The ADVISOR

Focus on Community Banking Issues

First Quarter 2024

ECONOMIC ENVIRONMENT

To Cut or Not to Cut

During the third quarter, a still-hot economy supported overarching sentiment for a higher-for-longer interest rate path, highlighted by a strong job market and lack of meaningful inflationary progress. Since then, the trends seen for the majority of 2023 have continued: unemployment is low, consumer spending is steady, and inflation, while somewhat lower, remains stubbornly above the Fed's long-term target. However, a dramatic reversal of consensus interest rate expectations took place following the December FOMC meeting, where the updated dot plot showed an additional 25 basis points of rate cuts expected in 2024. Many market participants saw this as a Fed "pivot," sending Treasury yields nearly 100 basis points lower and causing some to project cuts beginning as early as March. Yet, without a clear and significant downshift in economic activity, it is difficult to envision rate cuts in the next two to four months. While we do expect the Fed to reduce rates later this year, we believe it is more likely that a slower economic downturn will play out, leading the Fed to act in the Fall.

A Soft-Ish Landing?

This year offers a wide range of potential economic outcomes, which is reflected in significant divergence among Wall Street economists' projections. The consensus outlook calls for a relatively soft landing, characterized by slowing but positive real GDP growth, decelerating inflation, and accommodative monetary policy. This is roughly in line with the Fed's forecast (1.4% GDP growth & 4.1% unemployment rate in 2024). A second possibility is a hard landing, or recession scenario. Bloomberg's 12-month recession probability forecast is hovering around 50%, and while lower than the 68% probability last January, is still well above its historical average (15 – 20%). A third scenario is a soft landing coupled with an acceleration in nominal GDP growth. Here, loosened monetary policy would propel capex/investment spending, hiring, and pent-up demand for goods affected by interest rates such as housing and automobiles. While initially positive for risk assets, this setting could ultimately drive rates higher if an uptick in infla-

EPG RATE FORECAST

December 2023

MARKET RATE	Actual (%) 12/31/2023	Projected (%) 12/31/2024	Yr1 Δ	Projected (%) 12/31/2025	Yr2 Δ
FedFunds	5.50	4.50	-1.00	4.00	-0.50
Prime	8.50	7.50	-1.00	7.00	-0.50
3mthTsy	5.40	4.45	-0.95	4.00	-0.45
6mthTsy	5.26	4.40	-0.86	3.80	-0.60
1yrTsy	4.79	4.25	-0.54	3.70	-0.55
2yrTsy	4.23	3.90	-0.33	3.55	-0.35
3yrTsy	4.01	3.70	-0.31	3.45	-0.25
5yrTsy	3.84	3.65	-0.19	3.35	-0.30
10yrTsy	3.88	3.60	-0.28	3.25	-0.35
30yrTsy	4.03	3.55	-0.48	3.15	-0.40

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates.
Depending on the actual timing of the ALM meeting, the forecast may be altered and/or updated.
For the most accurate current rate forecast, please call EPG, Inc. at (781) 235-2666.

Features

Economic Environment: Will the Fed Pivot Lead to a Soft Landing?

Fixed Income Strategy: Investment Yields are Down but Remain Attractive.

Equity Strategy: How will the Equity Markets React to the Pivot?

ALM Strategy: Positioning the Balance Sheet for 2024.

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ECONOMIC ENVIRONMENT

tion follows. In our view, the most likely path falls somewhere in between the first two scenarios, where economic activity (GDP growth, hiring, manufacturing activity, etc.) gradually worsens throughout the year as the 525 basis points of monetary tightening continues to impact the economy, causing inflation to creep lower.

Is Inflation Stalling?

Since the Fed began its tightening cycle, higher rates have certainly worked to ease overall price pressures within the economy. From December 2022 to December 2023, Headline CPI encouragingly fell from 6.8% to 3.4% and Core CPI dropped from 5.7% to 3.9%. In recent months, however, noteworthy progress towards the Fed's 2% target appears to have hit a roadblock. Since reaching a low point of 3.0% last June, Headline inflation has been range-bound between 3.2% - 3.7%. Core inflation took a more linear path to reach a two-year low of 3.9% last month, but the pace of decline has slowed considerably since August's 4.3% reading. So where does it go from here? The Fed's latest Summary of Economic Projections shows the Central Bank's preferred measure of Core PCE reaching 2.4% this year, 2.2% in 2025, and 2% in 2026. That forecast implies a pullback in consumer spending, wage growth, and job creation. However, energy price volatility is likely to persist as geopolitical tensions continue, and other key price categories such as shelter and health care have remained sticky. Overall, additional slowing may take longer than the Fed would like if the consumer continues to prove more resilient than expected.

