The Earth is flat
Or, how to manage in a flat yield curve.

By Jim Reber

From a community banking performance standpoint, 2018 is beginning to resemble 2007 in some facets, but not all. Eleven years ago, the industry was posting record earnings. Loan demand was high, loan-to-deposit ratios were increasing and liquidity was hard to come by. That sounds like today’s conditions.

Happily, loan quality continues to improve. The most recent Quarterly Banking Profile from the FDIC shows that total noncurrents were only 0.88 percent of loans, which is the lowest, ironically, since June 2007. We all hope that, unlike last time, the credit quality factors keep trending in the right direction.

A noticeable departure from 2007, however, is the interest rate landscape. Attendant to an improving economy is a monetary policy engineered by the Federal Open Market Committee, which is attempting to remain compliant with its dual mandate of stable prices and maximum employment. At the moment, that means increasing the fed funds rate.

Two years later
By historical standards, this tightening phase has proceeded at a glacier’s pace. We’re now more than two years into these gradual hikes, and fed funds is up only 125 basis points (1.25 percent). However, that, plus the beginning of the big wind-down of the Fed’s balance sheet (which began last October), has caused short-term rates to reach levels not seen in a decade.

Predictably, longer rates have not followed suit. Investors further out on the curve, which usually means five years and further, are not so much bothered by what the Fed is doing as much as they are by where they expect inflation to run over the course of their positions. There are a variety of barometers that keep projecting the Fed’s preferred inflation index to attain, but not exceed, the target of 2.0 percent even into the next decade.

How yields have changed
Between December 2014 and December 2017, the one-year and two-year Treasuries increased in yield by 140 and 120 basis points, respectively. Recall that fed funds rose by 125 basis points in that same period. So, short maturities out to the two-year sector really had a parallel shift. Longer maturities, as mentioned, have lived a separate existence. Five- and 10-year Treasuries are up in yield only 56
Nuts & Bolts

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Common strategies
Here are a couple of ideas for community bankers to employ. Each of them has at its genesis the expectation of slow, steady rate increases that most forecasters are, you know, forecasting. The benchmark money-market alternative is a CMO floater; these are priced very near 100.00, and they float each month based on LIBOR. Today, they yield about 1.75 percent; if the Fed raises rates three times this year, as it’s suggesting, the end-of-year yield would be about 2.50 percent. That is roughly what a seven-year callable agency yields now.

Two other related ideas: First, use interest rate swaps to shorten assets. The initial hit is less now than ever, thanks to the flattened curve. You can turn a 10-year amortizing loan into a 30-day adjustable and see your initial yield decline by only about 80 basis points (for the moment). You also get less price volatility and the ability to finance it with short money.

Speaking of money—in other words, deposits—it may be a good time to extend. Speak to your asset/liability consultant and your favorite brokers about your options there. Many community banks have positioned themselves via wholesale deposits and interest rate products for what could be a robust banking year. Let’s hope 2018 sees a repeat of the positives of 2007 (loan growth, earnings) without the consequences of 2007 (credit deterioration, capital issues). The Flat Earth Society’s annual meeting is now in session.

and 20 basis points in the three-year stretch. Do the math, and the “2-to-10” curve has flattened by a full 1 percent since 2014.

Here are the outcomes for this look-back (some of them are counterintuitive): Many short-duration investments actually lost market value in 2017, whereas the longest investments held their value.

Lenders/buyers are not being rewarded as much today to extend.

Extending the maturities on deposits may be a wise play in 2018.

Yields on loans and investments have risen much more sharply than costs on deposits, hence improved net interest margins.

1.78%
Average slope of the U.S. Treasury curve from two years to 10 years in the last decade. As of Dec. 31, 2017, the slope was down to 0.58 percent.

Source: Bloomberg

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