inflation bugs don’t swarm the country this summer.

Impact on your bonds
We will now get to the portion of this column that contains some insight. The table is notable mainly for the period of time it’s taken for the curve to flatten. The first interest-rate hike in the current phase was way back in December 2015, which means as of this writing, this cycle is over two-and-a-half years old. That is more than the entirety of the last rate-hike cycle, which lasted from June 2004 to June 2006, and contained 17 consecutive 25 basis point (0.25 percent) rate bumps. At the moment, we’re sitting at seven rate hikes.

There are two dynamics in play here that were not the case in 2006, and both of them are presenting challenges to community bank performance. The first is that yields haven’t (yet) risen enough for portfolios to show much improvement in income, and the second is that tax reform has had some consequences.

Different this time around
If you’re a veteran portfolio manager, you’ll remember that your collection of bonds was worth about 3 percent less than you paid for them in June 2006. That was near the peak of interest rates, and as mentioned, it didn’t take very long to get there.

Today, investment portfolios are more than 2 percent under water, and there’s more where that came from on the way. True adjustable-rate securities, such as collateralized mortgage obligation (CMO) floaters and Small Business Administration (SBA) pools, have generally held their market values, as would be expected, but yields aren’t yet at absolute levels that have helped overall earnings.

More significantly, as corporate tax rates have substantially dropped this year, municipal bond market values and tax-equivalent yields have both declined. Retail investors, who make up about two-thirds of the total muni market, have continued to support the short end of the muni curves. The traditional domain of institutional buyers, which

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is farther out on the maturity scale, has lost some ground as the market adjusts to produce tax-equivalent spreads in parity with 2017.

**Managing through the cycle**
So, how does a portfolio manager take advantage? I have two “actionable” suggestions. First, remember that a portfolio being under water is proof that higher market yields are available. A bank can sell bonds at a loss, reinvest into higher-yielding instruments and begin to make back the loss immediately. The strategy of a “tax swap,” which entails the sale of tax-frees at a loss, isn’t the panacea it once was, but it still has advantages over the sale of taxables at a loss.

Finally, with loan demand high and reinvestment rates likely to improve over the remainder of 2018, you may want to add some bonds that are nearly certain to provide cash flow. These can include high-coupon seasoned mortgage-backed securities (MBSs) or short reset adjustable-rate mortgages (ARMs). As we cover some more distance on the road to higher rates, active management can keep your portfolio out of the ditch.

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Source: Bloomberg