EPG Rate Forecast: A Patient, Yet Proactive Fed

Following a third consecutive pause in December, it can be inferred that the Fed's tightening cycle has concluded, pending a reacceleration of inflationary pressures. This is reasonable, as inflation has fallen and the effects of previous rate hikes are still flowing through the economy. However, the overwhelmingly dovish market expectations are more difficult to justify. Currently, Fed Funds futures contracts are projecting a 44% probability of a 25 basis point cut by March, more than a full cut priced in by May, and a total of 6 cuts (150 basis points) in 2024. The probability of a March cut was fully priced into the futures market on December 22nd before multiple Fed speakers adopted a more hawkish tone in recent weeks. In our view, it is unlikely that policymakers would take action with a 3.7% unemployment rate, core inflation hovering around 4%, and shockingly high consumer spending. Considering these trends have now persisted for over a year in a high-interest rate environment, we believe an economic slump large enough to warrant 100+ basis points of rate cuts will take multiple quarters to transpire. As such, we expect the Fed to hold rates steady until late in the third quarter, when we project the first 25 basis point reduction to occur. Since the onset of QE1 in 2008, the Fed tends to lower rates to its targeted level rapidly once it decides cuts are needed. With an objective of mitigating potential economic damage, we expect the Fed to follow this playbook by lowering rates to 4.50% from Q3 to year-end and achieving a terminal point of 4.00% in spring 2025. This "earlier and faster" mindset is likely the driver of current market expectations for a near-term policy reversal. The FOMC has continued to adopt the stance that any policy decisions will hinge on incoming data, and that 2% inflation remains the focus. Based on these criteria, a wait-and-see approach resulting in a pause for at least two additional quarters is a logical outcome.

So, when will the yield curve normalize? The 2-year/10-year relationship has been inverted since July 2022, and the 3-month/10-year since October 2022. Historically, periods of inversion signal a recession on the horizon, where investors typically lock in yields in anticipation of rate cuts. If cuts occur faster and in greater magnitude than expected, the curve should steepen due to the short end falling faster than the long end. If

the Fed cuts but keeps rates at a relatively high level, the curve could gradually flatten because investors would likely demand a greater term premium for longer dated bonds, especially if the economy avoids recession. However, the long end has been pricing in a recession, and any signals of economic weakness have driven 10-year yields lower within the current rate cycle. Therefore, the initial reaction to cuts could see the 10-year falling alongside the short end, creating a flatter but still-inverted curve through 2024.

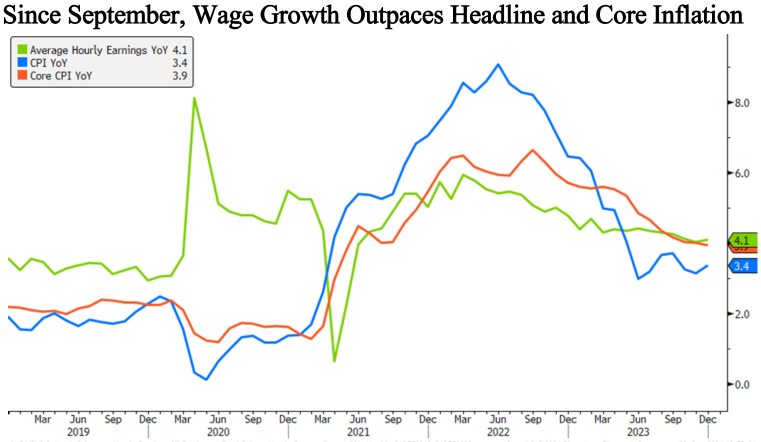
Buy Now, Hopefully Pay Later

Ever-growing consumer spending was another unexpected twist that allowed the economy to stave off recession last year. Despite an environment of stubborn inflation, elevated interest rates, and dwindling pandemic-era savings, monthly retail sales figures continue to surprise to the upside. According to the National Retail Federation, holiday sales hit a record $964 billion last year, with online spending representing a significant portion. Yet again we ask, is this trend sustainable? Overall, we believe spending will slow over time, but it is unlikely to occur overnight. Concerns are certainly mounting, as credit card debt reached a record $1.08 trillion (15% YoY growth), an increasing number of cardholders carry a monthly balance (now 46% per Bankrate.com), and average credit card rates hover around 19.6%. Remember that record holiday spending? Adobe Analytics data show growing usage of "buy now, pay later" shopping options was a major driver of the increase. However, one positive catalyst for spending exists. Wage growth, while slowing, has outpaced inflation over the last several months. If inflation continues to fall and wages do not drop in tandem, consumers should theoretically have more in their pockets (and more to spend). Thus, heightened spending could persist until wage growth is no longer supportive of higher debt servicing costs.

