



## Community Bank Views – 2020 Year in Review

January 31, 2021

It has been several months since we last published this piece. We have been rather busy and assume you have been too. Therefore, in this edition we opt to provide a brief overview of our 2020 experiences/lessons learned and what we believe is in store for 2021. We hope you enjoy this publication...

**COVID-19:** Believe it or not, almost 100% of our Capital Markets Group has been working from home for the past 11 months. We've learned a lot over this time period. Learning to live without paper printouts has been this author's largest challenge. The coffee is better, but no longer free. We are excited about the possibility of bringing our team together, hopefully, in the coming months. Collectively, we are most grateful for the opportunity to maintain our jobs while this very difficult situation plays out. We realize you, our customers, are the reason why we still have this employment opportunity. Thank you for letting us help you in your banking pursuits.

**Asset/Liability Management (ALM):** 2020 showcased the importance of an effective ALM framework. Here are some of the key themes:

### Paycheck Protection Program (PPP)

- Most highly liquid institutions self-funded PPP loans at origination, then invested excess liquidity via barbell/modified barbell investment strategy. On the long end, taxable investment grade municipals with maturities from 10-20 years provided good value while mortgage-related Agency securities were generally a source of cash flow.
- Some banks utilized the Fed Reserve PPPLF or Discount Window to secure funding for PPP loans.
- Various volumes of PPP loans were done – Some clients went all-in and increased asset size as much as they could while others met the needs of existing clients. Regardless, portions of excess liquidity were invested into bonds.
- Round 2 origination volume looks to be slightly less than Round 1. Banks will be remembered for their actions during this time. Reputations are important but helping those that need it is more important.

### Investing

- Looking ahead, we anticipate that short-term rates will remain at/near current levels through at least 2021 – basically hitched to the Fed – but with increasing pressure on longer term rates (steepener). The 2yr-10yr treasury yield spread will likely remain range bound at approximately 80-120bps as the Fed could increase its use of yield curve control if the market gets ahead of itself. Spreads near the higher end of the range present buying opportunities for those willing to invest money farther out on the curve – depending on the institution's overall IRR profile.
- For those with a more concerning IRR profile, a barbell strategy may be prudent in order to capture higher yields/spreads normally associated with longer bonds while hedged on the short end to meet cash flow needs and/or be ready in case short-term rates defy current expectations.

### Liquidity

- Most banks found themselves with more deposits than anticipated due to customers spending less, receiving stimulus and holding on to it. Therefore, no real increase in deposit gathering strategies/tactics were necessary last year. Actively managing overall funding cost became key as some institutions saw increased volumes in higher paying deposit categories.
- Many institutions lowered board rates but still saw deposit volume increase.
- Looking forward, funding costs could decline slightly through 2021 as time deposit runoff hopefully reprices lower. Those needing additional funding may want to tap wholesale borrowing sources and avoid the urge to get into high-priced CD competitions (via CD specials) with competitors. Banks that did this the last time (2018-2019) are still paying for it.



**Bond Trading & Relative Value:** Absolute value is hard to find given low yields; however, we still see pockets of relative value. The taxable municipal bond sector was a popular one in 2020 and continues to see demand as we progress through the month of January. Not only have spreads vs benchmark US Treasuries continued to be attractive as compared to other taxable alternatives, but 5-year generic AA rated taxable municipals trade at approximately 20 basis points over US Treasuries. We continue to be very active in the mortgage related securities (MBS/CMO) sector. Yields on US Treasuries rose in early 2021, but spreads on mortgages widened as well; creating more attractive yields for this asset class. Yields have since moved lower, yet we still see value in 20yr 2% pass throughs and 4-5yr avg life CMOs. Generic 5-year agency backed MBS paper currently trades at approximately +70 spread vs comparable Treasuries.

**General Comments:** Our bank is facing the same challenges you face. Our deposits and bond portfolio have grown tremendously since the onset of the COVID-19 Pandemic. During this time, we've had many temptations and situations to navigate. By and large, while navigating, we've stuck to our core ALM principles of managing income and liquidity risk in a prudent manner. Duration, asset quality, liquidity and security selection have followed our legacy approach. We don't know what is in store for the market, but we do know following a sound playbook can help us weather most any storm. We are here to help in any way that we can.

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