Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] Historic sell-off

[dek] This year’s market rout takes us back decades

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Holiday greetings! Let’s add to the spirit of the season by discussing the people’s choice for the conversation of the year: interest rates.

And this isn’t just any old rate discussion. We’re talking constant, may-be-getting-worse, haven’t-seen-this-in-my-career-type dialog. Heck, you know this has gone mainstream when the person who cuts my hair knows who Jay Powell is. Multiple surveys have pegged inflation as the number one issue among voters during this election year.

Given all that’s gone on in the economy this year, let’s put a pencil to just what the aggressive tightening by the Fed has produced, both good and bad. Maybe, just maybe, a year from now we can talk about how an efficient market, such as our bond market, will both taketh and giveth, as long as we examine a sufficiently broad time frame.

[subhed] Bellwether year?

The financial markets this year aren’t evoking the feel-good holiday music classics we’re used to hearing in December. It’s more like Martha and the Vandellas’ “Nowhere to Run” from 1965. The benchmark for tracking the bond market is the old Lehman Aggregate Bond Index, which now known as the “Bloomberg Agg” in many circles. The index has some application to community bank bond portfolios. For example, it includes a number of sectors that banks own, such as treasuries, agencies and mortgage-backed securities (MBS). It’s not a perfect template, as there are more corporates and no tax-free munis in the index, but it’s still the best known, most visible and deepest bond index available.

Through 11 months of 2022, the Bloomberg Agg is down 14.5% on a total return basis. This is by far the worst year since at least 1990. In fact there wasn’t a single year in that era that had even a 5% loss. This is what happens when the Fed promises to get inflation back in its 2% box and makes little headway even as rates have risen well over 300 basis points (3%). (The index’s decline roughly mirrors the drop in community bank portfolio market values.)

[subhed] Impact on consumers

A number of other sectors have been compromised by this rate shift. You may have noticed equity holdings have “corrected.” It’s true that commodity prices, most visibly oil, have increased year-over-year, but those numbers have declined dramatically since May, which is a major reason many economists are projecting a durable recession for 2023.

And let’s not forget the beleaguered homebuyer. The pace of price increases cooled off in the second half of the year, but they were still up by double digits in 2022. Mortgage rates, as have been well reported, have more than doubled. Taken together, the average-priced home late in 2022 produced a P&I payment of *52%* higher than the start of the year. This factoid alone could well cool down the housing market. Housing supplies are also finally catching up to pre-pandemic levels.

[subhed] Retrospectives

And now … wait for it … the good news. Or at least, a look-back to the rate environments that ensued after aggressive rate hikes by our central bank. We will use the 2000/01 and 2007/08 periods in this discussion, as they share several criteria. Both times, the Fed engineered multiple rate hikes to get inflation under control. Another common trait is they stopped out at levels that we haven’t seen since the 6% range. So, what did the phases that followed look like?

From early 2000 to mid-2001, core PCE rose about 0.6%, to about 2.1% annually. Economic activity had begun to slow, thanks in no small part to fed funds reaching 6.5% in 2000. The Fed then cut rates all the way to 3.5% even *before* the events of 9/11. The upheaval that followed produced a run of inflation well below 2% all the way into 2004, even with fed funds as low as 1%. We can say that the stout medicine from high fed funds was at least partly responsible for returning inflation to its target.

Much the same happened in the 2007/08 period. Core PCE spent the better part of that era over 2%, as the housing market, notably, was overheating on its way to the historic meltdown. The Fed again pushed overnight rates as high as 5.25% before the Great Recession that began in 2007. PCE didn’t rise back up the target level again until the end of 2011. Bond market returns for that multi-year period were above long-term averages.

Does past experience foretell future results? Of course not. But there is reason to recall that rough patches in the bond market are followed, sometimes in short order, with a return to more typical circumstances. A normally sloped curve and positive real yields are still the norm, if elusive in the current environment. More on this to follow as we embark on a new year.

Cheers!

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[sidebar] Education on tap

Quarterly bank industry update

Stifel’s Marty Mosby and David Kantor presents the quarterly Bank Advisory and Strategic Services webinar on Dec. 8 at 10 a.m. Central. Bank profitability, industry risk and capital management will be discussed. One hour of CPE is offered. Contact your Stifel rep to register.

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“A normally-sloped curve and positive real yields are still the norm, if elusive in the current environment.”

[quick stat]

14.5%

The decrease of the Bloomberg Agg on a total return basis in 2022—the worst since 1990.

Source: Bloomberg

[quick stat ends]