Labor Market: Are Cracks Forming?

Perhaps the largest surprise of 2023 was a job market that maintained strong momentum throughout the year, thwarting consensus expectations of a recession. At surface level, little has changed; the economy added 216,000 jobs in December and the unemployment rate held steady at 3.7%, barely higher than the 3.5% reading in December 2022. Looking deeper, however, several signals of weakness may suggest that the streak of strong job creation numbers could be approaching its end. First, the quits rate, which reached historic heights during the pandemic, is now below 2019 levels. This makes sense in the context of slightly declining labor demand, as shown by recent job openings data and ISM Employment Surveys. Additionally, while overall job creation is sturdy, the headline gains are concentrated in the Leisure & Hospitality and Private Education & Health Services sectors, which represent about 75% of private sector payroll gains in the last 12 months. The labor force participation rate has also risen linearly over the past year. So, what does this mean? It seems that while jobs are still plentiful, they are becoming more difficult to obtain and workers are adopting a more cautious attitude. A meaningful downshift in the labor market will still likely take multiple quarters to play out, but warning signs are certainly beginning to emerge. ◆

Since September, Wage Growth Outpaces Headline and Core Inflation



Source: Bloomberg

FIXED INCOME STRATEGY

FIXED INCOME STRATEGY

Elevated Volatility during the Fourth Quarter

The fourth quarter began with expectations of the Federal Reserve maintaining their path to contain inflation, with the anticipation of additional short-term interest rate increases. Banks and retail investors were reluctant to add duration, leaving U.S. Treasury auctions with light demand, causing interest rates to spiral higher in yield. In late October, Ten Year Treasury yields reached their highest level since 2006, while mortgage rates hit their highest level since 2001. The Federal Reserve increased short term rates by 525 basis points over an 18 month period from March 2022-July 2023, significantly impacting bank funding costs. With an inverted yield curve, liquidity became scarce while deposits became extremely competitive. If 2022 was the start of the Federal Reserve's fight to rein in inflation and 2023 was the bumpy middle, sending interest rates to near term peaks, 2024 could be the end game, with both price growth and interest rates settling back towards a lower range later this year. It will not be easy, and the upcoming year could prove to be consequential to the U.S. economy as policy makers work to achieve a softer landing than most economists had predicted during this aggressive tightening cycle. This remains a possibility even with the Fed initially behind the curve, implying that inflation was transitory in late 2021. The Consumer Price Index has dropped substantially from its high of 9.1% in June of 2022 and is now just above 3.0%, with expectations to drop further in coming months.

The decline in interest rates and corresponding surge in equity valuations was driven by the third consecutive pause at the December FOMC meeting, along with markets completely pricing out the possibility of additional rate increases in 2024. Along with the decision to stay on hold, committee members also penciled in three rate cuts for 2024, up from the two cuts at the September meeting. Although there was dispersion regarding next year's rate projections among voters, this was still interpreted positively to both equity markets and Treasury yields.

Where do Interest Rates go From Here?

The Federal Reserve now has the dilemma of whether they will fulfill market expectations with a series of rate cuts potentially beginning by the March meeting. We see this as a risk in 2024 if the Fed were to prematurely cut short term rates prior to meeting their objective of price stability with full employment. If policy makers cut rates, it could increase the probability of a "hot landing", rather than what has appeared to be a "soft landing" as the economy has remained strong. Under this scenario, the dollar could weaken,

Source: Bloomberg

Yield Curve Changes

Term	12/31/2022	12/31/2023	Change
2 Year	4.43	4.25	-0.18
3 Year	4.22	4.00	-0.22
5 Year	4.00	3.85	-0.15
7 Year	3.97	3.88	-0.09
10 Year	3.88	3.88	0.00
20 Year	4.14	4.19	0.05
30 Year	3.96	4.03	0.07

which could have a counterproductive impact and reaccelerate inflation. Our interest rate forecast calls for the first rate cut in September, and we believe it is possible for the economy to slide into a mild recession later in the year.

