Many community bankers are sitting on the sidelines with significant liquidity waiting for rates to become more attractive.” This is a direct quote from this column in Independent Banker’s March 2003 issue.

A year later many bankers are still on the sidelines with significant liquidity earning overnight rates of 1 percent or less. And, as this month’s column is written in February 2004, rates are still down, and the Federal Reserve states that “it can be patient in removing its policy accommodation.” How long will the Fed “be patient”? What investments might make sense until rates do rise? Easy questions, only the answers are difficult. However, let’s address one way to evaluate overnight rates versus investment alternatives.

Three-Year Rate Projections

History says that rates can rise rapidly. Federal fund rates rose 300 basis points, 300 basis points and 200 basis points in 12 months in 1989, 1994 and 1999, respectively. So it could certainly happen again—possibly in 2004 or 2005.

Assume a worst case of Fed fund rates rising by 300 basis points in 12 months starting next quarter, or the next quarter, or the quarter after that. If investments were made today, how long would Fed fund rates have to remain at today’s low levels before the alternative investments make sense?

Consider the alternatives—investing in Fed funds over the next three years or investing in higher yielding, longer term securities. The average Fed funds rate increases over the next three years from now is dependent on when Fed fund rates begin their 300 basis point increase:

For example, the average increase in Fed fund rates will be 1.88 percent over the next three years from now, if Fed fund rates move up 300 basis points starting four quarters from now.

Table A on page 104 and Graph I on page 105 show the average increase in Fed funds, over the next three years from now, based on when rates rise. Points A, B and C show that the average increase in Fed fund earnings will be 2.63 percent, 1.88 percent and 0.88 percent, respectively if Fed fund rates move up by 300 basis points in 12 months starting in quarters one, four or eight.

Graph I also compares the average increase in Fed fund earnings with earnings from three alternative investments. The first alternative yields 1 percent more than the initial Fed funds rate. Therefore, the average increase for this investment over the initial Fed funds rate will remain constant at 1 percent for the entire three-year period. This means that Fed funds will have to remain at today’s low rate for at least eight quarters for the 1 percent alternative to earn more than Fed funds over the three-year period.

<table>
<thead>
<tr>
<th>Quarter in Which Fed Fund Rates Start Up</th>
<th>Average Fed Funds Earnings Increase Over 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.63%</td>
</tr>
<tr>
<td>4</td>
<td>1.88%</td>
</tr>
<tr>
<td>8</td>
<td>0.88%</td>
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</tbody>
</table>
However, if an alternative can be found that yields 2 percent more than the initial Fed funds rate, the alternative will earn more over the three-year period if Fed funds stay at today’s rate for at least four quarters. And, if an alternative can be found that yields 3 percent more than the initial Fed funds rate, the alternative will always earn more, even if Fed fund rates start up immediately.

Consider Cash Flows
Principal cash flows (amortization plus prepayments) change the results. Cash flows can be used to reinvest as rates rise and, therefore, can increase average earnings even faster over the three-year time frame as shown below. (Assume that rates on the alternative investments rise 66.7 basis points for every 100 basis point rise in Fed fund rates and that all rates start up in the first quarter.)

Graph II on this page uses this information to compare Fed funds with alternative investments with cash flows of 10 percent per year. Alternatives with an initial advantage of 1 percent over Fed funds earn more only if Fed funds remain low for at least six quarters (Point D). However, any alternative with an initial advantage of at least 2 percent will out earn Fed funds regardless of when rates start up.

In other words, if rates remain at today’s level for at least two quarters, an investment that yields 2 percent more than Fed funds at today’s rates, and which will have annual cash flows of at least 5 percent will out earn Fed funds over the three-year period.

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