Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] Inversion investing

[dek] Upside-down yield curve offers some possibilities.

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By Jim Reber, ICBA Securities

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Some rumors are true: There is an historical relationship between the phenomenon known as an inverted yield curve and a subsequent recession. This isn’t any idle talk among Fed watchers and other pundits this time around. Nor is it peripheral to the management of financial institutions, including community banks.

Being the Master of the Obvious, I’ll point out the treasury yield curve has been inverted since July, often by as much as 40 basis points (0.40%). This presents dilemmas, and opportunities, for bond portfolio managers. And for those keeping score, every curve inversion in the past four decades has been followed by a recession within a year.

It occurs to me that the conversations my associates at Stifel and I have had recently with our customers have followed a pattern, driven by the interest rate cycle. Rates fall, and the curve steepens, and bankers need reminding how to lock in yield and harvest gains. Rates rise, and the curve flattens, and bankers want to know how manage their unrealized losses. And then, the curve inverts, and it seems that everything we learned about risk/reward has gone haywire. So we will devote the rest of this column to discussing why curves invert and where value may appear in the various investment sectors that matter to community banks.

[subhed] The what and why of inversions

When the Fed determines it’s time to begin raising rates, the most visible tool at its disposal is to increase the effective fed funds rate. Whenever the overnight rate increases, so do other shorter-term yields, which most analysts take to mean two years and less. Longer-term buyers, which include, but aren’t limited to, depositories, have wholly different investment objectives and risk tolerances. Long investment yields, the proxy for which are ten-year bonds, are more affected by inflation <i>*expectations<i>*.

Every fed fund hike should, in theory at least, give longer buyers some added comfort that inflation will be well behaved. In a year like 2022, which has seen three full percentage points in rate hikes on the short end, we’re almost certain to see the curve flatten, and possibly invert. As investor sentiment by a number of measures now expects inflation to remain off its peak from earlier this year, the final component for a curve inversion has entered the mix.

Here’s the dilemma: If an inverted yield curve is a reliable predictor of an impending recession, and interest rates both short and long are going to fall soon, where should investors place their bets today? In theory, it should be on the long end, which leaves money on the table—today.

[subhed] MBS, too

As we dig into the less-is-more narrative of upside-down curves, we can now add mortgage-backed securities (MBS) to the list, which is highly unusual. It is a rare condition indeed when shorter MBS out-yield longer ones, and this has to do with prepayment expectations. As home mortgage rates have doubled this year, anyone with an existing loan is going to sit tight and pay only the minimum amount of principal each month.

That means the lower rate pools will be longer in duration, and also lesser in yield, than more current ones. To put a pencil to it, a FNMA 15-year pool with a 4% stated rate will yield about 4% at the moment, whereas a 15-year 3% pool will produce about a 3.5% return. When we add that the 4% MBS is expected to be nearly a year shorter in average life, one can see why the “up in coupon” trade makes full economic sense in 2022.

[subhed] Muni curve still steep

I need to mention that a sector that is quite important to community banks is not now, nor has it ever recently been, inverted. Tax-free munis appeal to many buyers, including individuals. In fact, most of that sector is owned by retail investors, whose needs (and marginal tax brackets) are different than your bank’s. Retail demand sets the yield curve for all muni buyers, and mom and pop tend to load up on short bonds, which keeps short yields under wraps.

As of October 2022, the investment-grade muni curve was <i>*positively<i>* sloped by about 70 basis points (0.70%) for C corps, and even more for S corps. This is proof that the municipal sector has a mind of its own. It is the least affected, for better or worse, by Fed activity.

[subhead] Here’s a thought

So what do we make of all of this inversion business? The yield curve is on a 40-year winning streak of predicting slowdowns. It’s also clear that short yields have gotten to levels that can make some money for community banks, whose deposit costs have remained quite low. So how about this as a suggestion: a barbell structure.

Equal amounts of short- and long-term investments (you get to define those limits) will work out fine, if either a) the curve inverts further; b) the curve begins to steepen; or c) the curve remains flat. And I’d say there’s a good chance of one of those results occurring. So my advice (no surprise here!) is to invest at different parts of the curve, in a variety of products. And you can leave the tumult of the yield curve’s shape to the pundits.

Jim Reber **(*****jreber@icbasecurities.com*****) is president and CEO of ICBA Securities, ICBA’s institutional, fixed-income broker-dealer for community banks.**

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