Independent Banker

March 2022

Portfolio

[tag] Portfolio Management

[hed] March sanity

[dek] This month has proven to be good for bonds.

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If one were to look at the aggregation of literature pertaining to the month of March, you’d see some pretty harsh prose and verse. To wit: “In like a lion, out like a lamb” isn’t much of a promo for the weather. Julius Caesar would have done well to take heed of the “beware the Ides of March” suggestion. And then there’s Garrison Keillor’s observation: “March is the month God created to show people who don’t drink what a hangover is like.”

What this has to do with community bank investment management may not be readily apparent. In fact, the tone is about to improve. Please hang in there as we build a case that, Fed words and actions notwithstanding, March has usually been a good month in which to buy bonds. “March Madness”? Not so often.

[subhed] Debt versus equity

As a hostage to the business networks CNBC and Bloomberg TV while working remotely the past two years, I’ve often heard this hypothesis: Bonds are negatively correlated to stocks. This can be true in some cases, but not all. It seems that the relationship really comes down to causation versus correlation. Fresh on our minds is the year 2020.

In March of that year, while thousands were attending ICBA LIVE in Orlando, the financial markets went into a frenzy. Up in price were all things viewed as a flight-to-quality haven, most specifically treasury bonds. The five-year note rose in price nearly 3% that month. Equities? The S&P 500 Index dropped 12.4%, which was the worst monthly stock performance since 2008. Clearly, the singular expectation of economic shutdown affected both sectors, and hence the disparate results, which seems to argue in favor of negative correlation.

[subhed] Belly of the curve matters to community banks

More often, the two operate independently. The bond market, represented in this column by the five-year treasury note, has risen in March seven of the last 10 years. Ironically the stock market, using the S&P 500 as a proxy, also has risen seven of the last 10, but they’re a different set of years. What also deserves some explanation is why I’m using the five-year as our test case.

There are really two reasons. First, the average duration of a community bank bond portfolio is more than four years right now. As we’ve mentioned recently, this is longer than normal; as recently as June 2020, that figure was in the mid-twos. So, the five-year treasury is a better approximation of the price volatility of what community banks own than any other benchmark. Second, we know that the treasury yield curve will almost always flatten when interest rates rise, which is widely expected this year. The “belly” of the curve, which most analysts consider to be from three to seven years, forms the fulcrum of the see-saw. The average change in yields across the maturity spectrum can therefore be distilled to around five years.

[subhed] Cash could stay costly

It bears mentioning that there’s no telling where rates will go in the near future (or at any time in the future, for that matter). But several thoughts come to mind. One is that the belly’s yields are at cyclical highs as of this writing in early 2022; the five-year’s yield spread over fed funds is the most in two years. Another is that the futures market is pricing in about four hikes in 2022, and a leveling off fed funds around 2% all the way through 2025. Stated another way, bond yields have already accounted for most of 2022’s expected Fed actions.

Finally, it could happen that the bonds your community bank buys and owns don’t move much in terms of yield and price this year. In three consecutive Marches (2017, 2018 and 2019), the five-year treasury note’s yield fell, even though the Fed either hiked in that calendar month or held rates steady. By 2019, yields across the entire curve had coalesced right around 2.5%. The changes in yields and prices in your own portfolio will be dependent on your sector weightings and certainly your price risk profile.

The month of March holds lots of promise and opportunity for community bank portfolio managers this year. Yields are the highest they’ve been for several years, and by most measures banks still have more than adequate liquidity. For the municipal sector, spring is often when supplies begin to reappear. For all the college basketball fans, you can dream of a deep run into March Madness for both your favorite team and your own bracket(s). As we learned from Alexander Pope, “Hope springs eternal.” And good luck with those longshots.

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[sidebar] Education on tap

2022 webinar series continues

ICBA Securities and its exclusive broker Vining Sparks present the next installment of the 2022 Community Banking Matters webinar series on March 8 at 10 a.m. Central. The topic is “Balance Sheet Strategies in an Expected Tightening Cycle.” To register, visit [viningsparks.com](http://www.viningsparks.com).

Bond Academy registration opens

ICBA Securities and Vining Sparks will host the 2022 Bond Academy live in Memphis, Tenn. on April 25–26. Up to 12 hours of CPE credit are offered. For more information, contact Jim Reber or your Vining Sparks sales rep.