The Federal Reserve has been fortunate that the employment picture has remained strong along the way to lower headline inflation, at the expense of higher short-term rates. After 18 months of aggressive tightening, the unemployment rate remains at 3.7%, remarkably low during a period that should have significantly raised the unemployment rate. The resilience of employment has given the Fed merit to maintain the 'higher for longer' interest rate scenario. Bond yields will likely adjust as we get closer to the March meeting and gain more clarity on when the first rate cut may be. That said, the Fed Funds Futures contract is currently pricing in the first rate cut in March, and it seems unlikely based on current economic conditions that rate cuts will begin as early in 2024 as the futures market implies.

Investment Opportunities

Regardless of how soon the first rate cut is implemented in 2024, longer term forecasts across Wall Street call for lower interest rates. During the December FOMC meeting, it was not a surprise that they held rates steady for the third straight meeting, but the dovish post-meeting capital markets reaction was clearly a change in posture regarding their interest rate forecast. Committee members increased the number of rate cuts in 2024 to three, previously two at the September meeting. Although policy makers have been consistent with the 'higher for longer' theory, this update was well received by investors, with equities and bonds reacting as if rate increases are behind us, and rate cuts imminent.

This dynamic continues to create the opportunity to add investment alternatives with accretive price potential and/or yields in the vicinity of 6.0%, depending on the risk and duration profile of existing balance sheets. The increased volatility during the fourth quarter still allows longer dated Callable Agencies to yield near 6.0%. There has been demand for higher yielding Callable Agencies further out on the yield curve, offering an attractive yield in comparison to overnight funding levels. With compressed margins, the ability to lock in accretive yields even if only for 3 to 6 months is attractive. As a strategic longer-term play, investing in slightly discounted Agency Mortgage-Backed Securities can not only offer attractive yields, but also have potential for price appreciation. Even in a slow prepayment environment, the incremental benefit of reinvesting monthly portfolio runoff into current yields could boost current portfolio yields as interest rates fall. Additionally, discount to par MBS will prepay slightly slower than current coupon securities in a falling rate environment, allowing investors to lock in attractive yields for longer. Corporate spreads remain below long-term historical averages, and in our view do not present a worthwhile risk-return trade off at this time. Similarly, Municipal bond spreads remain firm due to demand for longer term call protection in an inverted yield curve environment. ◆

EQUITY STRATEGY

Equity Investing: With the Fed set to pivot to cutting rates, will equity markets pivot as well?

With 2024 now anticipated to include not just a period of lower inflation but also acceptable growth, it is all but assumed that the Fed will move from a position of raising rates to combat inflation to one of cutting rates to ensure comfortable levels of inflation and associated levels of economic growth. Is this combination of improving growth and declining inflation a perfect environment for equity investing?

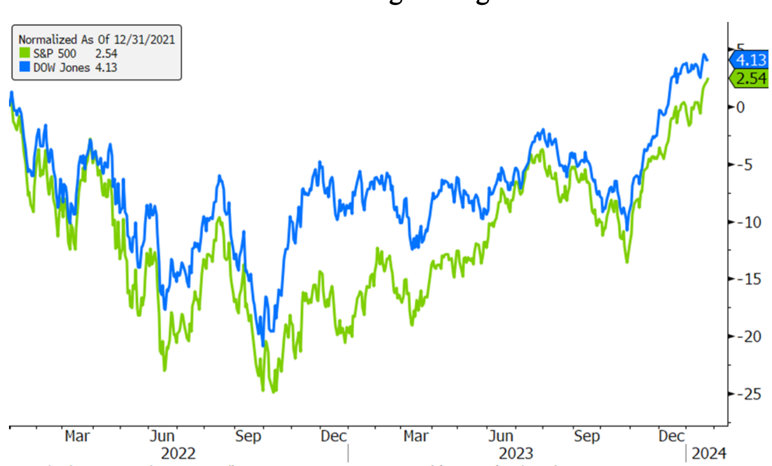
While the equity markets have now begun reaching new highs, after retracing the declines from 2021 highs, recent momentum has been attributed on a macro basis, on the assumption that the Fed pivot includes a short period of pause, with rate cuts beginning as early as this spring. This outlook has created a platform of optimism for equity investing. In particular, a segment of investors are forecasting March of 2024 as the commencement date for Fed rate cuts. This seems overly optimistic to many, and most would argue rate cuts beginning in late summer/ early fall represent a more likely and realistic forecast – we concur with this latter view.

