Inflation
Where Is Thy Sting?

Review your bond portfolio to inoculate against possible interest rate hikes

We keep hearing ominous predictions about the oncoming freight train known as inflation. To be sure, Economics 101 taught that the cause of inflation is too much money chasing too few goods. The huge expansion of outstanding government debt over the last year has most assuredly increased the supply of money. In the week that ended June 22, the Treasury auctioned a mind-boggling $104 billion of notes.

The Treasury has reported that its outstanding debt has ballooned from $9.4 trillion in April 2008 to nearly $11.3 trillion in April of this year, an increase of more than 20 percent. Moreover, most elements of the “spendulus” bill, the American Recovery and Reinvestment Act that became law in February, have not yet been spent and won’t in many cases for some years to come. It’s a fair bet that at some point general prices will begin to rise. Just not yet.

Favorite Gauge
You will recall that Federal Reserve Chairman Ben Bernanke’s preferred measuring stick for inflation is the Personal Consumption Expenditures (PCE) core index, which many economists feel is the most responsive to actual changes in buying habits of U.S. consumers. The Federal Open Market Committee, which sets short-term interest rates, has been so kind as to tell us the level of year-over-year PCE changes that it prefers. That range is between 1 and 2 percent.

If the number is running within the Fed’s comfort zone, market participants often assume that short-term interest rates, specifically fed funds, may be stable in the near term. In the last 12 months, the year-over-year number has indeed behaved well and has fallen to under 2 percent. From this set of facts we can analyze bond market sentiment and behavior.

Link to Yields
The short end of the maturity spectrum (say, three years and less) usually takes its cue from fed funds. That is to say, there is decent correlation between their yields. This includes not just Treasuries but most investment sectors such as agency notes, short mortgage-backed securities, corporates and even tax-free munis.

The long end (say, those beyond seven years) has a mind of its own. Longer-term investors demand returns based on expected inflation, and low short-term rates can be a catalyst for economic expansion and therefore increased prices. Add a generous dollop of fiscal stimulus, and one can see why the 10-year Treasury note jumped from a yield of 2.21 percent at the start of the year to over 3.9 percent at the beginning of June—this during a period of shrinking inflation.

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Defensive Strategies
Which brings us to the advice portion of my column. It may be time to dust off the list of bonds that perform well in a rising rate environment. Part and parcel of this mind-set is determining whether an institution is actually exposed to rising rates. Many community banks are not; their asset sensitivity will allow for increased margins as fed funds (and therefore prime) begins to rise.

Still, here is a sampler:
- adjustable-rate MBSs (especially those with near-term resets)
- Small Business Administration loan pools
- Collateralized Mortgage Obligation floaters
- premium callables (a.k.a. “cushion bonds”) and
- short final bullets (which do particularly well in steep yield curves).

Again, “short” is a fluid term. For corporates or agencies, that typically is three years and under. For tax-free munis, the horizon is longer—probably seven to 10 years.

Keep in mind also that, if the portfolio manager or ALCO is trying to plug a gap in an asset/liability hole, there can be other fixes. In particular, entering into an interest rate swap of the “pay fixed, receive floating” variety can achieve that goal in a hurry. These swaps can be built around a loan, a loan sector or deposit sector and packaged in block sizes that fit most community banks.

All of which presupposes the return of inflation, at least above the FOMC’s preferred range. It’s clear that inflation, like unemployment, is cyclical, and the seeds have been planted for some pretty stout price increases sometime soon. The market, especially beyond five years, can move faster than an individual bank can react. So perhaps it’s time to take a good look at your bank’s interest rate exposure and be prepared for the sting of inflation.

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