

Caution: Growth ahead?

Yield spikes post-election are far from parallel

By Jim Reber

Who'd a thunk it? As of this writing, the U.S. bond market is still in the grips of a sell-off, the likes of which hasn't been seen in more than seven years. Investors in direct government obligations, their agencies, state and local issues, and corporate bonds saw their

ambitious growth period. Perhaps this is the result of nearly a decade's worth of fiscal and monetary stimulus, or perhaps it's due to the expectation of additional infrastructure spending and debt financing by the Trump administration. Regardless, community banks that own debt securities have been scrambling to get a grip on the impact on their own balance sheets.

This column will go through some reminders of what usually happens to market yields, and therefore market prices, when interest rates go on a sustained march upward. We had a

mini sell-off in late 2013. (Remember the "Taper Tantrum"?) But because this rate move has already gone further and in a much shorter time, the impact has been more acute. The

good news is that there's some good news that attaches to a bear market.

Where we've gone

In just five weeks after the election on Nov. 8, the five-year Treasury note rose 75 basis points (0.75 percent), putting the yield at its highest level since mid-2011. The 10-year Treasury rose 72 basis points for its biggest one-month movement since 2009.

The most common measurement of the steepness of the yield curve—being the difference in the two-year and 10-year notes—showed a steepening of 32 basis points. This is perhaps the most unexpected reaction of all, because the vast majority of analysts had factored in a curve flattening as the next movement.

Options galore

So what has become attractive for a community bank investment manager to consider? Two of the more popular items, 15-year mortgage-backed

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

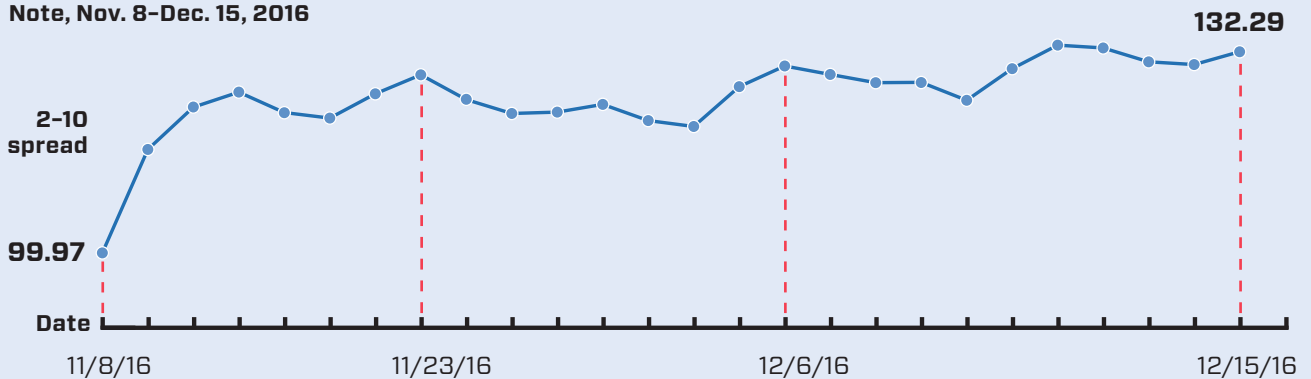


market values plummet and market yields skyrocket in the immediate post-election reckoning.

The market had decided that the domestic economy is set for an

Mind the gap

Difference in yields of 2-year Treasury Note and 10-year Treasury Note, Nov. 8–Dec. 15, 2016



Source: Bloomberg

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securities (MBSs) and discount callable agencies, have decidedly different risk/reward profiles in just a couple of weeks.

MBSs with a stated coupon of 2.00 percent declined almost 4.00 percent, to prices below 97.00. This may look enticing to premium-weary buyers who haven't seen discount levels in years. It's my duty to remind you that forecasted prepayments for such pools, which were never very fast, are now expected to be (technically speaking) dead slow. It may be a safer bet to look at slightly higher coupons, say 2.50 percent or 3.00 percent, to keep the principal cash flow coming.


Discount callables, which are the opposite of "cushion callables," have a big payday if they ever get called. Again, it's been years since the market has been able to produce such choices. An example is the FNMA 1.43 percent bond that matures on Nov. 30, 2020. It is callable one time only, on Nov. 30, 2017. This bond came to market the day after the election, at par. It was recently offered at a price of 99.00 to produce a yield to maturity of 1.69 percent and a yield to call of 2.50 percent.

Munis a bargain?

And if you, the community bank portfolio manager, like the newly improved yields on taxable securities, you should love the rates on bank-qualified munis. Using the same one-month period, tax-equivalent yields increased by nearly double the increase on Treasuries.

Just as for MBSs, be careful when purchasing discounted municipals. If an investor buys a tax-free bond at a higher yield than its original yield and pays a price below par, capital gains will be owed on it. This will lessen

the overall tax-equivalent yield, so be sure to have your broker display for you the next-of-tax effect.

Finally, here's a reminder for investment managers who suddenly have net unrealized losses in their bond portfolios. The only way for your yields to improve is for you to purchase more securities while you are underwater. This is evidence that rates have risen, on balance, since you've accumulated your portfolio. Happy bargain hunting! 

Current market opportunities

ICBA Securities' exclusive broker, Vining Sparks, publishes the Investment Alternatives Matrix each Tuesday. It displays current yields on a wide range of popular community bank investments and also calculates total returns to 12- and 36-month horizons.

To learn more, contact your Vining Sparks sales rep or visit www.viningsparks.com.

Popular webinar series scheduled

ICBA Securities has announced the 2017 schedule for Community Bank Matters, its webinars that discuss a variety of balance sheet products and strategies. This eight-part series commences on March 21. Continuing Professional Education credit is offered.

For more information, contact your Vining Sparks sales rep.