How Flat Is Flat

by Steve Brown

Driving across the US, the monotony of the landscape is striking in certain areas, especially as one crosses the Midwest. In fact, while it is as flat as a pancake in KS, you might be interested to know that the state doesn't even make the list for the top 5 flattest. The flattest state is in fact FL with its highest point only 345 feet above sea level. Next in line are IL, ND, LA, MN DE and then KS. Sometimes what you think you see isn't always reality when you get down to the real facts.

When it comes to the markets and banking, it's not always completely clear how flat the yield curve may be. Over the past few months, we've seen a pretty remarkable drop in yields on the long end of the Treasury curve. That is interesting, but how quickly we forget where rates were not so long ago. Things do seem flat considering where we began the year. The yield on the 10Y dropped to 2.06% and the 30Y to 2.69% as of yesterday and this seem low indeed - unless we go back to Jun 2012 when the 10Y was yielding around 1.50%.

Community bankers have been watching external forces push down loan yields for years now. First it was dropping interest rates and slow growth, then it was competition and now it's all of the above. There had been some hope that a rise in Fed Funds would drive a proportional upwards move in longer rates. Now we are looking at a flattening yield curve with little risk premium paid for underwriting longer term loans. Still, the prospect of higher deposit rates remains with an increase in short term rates.

What is a bank to do? At PCBB, we have long been a proponent of hedging longer term fixed rate loans to better address funding and interest rate risks. This protects the bank from interest rate risk that would result from increasing longer term interest rates, but what if longer term rates aren't rising? In considering whether the time is right to originate long-term fixed rate loans and then hedge them, banks should also consider borrower behavior. Most of the time, borrowers will take on a longer maturity or reset date if the premium to go longer is less painful. Given the steep yield curve of the past year, borrowers have been content with a 5Y reset but now things are shifting. The difference between 5Y yields and 10Y yields has decreased significantly over the course of this year and therefore the longer reset is more attractive for borrowers. They are in effect passing along the interest rate risk to the bank by going longer though, and this is where lenders need to be careful.

Placing a hedge on a loan that locks in the borrower at an attractive rate is not only a benefit to the borrower but it also mitigates credit risk for the bank. Further, it also protects the bank from interest rate risk in a rising rate environment. However, if longer term rates are dropping or just hold steady, bankers often ask us whether hedging still a sensible tactic? The answer is a resounding yes. Taking a closer look at this question, consider that most folks are pretty sure the Fed will increase short term rates in Q2. Those rising short rates will make floating rate instruments immediately accretive to NIM - even if longer term rates remain steady or drop further. Hedging a long term loan allows the bank to offer attractive terms to good borrowers and to protect itself regardless of the interest rate environment.

In the end, hedging some of the bank's loans is an important tactic for diversifying holdings and to mitigate both interest rate and credit risk regardless of the interest rate environment.

Certainly the topography of the yield curve is beyond anyone's control, so banks should be prepared for both flat and steep situations. As for the topography of the states, if you were wondering which state was the hilliest you might be thinking CO. Although if you've ever driven across eastern CO, you know it's as flat as KS. The actual answer in order is WV, VT and NH.

BANK NEWS

M&A

UMB Bank ($16B, MO) will acquire the holding company of Meridian Bank ($720mm, AZ) and Meridian Bank ($433mm, TX) for about $183mm in stock or roughly 1.6x tangible book.

M&A

Northwest Savings Bank ($7.9B, PA) will acquire The Lorain National Bank ($1.2B, OH) for about $183mm in cash (50%) and stock (50%) or roughly 1.98x tangible book.

Rate Hikes

The latest CNBC survey of 38 economists, strategists and fund managers finds the average month the first rate hike is expected is Jul 2015, with an average Fed funds rate by year end of 0.83%. The group projects the Fed funds rate will then rise to an average of 1.93% by the end of 2016 and would stop raising rates once it reaches 3.20% in Q1 2018.

Hiding Here

Deflationary pressures abroad and weak economies have pushed overseas investors to purchase Treasuries at a blistering clip (pulling Treasury yields lower). During the first 9 months of 2014, foreign investors have purchased $284B vs. only $83B in 2013 (+242% YOY).

Fake Story

The NY high school student who said he made $72mm trading stocks at lunch has now admitted he made the whole story up.

Oil

Prices have dipped below $60 per barrel (down 50% since Jun), marking the lowest level since 2009. The decline is generally viewed as good for the US economy, as analysts predict it will boost GDP by 0.3% to 0.5%. On the other side of the coin, look for more market volatility as a result, as investors are spooked by hemorrhaging in Russia and other countries highly dependent on oil revenues to support their economies.

Busy Holiday

Forrester Research projects e-commerce sales will reach $89B in 2014, a 13% increase over 2013.