



Portfolio Management

By Jim Reber, ICBA Securities

Picking the winners

Community bankers are investing where the Fed is not.

“Without losers, where would the winners be?” baseball great Casey Stengel once said.

By now, it's been made sufficiently clear the Federal Reserve Board is going big, so we don't have to go (figuratively) home. Repo lines, money markets funds, multiple liquidity facilities and outright asset purchases all are elements of the Fed's response to the COVID-19 economic challenges. There could be more lending and investing on the way. As Fed chairman Jay Powell said on April 29, “We're not going to run out of ammunition.”

It's been noted in the business media that there

are a few new items on the Fed's investment menu this time around. In some cases, this entails the Fed investing in bonds with credit risk, which is a first. Although the criteria require that any corporate or municipal bonds are of investment grade to be considered eligible for purchase, it's given Fed watchers plenty of ammunition (that word again) to wonder if the board is going to be picking winners and losers.

There are a finite number of nationally recognized statistical rating organizations (NRSROs) approved by the Securities and Exchange Commission (SEC) to give credit ratings. Even though there is some consensus



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among them on most of the issuers they are rating, some qualitative factors could have an influence on one or more of the NRSROs. There are also variables that could influence the liquidity of corporates or munis.

For example, a muni issue could be a small block size. (Actually, if it's a bank-qualified issue, it's limited to \$10 million.) It could also be in a location that's exposed to one or two major employers. Or, if it's a corporate issue, it could be an industry that's cyclical or mature. Given the lack of uniformity in these sectors, one can understand why the Fed's foray into these new credit-risk markets is getting some attention.

Haves ...

In this column this past month, we discussed the types of securities the Fed is buying. To recap, they include "TBA-eligible" mortgage-backed securities (MBS) and certain commercial MBS. And its buying them in large quantities. As of the end of May, the Fed's balance sheet was a new high of \$7.1 trillion.

TBA-eligible pools include conventional Fannie Mae and Freddie Mac fixed rate pools with maturities ranging from 10 to 30 years and Ginnie Mae 30-year fixed rate pools. The Fed has purchased coupons ranging from 2% to 4%. Commercial MBS purchases include several types we've discussed in this column recently, including "DUS" bonds, Freddie Mac "K's" and Ginnie Mae Project Loans.

As expected, and as the Fed hoped, prices have risen on these chosen pools. For example, between March 15 and May 15, Fannie Mae 3% MBS increased by more than 4% to the point that many investors actually have begun to sell their holdings and realizing their gains.

Municipal purchases through the Municipal Liquidity Facility (MLF) are just beginning, as the Fed has redefined what bonds and issuers are eligible. The investments will be shorter in duration than the MBS with maximum terms of three years.

... and have notes

What is of greater importance to community banks is what the Fed is *not* buying. This "losers" list includes MBS backed by jumbo loans, adjustable rate MBS and collateralized mortgage obligations (CMOs). Prices on these bonds have also risen this year, but by a fraction of TBA-eligible pools.

The municipal bond market has essentially been bifurcated. Short maturities, which have long been price-supported by retail investors, have now benefitted from the MLF. The yields on the short end of the curve (i.e., five years and less) are of little interest to community banks. Longer maturities, however, are another story.

Education on Tap



Quarterly economic update

Vining Sparks economists Craig Dismuke and Dudley Carter are presenting their next Economic Outlook webinar on July 14 at 10 a.m. Central. To register, visit viningsparks.com

New investment research

ICBA Securities' exclusive broker, Vining Sparks, has recently published a Strategic Insight, Potential for Selling Held-to-Maturity Securities. This document suggests that conditions may exist for banks to find liquidity from an unexpected source. To access your copy of this report, visit the website or contact your Vining Sparks sales rep.

There are several options for community banks that come from this tumult. My first recommendation is to identify whether any TBA-eligible MBS are already in the bond portfolio. Your brokers can assist you in this regard. You may be pleasantly surprised what they're worth.

Secondly, if you're so inclined to sell them, consider longer municipal bonds or non-TBA pools for reinvestment

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options. There are a lot more bonds that the Fed isn't buying than ones that they are, so finding replacement securities shouldn't be too difficult. And, of course, perform your due diligence on the creditworthiness of any muni offering.

Finally, be sure to sufficiently model the effects of the bond swap across the entirety of your financial statements. You'll want to be clear about the impact on capital, earnings, liquidity and interest rate risk. It's proper to have this documented sufficiently before pulling any triggers.

Community bank portfolio managers have long been adept at recognizing value. In today's bond market, that could mean selling "winners" and buying "losers." It's further indication that 2020 is a year for banking unlike any other. ■