Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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Tactical Adjustments into A Steeper Yield Curve

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

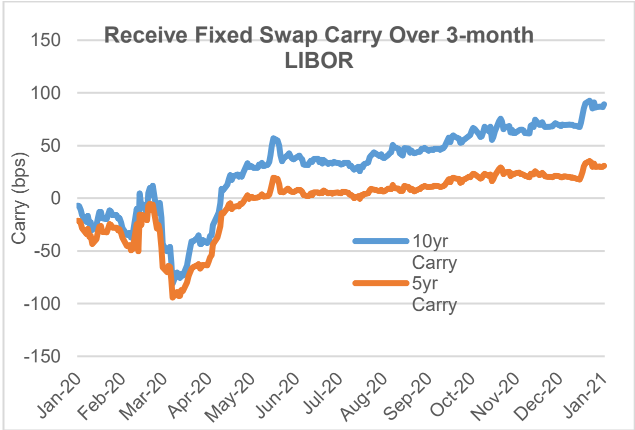
All three major equity indexes reached all-time highs Wednesday on the back of a comfortably uneventful inauguration day. However, enthusiasm stalled on Thursday after jobless claims data remains elevated at 900,000. Despite businesses continuing to lay-off employees due to COVID-19, investors appear to be fairly optimistic an economic recovery will take place in 2021. Treasury yields remain elevated from year-end levels driven by inflation expectations from additional government stimulus. Two weeks ago we explored some of the financial metrics that we consider relevant to community banking institutions, and saw increased volatility in 2020. Given the recent changes to the shape of the yield curve, this week we dive into different tactics to address those changes.

Extend Assets, Shorten Funding

Playing the spread between the short and long end of the yield curve was one of the founding principles of spread management (i.e., borrow short and lend long to capture the term premium between risk-free rates). The historically low rate environment over the last 12 years has obviously presented challenges to this model as a long-term strategy, but these principals can make sense tactically when market opportunities present. For balance sheets with asset-sensitivity to spend, extending asset duration can be carried out in different forms (and you can actually be compensated for it)! Simply originating longer-term fixed-rate loans, or purchasing longer-duration securities could both work. Banks can also roll shorter funding to reduce duration on the liability side. However, there are some wrinkles to these basic concepts that we will dive into below:

Derivatives Tactics

The steepening of the swaps curve over recent months has made it more attractive to receive fixed on a swap. For asset-sensitive institutions that will already benefit greatly from rising rates, it provides a way to remove a portion of their interest-rate bet. Swapping floating-rate assets to fixed is another viable tactic to extend asset duration. Conversely, the same ideas apply on the liability side. Institutions in need of funding can roll shorter liabilities; or existing term, fixed-rate, liabilities can be swapped to floating and designated as a fair value hedge to reduce current cost of funds while maintaining term liquidity. The carry profile over 3-month LIBOR for 5 and 10yr receive fixed swaps has changed by 125bps and 175bps, respectively, since their most negative levels in March of last year. Finally, many institutions are taking a look at the mark on pay-fixed swaps they entered into in 2020, and whether locking-in some gains may make sense at this point. It is, after all, one of the reasons why many institutions chose to pair a swap with short funding, rather than just using term FHLB advances.



Source: Bloomberg L.P.

Securities Portfolio Tactics

Take strategic gains by selling out of bonds that have rolled down the curve and are nearing their maturity or a call date. Market yields on the short end of the curve for most high grade products are anchored to the lowest yielding part of the curve, and spreads are generally tight. This makes higher-yielding assets that have rolled down more valuable. Ideally yield can be enhanced on the reinvestment from the book yield sold. The strategy may also make economic sense with a reinvestment yield that is lower than the yield on securities sold, as long as the gain is not exhausted before the sold securities mature or are called. Loss trades often also make sense at the start of the year. Shedding underperforming assets, such as mortgage-backed bonds whose faster-than-expected prepays are projected to remain elevated, at the start of the year, allows for ample time to recover and overcome a loss. Either way, proceeds can be reinvested further out the curve to pick up term premium and spread. Now is the time to consider all of these strategies, relative to interest rate risk position, and a full balance sheet analysis can help institutions choose from among competing options.

The Bottom Line

We are slowly seeing tactical opportunities for asset-sensitive institutions that have been patiently waiting for the ability to bring their overall interest rate risk position back to neutral. These are not recommendations to make wholesale changes to balance sheet management by adding interest rate risk. Rather, each institution needs to evaluate market opportunities against their positioning. The industry is positioned to perform well in a rising rate environment. However, asset-sensitive institutions can begin putting a thoughtful plan in place to adjust portions of their balance sheet management strategy, taking advantage of recent changes to the interest rate environment while managing their biggest downside risk: low rates for an extended period of time.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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