Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] **Will the wave return?**

[dek] Falling rates should boost cash flows.

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Remember “the wave?” It’s that spontaneous yet somewhat choreographed activity by sports fans in stadiums to ramp up the enthusiasm level. The most succinct description I can find is from Wikipedia: “The wave … is a type of [metachronal rhythm](https://en.wikipedia.org/wiki/Metachronal_rhythm) achieved in a packed [stadium](https://en.wikipedia.org/wiki/Stadium) or other large seated venue, when successive groups of spectators briefly stand and raise their arms. Immediately upon stretching to full height, the spectator returns to the usual seated position.” So, there you go. And don’t expect to see “metachronal” in this column ever again.

Before you turn the page, I promise that the wave is relevant to community bank portfolio management.

Flash back to 2020 at the outset of the COVID-19 pandemic, when the central banks attempted to stave off the impending economic collapse. “Cut interest rates to zero and motivate the consumer to consume,” went the reasoning, “and maybe we will limp our way through until we can get back outside.”

**[subhed] Didn’t see it coming**

The result of the aggressive monetary action was, of course, a tsunami of liquidity being dumped on community banks. This was aggravated by the phenomenon known as “flight to quality” as depositors everywhere sought sanctuaries to park their savings, and there was no better place to do so than community banks. However, a lot of the cash was organically generated. Most of the bonds owned by banks have either an implicit or explicit call feature, which means borrowers (bond issuers) can pay them back early if rates fall after issuance.

Although it’s not widely remembered, at the onset of the pandemic we were still in a pretty low-rate environment. Fed funds, for example, were never higher than 2.50% in the entire previous decade and were just 1.75% at the start of 2020. The totality of the rate cuts was only 150 basis points (1.50%), so most portfolio managers could be forgiven for thinking their investments were well insulated against falling rates and the attendant call risk.

**[subhed] Across the curve**

Those assumptions might have been valid had the Fed stopped at cutting just overnight rates. It also bought a ton of bonds in the open market, primarily treasury securities and mortgage-backed securities (MBS), pushing down yields to near-record lows across the maturity spectrum. As we know, borrowers will refinance their debt when it makes economic sense to do so; in short order, the call notices started rolling in virtually each business day for several years.

For an example of the ferocity of the prepayment push, let’s look at one MBS cohort. In 2019, there was around $328 billion of 30-year FNMA 3.0% pools issued. The average borrowers’ rate (gross WAC) was 3.87%, which is a bargain in 2024. However, within a year of the 2019 issuance, mortgage rates had fallen enough for even these seemingly low-rate loans to start converting. By the time they were two years old, more than half of the entire cohort was gone.

Extrapolating that over an entire community bank bond portfolio, including its callable agency, corporate and municipal bonds, we can see why the entire collection possibly turned over several times in 2020 and 2021.

**[subhed] Here we go**

And now we begin the much-anticipated easing phase of the interest rate cycle. While the speed and extent of the rate cuts will ultimately determine how much cash flow is unleashed from your community bank’s collection of investments, there are some factors that will make 2025 and beyond different than 2020—not the least of which is that banks had more liquidity on hand five years ago, so an initial dose of calls and prepayments will be welcome to most community bank balance sheets.

Also, while today’s portfolios yield a bit more than they did five years ago, their durations are much higher (4.3 years versus 2.9). This means that the flood of cash may take longer to materialize than it did in 2020. On the plus side, since today’s portfolios are still, on balance, underwater by about 6%, there’s room for them to appreciate in value if they have any staying power.

One final thought: Through September 2024, the year-to-date volume of calls being exercised on agency bonds totaled $300 billion, compared with $330 billion through the first nine months of 2020. This speaks to the “higher-for-longer” rate cycle just concluded. It also suggests that portfolio managers should have some sandbags ready in the form of call protection to guard against any incoming waves of cash flow.

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[sidebar] Education on tap

Thanks to ICBA affiliates for your 2024 support

ICBA Securities and its exclusive broker-dealer Stifel participated in education events for 28 ICBA state affiliates this year, which is the most in our history. We are grateful for the relationships and look forward to more collaboration in 2025.

ICBA LIVE 2025

ICBA Securities and Stifel will again be active at ICBA LIVE in Nashville, Tenn., March 11-14. We will host several Learning Labs and be visible in the Expo. Several Stifel strategists will be on hand to meet with management teams and discuss balance sheet and income opportunities. To register, visit *<i>icba.org/live<i>*

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