With 2024 expected to be one of the most challenging environments in banking history, where does equity investing "fit in?"

Consumers continue to be the backbone of the U.S. and one could argue, the global economy. With this being said, stable and strong employment tends to reflect strong consumer credit. An economy that can benefit from continued consumer spending along with adequate liquidity for such spending is expected to drive corporate earnings upward. The ability of the consumer to continue to spend is contingent on access to funding. Wage increases are no longer expected to be amplified and thus are assumed to be less of a fuel for spending. Utilizing a percentage of deposit balances along with earned income and ideally declining prices (i.e., lower inflation) will be the combination that can provide consumers the resources to fund continued demand for goods and services.

This scenario is what the Fed and markets have been focused on as an ideal outcome from the inflation fighting strategies of the last several years. However, with these strategies comes an accompanying risk - a lack of liquidity in the financial sector. The lack of liquidity leads to decreased lending, which in turn leads to weaker economic growth. This, coupled with the "inverted" yield curve, has created a 2024 outlook for financial institutions of tight, expensive liquidity creating marginal profitability, limited growth, and challenged income statements. The cost of funding new dollars is now greater than 5% in many markets, and this "high bar" has understandably dictated utilizing available funding to manage liquidity costs and fund higher yielding loans, versus deploying into alternatives that while providing longer term benefit, do not necessarily meet shorter term profitability bench-

Dow Jones & S&P 500 Percentage Change: 12/31/21 – Present



Source: Bloomberg

EQUITY STRATEGY

marks. This includes equity investing. Dividend yields do not meet or exceed yields available on cash or certainly loan alternatives. However, a longer-term strategic focus on balance sheet management and performance may include looking beyond the challenges of the coming year.

Diversified and longer-term potential sources of income and capital creation continue to be a strategic goal for financial institutions looking out over the longer term. Although uncertainty as to continued rising deposit costs remains, the worst is likely behind us, even with an expected lag in deposit cost reductions. Uncertainty related to fee income and residential loan opportunities (due to lack of inventory and competitive pressures) are two examples of challenges which banks are facing that dictate an expansive and objective perspective when looking for opportunities for diversified and accretive asset opportunities. This supports an argument for continued participation in equity investing, for those institutions able to do such.

Sizing of an equity portfolio and performance metrics will continue to be guiding principles for 2024. In particular, equity portfolio price volatility and its short-term impact on earnings and capital creates a parameter for portfolio size, dependent upon the institution’s comfort level from a "stakeholder” standpoint.

Long term capital accumulation achieved through diversified and accretive sources of income has historically included equity appreciation, but is always tempered by a comfort level with possible shorter term market volatility and its impact on balance sheet dynamics. Based on history, long-term total returns on quality equity holdings derived from stock appreciation and dividend yield are likely. However, 2024 represents a period of material challenges to bank profitability and therefore, careful, patient, iterative additions to equity holdings should take place. This can only happen, though, after comfort levels with other components of the balance sheet are achieved based on current standing and various “stress testing” of how equity portfolio volatility could impact key elements such as income calculations, capital calculations, and other strategic initiatives that may compete for limited available liquidity.

Stay the course on equity selection as guided by investment policy and performance benchmarks:

Macro investment strategy should, we believe, continue to focus on a diversified base of investment grade, industry leading companies that are typically represented by “large cap” corporations. With this dynamic, it is important to include leading industry groups and sectors that reflect innovation, new technologies, and cutting-edge application of the two. With a likely scenario of market interest rates declining yet staying above 3% if not 4%, the relative attractiveness of dividend yield is lessened, and a greater percentage of the portfolio holdings being more growth-oriented is an important strategic focus. Earnings per share and sales growth reflected in healthy profit margins will drive equity holding appreciation. Momentum of an equity position, relative to broader indexes and its associated industry will continue to be an important indicator and factor in buy, sell, or hold decisions. All of this will allow and dictate active portfolio management, whether a portfolio is maintained at current size or slowly grown over time. ◆

ALM STRATEGY
Positioning the Balance Sheet for 2024

The year ahead will present significant challenges from a balance sheet management perspective, but may also provide needed relief as we move into Q3 and Q4. This is predicated on a number of assumptions, the primary being that the Fed has now pivoted, and will likely begin easing rates later this year. If this scenario comes to fruition as expected, how should we approach the next few quarters?

