The Meek…  
Inherit a prominent place in bond portfolios.

By Jim Reber, ICBA Securities

There are a whole lot of anomalies in community banking in the waning stages of this restrictive Fed cycle. One of the overriding themes is the sheer duration of the process. We’re now fully one year past the last tightening, which has left the effective overnight rate at 5.375% since July 2023, and giving rise to the “higher for longer” sound bite. The past six tightening cycles have averaged well under a year between last hike and first ease. We will be soon approaching another record: the longest-ever pause between last hike and first cut is 15 months, from June 2006 to September 2007.

There are myriad implications on community bank operations from this year-plus hibernation. Being a representative of the broker-dealer industry, I’d like to point out the attractive yields available in most any investment sector that banks care about. Baked into this decadent batter, however, are three obstacles for portfolio managers.

Hills to climb

The first is this persistently inverted yield curve, which is now more than two years old. This makes decision-making dicier: Extend, and forego current income for future total return benefits, or stay short and invest at today’s higher yields, and accept some reinvestment risk?

The second is the still-to-be-determined outcome of the great deposit shuffle, which really began with Silicon Valley Bank’s demise in March 2023. The disintermediation of core deposits continues. Many community banks have, for the first time ever, entered the brokered deposit market. FHLBank system advances nearly tripled between March 2022 and March 2023, from $375 million to $1.04 trillion.

The third are the hefty unrealized losses as quantified in the AOCI account at virtually all depositories. As of the end of June, those losses are still in the neighborhood of 12% of face value. This number has actually gotten a bit worse since the Fed hit the pause button, as yield spreads have remained historically wide and the effect of the inverted curve has taken root.

Simply elegant

Here’s what estimable investment managers have noticed: It can pay to rid oneself of option risk. That’s a complicated way to say that the simplest bonds may have the best relative value in mid-2024. So far this year, a large percentage of bonds purchased by community banks have been treasury and non-callable (“bullet”) agencies. This may be the first year in a generation for high performing portfolios to hold more treasuries than municipal bonds. The current appeal of treasuries and agencies is due to the nominal yields, which investors sense may be short-lived. Add to this the “lock in” benefits of a bond that cannon be redeemed early, and you’ve got a winner.

Many portfolio managers are building in some future ability to swap out of these highly liquid instruments for others with better market yields once the yield curve assumes its normal shape. Also, munis continue to be prohibitively expensive for C Corporations. Investment grade tax-frees trade at levels that are “through the curve” (i.e., lower than treasuries) for most maturities out to 10 years.

Born to run

Mortgage-backed securities (MBS) continue to play a significant role for community bank balance sheets. In aggregate, MBS still comprise the majority of all positions in bond portfolios. The runup in their sector weightings took place between 2019 and 2021, and as a group their unrealized losses are well over 10%. Those positions are paying down at a torturously slow pace as new mortgage rates remain elevated.

Still, their appeal in the current market stems from the ready supply of product at prices deeply discounted to par. One day there could be an acceleration of refinance activity, and MBS with purchase prices in the mid- to low-90’s will show a big bump in book yields if mortgage rates drop 200 basis points (2%). A popular example is the “Hybrid ARM.” Hybrids are issued by your favorite government sponsored enterprises (GSE), namely Fannie Mae, Freddie Mac, and Ginnie Mae. They have 30-year amortization periods, and a fixed rate period between three and 10 years that you can pick. After the “roll date,” the remaining face value will float annually. And this: they’re available at well over 5% yields, and no premium risk.

Best news yet

We have established that the highest-yielding bond portfolios have a healthy dose of the most simplistic bonds. What else is a departure from convention is that the shorter the collection of investments, the better the performance. According to Stifel, as of June 30 the top quartile portfolios have an effective duration of only 3.5 years. The bottom quartile’s duration is a full year longer, and has tax-equivalent yields that are exactly one-half of the top 25%’s: 3.87% versus 1.94%.

There will be a day when investment fundamentals will normalize. Positively-sloped curves, for example, will force managers onto a different branch of the decision tree. However, for the time being, less is more, and simple delivers relative value.

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