The ADVISOR

Focus on Community Banking Issues

Second Quarter 2024

ECONOMIC ENVIRONMENT

Another Fed Flip Flop

In December, the Federal Reserve shifted its hardline stance on monetary policy by forecasting an additional rate cut this year, leading investors and economists alike to believe lower rates were ahead. Given there was no apparent catalyst for imminent policy easing at the time, it was prudent to maintain a higher-for-longer outlook throughout this period. Since then, several months of blowout jobs reports, hot GDP growth driven by elevated consumer spending, and persistently sticky inflation have bolstered the case to maintain restrictive policy rates until either economic weakness becomes apparent, or inflation sustainably drops towards the 2% target. In response, key Fed governors adopted more hawkish language, which was reinforced by last month's updated dot plot showing one fewer cut forecasted in 2025. These dynamics drove bond yields upward as the consensus market view is once again a higher-for-longer policy environment. Now, the key question is "which will happen first?" An economic slowdown forcing the Fed to cut, or further demonstrable progress of lower inflation that allows for policy easing. Reignited geopolitical tensions and the looming presidential election further complicate the outlook, two factors worth monitoring in the medium term when assessing the path forward. Overall, we maintain the view that the combination of economic strength and sticky inflation creates difficulties in justifying a near term rate cut.

Inflation is Heading in the Wrong Direction

Last quarter, we pointed to sticky inflation as a catalyst that could cause the Fed to delay cuts; this has since played out. After bottoming at a 3.1% annualized rate in January, Headline CPI increased in two consecutive months to 3.5% in March. The timing of this uptick is noteworthy because March is typically a month where seasonal patterns are favorable for disinflation, so it is unsurprising that this particular print caught the Fed's attention. One dynamic contributing to the lack of downward progress is the catch-up effect between goods and services inflation. A good example of this is the auto market, where even though vehicle inflation is declining, prices are still over 30% higher than before the pandemic. As a result,

EPG RATE FORECAST

April 2024

MARKET RATE	Actual (%) 3/31/2024	Projected (%) 3/31/2025	Yr1 Δ	Projected (%) 3/31/2026	Yr2 Δ
FedFunds	5.50	4.75	-0.75	4.00	-0.75
Prime	8.50	7.75	-0.75	7.00	-0.75
3mthTsy	5.38	4.65	-0.73	4.00	-0.65
6mthTsy	5.32	4.55	-0.77	3.80	-0.75
1yrTsy	5.00	4.20	-0.80	3.70	-0.50
2yrTsy	4.62	3.80	-0.82	3.50	-0.30
3yrTsy	4.42	3.70	-0.72	3.45	-0.25
5yrTsy	4.25	3.65	-0.60	3.45	-0.20
10yrTsy	4.25	3.60	-0.65	3.55	-0.05
30yrTsy	4.38	3.55	-0.83	3.65	0.10

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: Fed easing pushed further into the future

Fixed Income Strategy: Do not forget about quantitative tightening

Equity Strategy: A pivot from rates to earnings focus?

ALM Strategy: 'Higher for longer' strategic approach

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ECONOMIC ENVIRONMENT

increases in car insurance premiums have lagged (20% rise in the last 12 months) and are still showing upward momentum. The Fed's latest Summary of Economic Projections supports a view that inflation may remain stickier than expected, as the report shows the central bank's preferred measure of Core PCE reaching 2.6% (was 2.4% previously) this year, 2.2% in 2025, and finally 2% in 2026. Chair Powell has been consistent in his remarks that until the Fed has increased confidence that inflation is moving sustainably toward 2%, the Committee does not anticipate it will be appropriate to lower rates.

While the conflict between Israel and Iran seems to have calmed somewhat, geopolitical tensions within the Middle East remain a wild card for the inflationary outlook. Gasoline was one of the largest drivers of inflation in March, and the possibility of sustainably higher oil prices remains if global oil supplies are disrupted.

Labor Market: What to Watch For

By most measures, the labor market has continued to fare remarkably well amid restrictive policy. Worker supply is low and demand is high, as shown in last month's jobs report (303k jobs created vs 200k estimate). However, early indicators of an employment slowdown exist. We must continue to point out that job growth remains concentrated in few areas of the economy, namely government, private health care, and leisure & hospitality. The public sector is particularly interesting; the government was the largest contributor in March with 71k jobs added, but it was also responsible for the majority of layoff announcements for the month. This suggests the pace of government hiring may slow in the coming months. So, where else is the labor demand coming from? The ratio of vacancies to unemployed workers is close to the pre-pandemic average for medium and large companies, showing that small businesses represent the majority of excess labor demand. Additionally, the number of workers holding multiple jobs is rising (8.4 million in March), implying that workers are searching for additional income sources amid still-high inflation and financing costs. Going forward, this number is worth monitoring given its role as an indicator of underlying stress in the economy.

