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Easing into the fall

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At long last, some rate relief

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By Jim Reber, ICBA Securities

I don’t know about you, but I’ve always looked forward to the early days of autumn. I’m of a certain vintage that remembers when September and October ushered in a break from summer heat (which seems to be later in the calendar these days), and there was a certain excitement around back-to-school activities. Football fans eagerly await gridiron season which is now in full swing, and baseball playoffs make their return.

And now, there’s this year’s long-anticipated win: rate cuts by the Fed! It’s been a while, but the tightening cycle that started in early 2022 has finally run its course. It appears the price stability mandate has been met sufficiently for the focus to turn to maximum employment. The rate cut in September marks the first time in four and a half years that the target rate of fed funds has dropped. This welcomes even more anticipation for an exciting fall.

Is your bank ready?

But maybe we’re getting ahead of ourselves—let’s first take stock of where most depositories stand as the fourth quarter of 2024 begins. Earnings will not be a record for the community banking industry this year, as margin pressure has taken the froth off bottom lines. Some positives are that credit quality remains outstanding despite some headline warnings. A lot of the consumer/auto/credit card delinquencies—which are on the rise—seem more to be problems for non-banks. The fear of commercial real estate’s market breakdown hasn’t happened yet either.

Another piece of the earnings puzzle is interest rate risk. Community bankers have told me on many occasions since 2022 that they’ve had to get current, and informed, and creative about managing their liabilities, which they admit had been on autopilot for years. Suddenly, at the same time the Fed was hiking at its fastest pace in over 40 years, depositors were demanding higher rates, or even worse, moving to non-bank alternatives. Collectively, the industry shifted from being very asset-sensitive to about neutral between 2020 and today.

What’s next?

Earnings are, well, meh, but delinquencies are still very low, and we think rate risk is under control. What to do about all this? If the bond market and the Fed are to be believed, and I’m not saying they are, we will finally see the interest rate curve assume a positive slope. And that’s when the fun should really kick in.

But—there’s always a “but” in these columns—be warned: multiple rate cuts and a normal yield curve will probably have less upside this time around for community banks, at least initially. In a “bull steepener,” which is what we’re likely to experience, short rates fall, and longer rates fall less *or* longer rates rise. Either way, since most community banks’ portfolio’s effective durations are longer than normal, the price appreciation of your current bonds may not be what you’re hoping for. (To put some numbers on it, a typical bank’s duration is now about 4.3 years, versus about 2.5 years back in 2020, according to Stifel).

Things looking up

Despite the buzzkill I just doled out, a community bank’s universe simply performs better when short rates are below long ones. Regardless of which part of the balance sheet you’re responsible for, it’s easier to price in relative risk/reward. For well over a year, the highest-yielding bank-suitable bonds have been collateralized mortgage obligation (CMO) monthly floaters. That’s fun for a while, but that’s not how financial instruments are supposed to work longer-term. Lower risk (i.e., lower duration) is supposed to produce lower yields.

I also suspect that “betas” for community bank deposits will be friendly into 2025. Interest rate models weren’t built for 2022–23, in which overnight rates spiked 5.25 basis points (5.25%) in just 16 months. The initial bulge in net interest margins (NIMs) started to shrink early in 2023, and are now about where they were before the tightening cycle began. From conversations I’ve had with community bankers, anecdotally and otherwise, cost of funds should begin to retreat. Deposit managers have demonstrated their ability to manage NIMs through plenty of rate cycles, and rate shocks, and I see no reason to doubt their capabilities now.

The big picture is the industry has held up remarkably well through a generation-high interest rate environment, that resulted from the Fed tightening activity, as well as inflation, that most of today’s community bankers have never managed through. I’m looking forward to the return of a number of fourth-quarter traditions in 2024: Sweatshirts, football, leaves, crisp air, and an interest rate environment that supports the community banking model.

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[sidebar] Balance sheet webcast in November

ICBA Securities and its exclusive broker Stifel will host their Quarterly Bank Strategy webinar on Nov. 7, at 1 p.m. Eastern. Several strategists and economists will make presentations, and up to 1.5 hours of CPE are offered. For more information and to register, contact Jim Reber or your Stifel rep.

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