Strategic Approach in the Current Environment

Over the last quarter, we have seen some initial changes in the marketplace, both on the lending and deposit side, driven in large part by the expectation of the Fed pivot. Now that we have moved to that phase in the rate cycle, here's where we stand:

Lending

The residential mortgage market remains slow, impacted by the combination of low inventory and still high rates, compared to the historically low rates of a few years ago. However, we have heard about a modest amount of prepay activity, specifically with fixed rate mortgages written in the 7.50% and higher range. Admittedly, though, there aren't many loans that fall into that category, but it is higher than the near zero level of the recent past. Current rates in the mid 6% range are attractive (from the lender perspective), especially if you believe that rates will decline over time, but not so quickly that a 6.50% mortgage will be heavily enough in the money to be refinanced in the near future. CRE falls in the same relative bucket, with rates slightly higher than residential, but have the added benefit of prepayment penalties which should make them stickier. Although the loans do not look nearly as attractive from a margin perspective as in the past, especially if funded with CD specials or FHLB overnight, that should improve later in 2024. And if you wait until later this year to become more aggressive in this space, while the funding may be cheaper, the loan rates may be 50 basis points or more below current levels. This may be the last, best time to lock-in current attractive loan rates as they likely trend lower through 2024.

Funding

CD rates seem to have peaked, and in some cases, have declined modestly from cycle high levels. With the anticipation of lower rates later in 2024, terms have shortened, with institutions seemingly more comfortable 'overpaying' for shorter terms (as short as 4 or 5 months at 5.50%, for example), rather than attempting to raise money at similar rates but with a term of 12-15 months. While this may position you well for a potential cut in mid/late 2024, it also places you in the middle of the pack with all the other institutions that will be forced to roll over their CDs at the same time. In this case, even if rates have started to decline modestly, that benefit may be offset by the added competition, negating any potential savings. It may be better to extend a portion later into 2024 or even early 2025, to diversify the reinvestment risk, as well as buy some protection in case the Fed is slower than expected. We have heard of very limited appetite to extend CD maturities (from the investor perspective), however, a savvy buyer should consider an extension at a lower rate, because the roll rate of a 5 month CD at 5.50% could be well under that level at maturity. Over the course of a 24 month period, a 4.25% fixed rate could eventually prove more attractive than rolling a 6 month CD four times, with the rate likely declining at each maturity point.

The Bottom Line

Although loan rates may decline 50 basis points, it is likely that marginal funding costs will decline more than that in the Q3/Q4 area. This is driven not only by a projected decline in CD special rates and overnight funding costs, but more so by a shift in the deposit mix back toward non-maturity deposits. While this may not be extreme in the beginning, if the economy slows as expected, a decline in consumer spending

combined with a continued mitigation of the impact of inflation and money moving back into community financial institutions from the Treasury market and online banks could prove enough to provide some meaningful relief to margins.

Even a modest shift from borrowings back to non-maturity deposits would provide some welcome relief. Using a simple example, the cost savings of a $10 million shift from overnight borrowings at 5.50% to CDs at 4.75% pales in comparison to the impact of the same amount of funding moving to non-maturity deposits at 0.50%. This may sound too good to be true, given the last 18 months of deposit activity, but if the economy slows later this year, this may be a reasonable outcome.

Update on Today's Interest Rate Risk Challenges

Last quarter, we discussed the continued rise in measured sensitivity levels related to valuation (EVE / NEV / NPV, etc.), and the good news is that after multiple quarters of steadily rising risk, the numbers have finally started to decline. The improvement has been modest so far, but at least they are trending in the right direction. The big driver has been the decline in the 10-year Treasury yield, from 4.59% at the end of September to 3.88% as of year end. This 70 basis point decline in longer rates has positively impacted asset values, without help from other key assumptions, such as prepay speeds. Once speeds start to inch higher, it should provide a nice additional boost to cashflow speeds and valuations.

The decline in longer rates has not been the only factor in the improved sensitivity levels; the still slow residential mortgage market and downward trending investment portfolio concentrations (as institutions allow longer-term, lower rate MBS to amortize off) have contributed as well. Over time, as the longer duration pandemic era assets age, risk levels should continue to improve. This is obviously in addition to actions taken by management to address the higher risk levels, such as swaps, funding extensions, loan pricing initiatives and asset sales.

Regulatory oversight of this area continues to be stringent, and in most cases, reasonable given the risk levels. A continued active approach to managing valuation risk is recommended, even as the measured risk likely trends lower over time. ◆

EPG INCORPORATED

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