When looking at the Fed's projections, there is an expectation for a rise in unemployment this year, but not by a significant margin. Policymakers see the jobless rate rising to an average of 4% by the end of the year, from the 3.8% seen in March, according to their median forecast. This year-end forecast is actually down from 4.1% a quarter ago, showing the view that a significant uptick in unemployment is unlikely in the next two quarters. Although some warning signs are emerging, we still believe a labor market contraction would likely take multiple quarters to materialize.

EPG Rate Forecast: Patience is Key

In recent months, market expectations have become more closely aligned with the EPG Rate Forecast. Various Fed officials, including Chair Powell, have repeated that they are seeking greater confidence that inflation is sustainably trending towards the 2% target before cutting rates. Following three consecutive months of hotter than expected inflation prints, it has become clear that it will likely take a longer period for the Fed to achieve that confidence. Currently, the fed funds futures market expects one cut by the September meeting and less than two cuts for the full year, in contrast to the Fed's own projection of three cuts in 2024. We have revised our forecast to project the first 25 basis point cut in December given the stickiness of inflation and lack of weakness in the labor market, consumer spending, and manufacturing activity. We are maintaining a long-term terminal rate of 4.0%, which represents a mild economic slowdown that spurs several additional 25 basis point cuts throughout 2025.

Moreover, the presidential election presents a challenge for

policymakers; the Fed is required to remain apolitical, and one can infer they would like to avoid any appearance of election interference. However, would this stop the Fed from initiating policy action if it is truly warranted? Western Asset Management studied the Fed's behavior in election years since 2004 and reached some interesting observations. First, the Fed delivers significant policy responses to macroeconomic shocks, regardless of impending elections. We saw this in 2008 and 2020, when policymakers cut rates and introduced stimulus/aggressive open market operations into the fall of election years. A more interesting theory is that the Fed may introduce a policy cycle change in the summer or winter rather than at the meetings directly before or after an election to avoid the perception of either propping up the economy for an incumbent or the lack thereof to support a challenger. The only case where this may have occurred is 2004, when former Chair Alan Greenspan began a hiking cycle in June of that year. Greenspan never stated the timing of the election was a consideration in that decision, but many have speculated that may have been the case. If Powell follows a similar playbook, the Fed may decide to avoid beginning a cutting cycle at the September or November meetings.

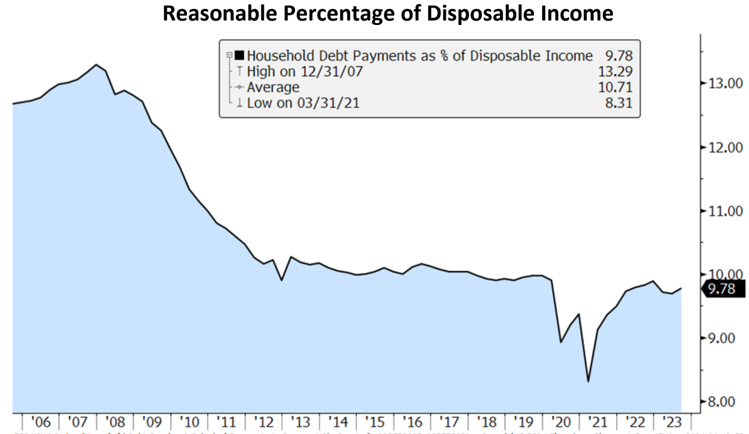
Yet again, we must ponder how long the yield curve inversion might remain. Given the outlook for delayed rate cuts, we see the inversion enduring into 2025, as curve normalization would likely require short term yields to fall much more sharply than the long end. However, a degree of flattening should naturally occur when investors begin to expect near term cuts.

Will the Consumer Continue to Support GDP Growth?

In post-pandemic America, the consumer economy has driven GDP growth, a trend that continued even after excess stimulus cash had been depleted for most households. Retail sales for March reinforce this pattern, growing 0.7% vs the consensus expectation of 0.3%. However, the longer this level of spending persists, the more important it is to ask whether it can be sustained. Record household debt levels coupled with high credit card interest rates certainly present a concern and may eventually cause a decrease in spending, but are consumers truly overextended in today's economy? To answer this question, we will once again point to the labor market. Real wage growth is now positive and in line with household debt growth, which slowed in the fourth quarter of 2023. Given this rise in income, household debt service payments as a percentage of disposable income (9.78% as of Q3 '23) are below the long-term average of 10.71%. This implies consumers should be able to continue repaying debt at current levels if wage growth remains above inflation.

