



The Federal Reserve's recent actions are designed to shrink spreads, reminiscent of a squeeze play in baseball.

Portfolio Management By Jim Reber, ICBA Securities

Squeeze play

The Fed's market interventions have a goal of shrinking spreads.

The Federal Reserve has been busy lately. The past 90 days have seen a rerun of sorts from what played out a decade ago, at the start of what is now known as the Great Recession. Several elements of its current multipronged strategy have been repeated for the same purpose of a decade ago, only in larger amounts. But their objectives are the same.

Included in the Fed's playbook have been such actions as cutting the overnight borrowing rate to nearly zero, the operation of money market facilities to keep the nation's financial plumbing

working, and the unparalleled amounts of quantitative easing affected by the outright purchases of investments.

It's these open market activities that have had the most tangible impact on community bank investment portfolios. Let's review the whys and hows of this round of intervention and see what the consequences are for ICBA members.

As it became evident that the epidemic was going global, and the Fed announced its original quantitative easing (QE) actions (ironically on the Ides of March), the bond market's first



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reaction was for spreads to widen on anything a community bank would own. These spreads stayed historically wide for more than a month, until the Fed was able to buy up enough of the existing supply to get yields more in line with longer-term averages.

This, essentially, was a repeat of QE 1 from more than a decade ago, which lasted from November 2008 through March 2010. Back then, the Fed bought \$100 billion in agency debt and \$1.25 trillion in mortgage-backed securities (MBS). The reasoning for this action in the previous crisis was that there was market disruption unrelated to default risk that needed correcting. All of the Fed's purchases in QE 1 were investments that were, at a minimum, conditionally guaranteed by Uncle Sam, but still had yields

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more in line with bonds containing *de facto* credit risk.

Just as in 2010, the purchases this time around did get spreads more normalized. For example, a simple five-year agency bullet had a spread of 31 basis points (0.31%) as of April 9. By the end of April, it had shrunk to ___%, which is more in line with history. However, there were several other sectors this time around that got the Fed's attention: municipal bonds and commercial MBS.

Retail investors in the municipal bond market were spooked by the growing pandemic. The week of March 2 was the first in *five years* that saw net outflows in muni bond funds, and that trend continued for six weeks. Only after the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law did the bleeding stop. Still, spreads were enormous for several weeks, even for solid investment-grade general obligation (GO) paper and remain wider than normal. On April 9, the Fed announced a Municipal Liquidity Facility (MLF), which will purchase \$500 billion in short-term notes from eligible issuers in terms of up to two years. That week, 10-year munis saw their raw yields fall 43 basis points.

Commercial MBS have recently been featured in this column several times, and their place in the mortgage market

Education on Tap



Webinar series segment this month

ICBA Securities and its exclusive broker, Vining Sparks, host the next segment of their 2020 Community Banking Matters webinar series on June 2 at 10 a.m. CDT. Kevin Smith will present Mortgage Market Update and Opportunities, which will discuss in more detail this column's topic. Visit viningsparks.com to register.

Coronavirus chartbook

Vining Sparks' economists are compiling and updating a set of slides about the pandemic, its effect on the domestic economy, and the fiscal and monetary policies enacted in response. To access your copy, contact your Vining Sparks sales rep.

continues to grow. That sector also saw dramatic widening in March until the Fed started gobbling up a lot of the Freddie K's, Delegated Underwriting and Servicing (DUS) bonds and Fannie Mae ACES in the secondary market. An element that affected MBS yields was the near-universal refusal by mortgage lenders to cut their posted rates, even after the Fed had cut rates to near zero. There was about a four-week period after the drastic actions by the Fed before even a modest drop in mortgage rates.

Relative value can be found

So, we find ourselves here in midyear with several conundrums. Yes, yields are certainly lower than the start of the year, but so is your cost of funds. Yes, your portfolio's duration is probably shorter than ideal, but the curve has some steepness, so at least there is some reward for strategic extension. Yes, spreads are have narrowed from their yawning gaps in the spring, but that means some liquidity has returned to the market.

It says here that past performance is no predictor of future results. But if we have some slowly improving yields out of the Treasury market in the second half of 2020, accompanied by slowly narrowing spreads, then the securities owned by the typical community bank should see some stability in their market values. Actually, that's essentially what happened during the QE phases in the past decade. The squeeze play being executed by our central bank could once again subsidize borrowers, while, at the same time, provide a floor for bond prices. ■