Aristotle and the Yield Curve

by Steve Brown

Greek philosopher Aristotle lived in the 3rd Century BC and until Renaissance times, his work was regarded as the basis for many of the hard sciences including physics, astronomy, biology and zoology. He was a great thinker to be sure, but his work in physics in particular had some problems. You see, Aristotle believed the laws of motion were determined by the nature of the substance in the object that was moving. For example, if one dropped a cannon ball and a feather from a tower, the cannon ball would reach the ground more quickly than the feather. While this is true, there are other factors involved, like friction. Later work by Galileo and Newton determined that given the same density and mass, both objects would actually hit the ground at the same time. We think it must have been tricky to do all the math to get a feather to the same density and mass as a cannonball way back then, so remain in awe to this day.

For common day bankers, you may not realize it, but one of the last bastions of Aristotle's laws of motion relates to the yield curve. The Aristotle part is that the substance of the curve actually determines how it moves. Over the course of the last few months, we have seen yields whip higher and drop sharply lower depending on where you are on the curve (i.e. short or long).

When analyzing yield levels on the Treasury curve, we know short maturities tend to reflect expectations for the Fed Funds rate. Meanwhile, longer maturities like the 10Y are more influenced by economic growth and inflation expectations.

Since the Fed continues to say low rates will remain low "for an extended period of time:" short rates have been locked in cement and barely move. On the longer end however, things are different. Consider that when the Fed said it planned to reduce QE3 bond purchases and GDP came in very strong, investors reacted aggressively and yields jumped. Consider more recently that choppy economic data and weak retail sales (the consumer is 67% of the economy) have driven investors back to safety so yields have declined sharply. Both are perfectly normal for investors, as the markets are always fickle. Further, one has to expect things will remain choppy over the short run, as the Fed begins to unwind stimulus and conditions slowly return to normal.

That means community bankers will have to be nimble and ready for nearly anything this year as volatility rules the day. One place to focus is on the balance sheet, which we argue is also Aristotelian. This is to say the duration of various assets and liabilities are determined by their substance. As such, movement of yields up and down mimics the yield curve and is determined by the ingredients. That said, the part that would have given Aristotle pause would be the ability for those ingredients to change. He may have marveled at how a core deposit customer can turn into a CD customer and generally be of shorter duration and more interest rate sensitivity. The result would be something to ponder indeed as it likely will increase funding costs over time. In addition, a floating rate loan customer may demand their loan be transformed to a longer term fixed rate, thereby extending the duration of the asset at a low interest rate.

For now, expect more shape-shifting as we move out of a protracted zero interest rate environment and customers seek to benefit from this change. How it all unfolds is a big question, but most banks know there are wild cards lurking in the balance sheet. Regulators are worried about interest rate risk, so that means bankers would be wise to heed the call and understand the risks you already own. Doing so will not only make the next exam go much smoother, but you may be able to take action before things get too out of hand. PCBB has a number of ways to assist you as you think about interest rate risk, including a robust Asset Liability Management solution, hedging and lending tools to help. Let us know if you would like more information and we will happily send it along and you philosophize about the ever-changing business of a community banker.

BANK NEWS

M&A

Union Center National Bank ($1.7B, NJ) will acquire ConnectOne Bank ($1.2B, NJ) for about $243mm.

P2P Banned

CNBC reports Wells Fargo will not allow its employees to lend their own money through peer to peer (P2P) platforms.. Wells called P2P lending "a competitive activity that poses a conflict of interest."

Single Family

Inside Mortgage Finance reports Wells Fargo and JPMorgan rank #1 and #2 respectively by originations and account for 28% of the market. The next 10 lenders account for 26% combined.

Millions

A study by Phoenix Marketing International finds the top 5 states with the highest percentage of millionaire households per capita (ratio of millionaires to total households) in order are: MD (7.70%), NJ (7.49%), CT (7.32%), HI (7.18%) and AK (6.75%). The bottom 5 states are: MS (3.63%), AR (3.73%), ID (3.76%), WV (3.82%) and KY (3.84%). Finally, states with the greatest number are: CA (12.9mm); TX (9.4mm); FL (7.6mm); NY (7.4mm) and PA (5.1mm).

M&A

SNL Financial reports there were 242 whole bank acquisitions in 2013 vs. 244 in 2012 and an average price to tangible book of 1.24x.

Summer Interns

The Wall Street Journal reports only about 25% of undergraduate students from Wharton went into investment banking last year vs. 41% in 2007. Experts say many have switched to technology and other fields given regulatory changes in the banking industry and limits on pay.