This is Jim Reber speaking.

“Hi Jim, this is Charlie Brown with Community Trust Bank calling again. How are you?”

“Hi Charlie, I’m fine! And I think it’s been a year since we last spoke. More importantly, how are you and the bank?”

“Well, as you can imagine, we’ve had some disruption, shall we say, to our business model. But in true community bank style, we’ve learned to adapt. And all things considered, we’re doing well.”

“It seems to me that banks have been through at least four phases this year. January and February were business as usual, and all the arrows were pointing upward. Then the pandemic took root and the Fed got busy cutting rates. Then the Paycheck Protection Program was rolled out, and banks understandably were consumed with trying to save the small businesses in their community. Now, bankers are getting back into their balance sheets to see where they stand.”

“That is precisely why I’m calling today. I...
had lost track of how low yields had gotten on the things we typically buy. And we’ve had more uninvested cash than we like and that’s yielding us not much above zero. What are you telling the Vining Sparks customers?”

“I believe we’ve come to the realization that interest rates aren’t going up much anytime soon. The Fed told us in its latest projections it expects overnight rates to be unchanged through 2022. So, the waiting game isn’t on your side.”

“Last time we talked, you suggested banks’ asset/liability positions were built for rising rates. That seems to be the case with us. And since local loan demand is going to be hard to grow anytime soon, how are we going to maintain our net interest margins?”

“To be succinct, you’re not. 2020 will not be a year of record earnings for the banking industry. And if you think about it, there are several other headwinds that are probably going to keep a cap on interest rates. Namely, the Fed doesn’t look like it’s going to be taking its foot off the gas pedal with its open market operations. And we haven’t even mentioned the inflation outlook yet.”

“I came to you for advice, but I haven’t heard any yet.”

“Here’s what we’re suggesting. First, stay invested. A very simple, boring bond that yields 60 basis points (0.60%) is going to beat Fed Funds by half a percentage point. When you drill down to what’s really available, a bond that yields even 1% is going to have some kind of uncertainty—either call risk, price risk or even credit risk. That’s how it’s going to be for a while.”

“Am I supposed to like this?”

“Let me try to spin it this way: If you buy these crummy yields, and interest rates start to rise, sure you’ll have some unrealized losses. But the big picture will get better, since that’ll mean your overall margins will improve. And to be sure, banks at the moment can stand to work on their bond portfolios’ durations, which are much shorter than they were intended to be.”

“OK, give me some thoughts on what you bond people refer to as ‘relative value’. What has a decent risk/reward profile in this environment?”

“Many indicators point to the municipal bond market. For six straight weeks back in March and April, retail investors, who own two-thirds of the overall market, were big net sellers. That pushed all muni yields higher, even on high-quality issues that banks usually own. That sector’s yield has dropped throughout the summer, but the spreads are still far wider than earlier in the year.”

2020 will not be a year of record earnings for the banking industry.

“I realize that’s a sector where I can build back my duration to where I want it to be. But I keep hearing that the other shoe is going to drop on state and local governments. How is a community bank supposed to get comfortable with that?”

“There are several ways to do that, Charlie. First and foremost, keep doing your pre- and post-purchase due diligence. We can certainly help you with that. Strategically, the local issuers, like school districts, townships and local utilities, generally have a more consistent revenue stream than state governments, which usually rely more on sales taxes. And, of course, pay close attention to any credit enhancement features that may be present.”

“Never would have thought I’d be talking to you in a rate environment like this. Thanks for your time.”

“Charlie, your brokers never run out of things to suggest. Glad to help. And keep your eyes on your portfolio’s duration.”

You can read previous years’ Shop Talks at independentbanker.org

Education on Tap

2020 webinar series resumes

ICBA Securities and Vining Sparks will present the next segment of their 2020 webinar series Community Banking Matters on Sept. 15 at 10 a.m. CDT. Justin Sparks and Dennis Porcaro will present Municipal Market Update: Investment Strategies and Credit. Free CPE is available. Visit viningsparks.com to register.

Virtual speaking schedule

Most of the 2020 ICBA state affiliate live events have been cancelled or postponed, but a number of them have been converted to virtual events and include ICBA Securities speakers. To view a current calendar, visit icbasecurities.com/events