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Short interest

Earnings can be found on the front end of the curve.

By Jim Reber

If you are responsible for the management of your community bank's investment portfolio, there's a good chance you have been in this conversation in the past 10 years:

You: "I need to buy some short-maturity bonds. What kind of yield can you show me in a two-year final?"

Favorite broker: "I can get you around 45 basis points to maturity, if you're willing to live with some call risk."

You: "You've got to be kidding me."

Overall portfolio yields have not yet begun to show the effect of the Fed's multiple hikes to the Fed funds rate since December 2015, but market yields for shorter-duration bonds have noticeably improved. Although most bond analysts are forecasting some further flattening to the yield curve, we have seen some of that already take place.

Just in the first eight months of 2017, the difference in short (e.g., two-year) and long (e.g., 10-year) Treasury yields shrunk by 47 basis



result of short rates rising and long rates falling. The good news is that community banks' cost of funds has barely budged in the nearly two years since the Fed began raising interest rates, so short investments can now actually create some net interest margin.

Funds cheap and plentiful

Overall costs of funds for community banks remain near their historical lows. According to the FDIC, the average bank with less than \$1 billion in assets was paying all of 46 basis points to finance its opera-

tions as of March 31, 2017. This was only 6 basis points above the all-time low of a year earlier.

This means that for each \$100 million of deposits, your community bank's interest expense has increased just \$60,000 annually.

Recall that the target level of Fed

funds was 50 basis points higher in March 2017 than 12 months prior. Despite banks being quite deliberate about increasing their rates on deposits, they remain capable of attracting them; insured FDIC deposits grew by more than 6 percent in this same 12-month period. So it would appear that depositors are not demanding higher returns on their insured deposits, at least not yet.

Full Fed disclosure

The global parlor game known as Fed-watching has produced a complete lack of consensus for the near future. The Fed's own "dot plot" projects that year-end 2018 will have Fed funds at a median of 2.125 percent. If historical spreads prevail, that will mean the two-year Treasury note would yield about 2.40 by then.

Conversely, the "market," as defined by Fed funds futures, is suggesting only one more increase to overnight rates in the next year. Compared with the Fed's projections, that would mean less yield for all investors on the short end, whether

ICBA VOICE

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points (0.47 percent). And that flattening is more pronounced when we analyze the securities that community banks actually own, such as agencies, mortgage-backed securities and municipal bonds.

So far, the 2017 levelling of the interest-rate curve is equally the

2.125%


Federal Reserve Board median projection for overnight rates by December 2018

we're talking about money market instruments or floating rate securities. For the record, the futures contract has recently been more accurate than the Fed's own estimates. To be fair, the only reason the Fed creates the dot plot is to increase transparency, and not because it particularly wants to.

More fun than lately

Nevertheless, as of this writing, a two-year bond issued by one of the government-sponsored entities that has no call feature yields around 1.45 percent. It is not a coincidence that it's 100 basis points higher than the yield mentioned in the conversation earlier in this column, as it has mirrored the change in Fed funds during that time.

And recall that if your community bank's cost of funds is similar to the national averages, you would now enjoy a net margin of right around 1 percent by owning our two-year bullet, versus having a virtual push several years ago. It wouldn't make you rich and famous, but it's still a help to the bottom line.

I would recommend, therefore, that the next time you are considering the purchase of some securities, don't eschew the short-term option. Yields have improved and are likely to continue to improve, in step with Fed actions. Your brokers should be able to produce some offerings that offer short maturities, with interest, and margin. 

Difference in yields: US Treasury curve

Maturity in years	06/30/17	06/30/14	Change in basis points
1	1.23	0.10	+113.1
2	1.38	0.46	+92.5
3	1.55	0.87	+67.9
5	1.89	1.63	+25.8
7	2.14	2.14	+0.6
10	2.30	2.53	-22.7
30	2.84	3.36	-52.5

Source: Bloomberg



Education on tap

M&A briefing

Tom Mecredy of Vining Sparks' Community Bank Advisory Group will present the next segment of our popular Community Bank Matters webinar series on Oct. 17 at 10 a.m. CST. He will discuss "M&A and Community Bank Valuation Update." One hour of CPE credit is available. To register, visit viningsparks.com.

Tom and Jim Reber will both be making presentations at the 2017 ICBA Directors' Conference Oct. 15-17. Tom will speak on "Today's Bank Valuation" and Jim will present "The Great Liquidity Squeeze of 2017." The event will be held at the Loews Don CeSar Hotel in St. Petersburg, Fla. For more information, visit icba.org/education.