Any combination of rapid increases in total household debt, higher credit card interest rates, slowing income growth, and/or accelerating inflation could cause this percentage to rise, potentially triggering a pullback in spending activity. For now, however, a runway for consumer-led GDP growth exists until the economy reaches this inflection point. ◆

For Now, Household Debt Payments Represent a Reasonable Percentage of Disposable Income



Source: Bloomberg

FIXED INCOME STRATEGY

FIXED INCOME STRATEGY

We may have seen the last rate hike, but when will we see the first cut?

Entering 2024 it was widely believed that interest rate cuts were on the horizon, as policy makers set the tone at the December FOMC meeting by increasing their interest rate forecast to three cuts, previously at two for 2024. Considering that any policy action was data dependent, this was initially accepted in a dovish manner by investors as the likelihood of rate hikes appeared to be over. The fed funds futures market quickly adapted and priced in six rate cuts for 2024, the first as soon as March. Following a period of unusually high inflation and rapid monetary policy tightening from March of 2022 to August of 2023, inflation has fallen significantly and has been hovering just above 3.0% in recent months.

Meanwhile, the United States labor market remains extremely tight, considering the FOMC's attempt was to lower inflation at the expense of ultimately slowing the economy and softening the employment picture. As a surprise to the economy during this period of aggressive policy tightening, the unemployment rate has remained consistently below 4.0%. As a result of lower than anticipated unemployment and still-sticky inflation to start the year, market sentiment has changed regarding not only how many interest rate cuts we may see but also the timing of the first cut.

Policy makers are faced with the risk of easing monetary policy too soon, which could allow slightly above target inflation to soften even further than the 3.5% CPI in March, creating pricing pressure again. Federal Reserve Governors' Bostic, Waller, Kashkari, and Chair Powell have all recently commented that the economy remains strong, and the first quarter economic results could warrant delaying and/or reducing the number of rate cuts this year. They are all concerned with disappointing inflation results in the first quarter coupled with robust hiring, providing the Fed flexibility to be patient with policy action in order for them to gain the confidence they need that inflation is back on path towards the long-term target rate of 2.0%. Unfortunately, unless we have an accelerated weakness in the economy, the "higher for longer" scenario will likely hold, even more so as we get closer to the election, giving officials another reason to be patient.

Will Quantitative Tightening Change?

With all the focus being on the fed funds rate, it seems investors have forgotten about another tool the Fed has used for easing and tightening of monetary policy. At an upcoming FOMC meeting it is likely that a modification will be made to "Quantitative Tightening." The Fed's investment

Source: Bloomberg

Yield Curve Changes

Term	12/31/2023	3/29/2024	Change
2 Year	4.25	4.62	0.37
3 Year	4.00	4.40	0.40
5 Year	3.85	4.21	0.36
7 Year	3.88	4.21	0.33
10 Year	3.88	4.20	0.32
20 Year	4.19	4.45	0.26
30 Year	4.03	4.34	0.31

portfolio size has declined since June of 2022 by nearly $1.5 trillion. At the moment, the Fed is considering when and how much tapering of the roll-off is needed. They are trying to avoid a similar event that happened in 2019, when there was a shortage of short-term U.S. Treasuries in the funding markets. This caused overnight repurchase rates to rise, adding stress to funding markets and Wall Street positioning of inventory. Currently, the Fed is allowing up to $60 billion of U.S. Treasures and $35 billion of Agency MBS to mature or roll off from principal payments on a monthly basis. With the rise in interest rates over the last 2 years, prepayment speeds on mortgages have plummeted and the monthly amount of roll off has not come close to exceeding the monthly cap of $35 billion. Fed officials have historically commented that if possible, they have a preference towards a Treasury only portfolio, however, it is unlikely they will sell MBS into the market. We also believe that they will continue to let MBS roll off their balance sheet in accordance with the monthly principal and interest payments. Where there could be a change, though, is in the Treasury holdings. They are considering lowering the monthly cap, which would allow them to reinvest the additional cash proceeds of maturing securities above the new cap level back into short term Treasury Bills. This would assist with the collateral shortage in funding markets as the Fed's balance sheet is a direct source for collateral in the repurchase market. Unlike other scenarios when the Fed had been purchasing bonds during QE periods, such short duration securities would have a minimal impact to longer term interest rates, but would help enhance liquidity in the funding markets.

Investment Alternatives

The long-term forecast from virtually all economists still calls for lower rates, regardless of the timing of the first cut. With the recent back-up in rates to start the second quarter, there continue to be opportunities to add accretive yield to existing balance sheets. The recent stronger than anticipated data supports the "higher for longer" scenario, as the ten-year Treasury has risen back above 4.50%. This level of rates has created another opportunity to add accretive yields that would enhance the book yields of current investment portfolios.

Agency (FNMA/FHLMC) CMO floaters are currently offered with a spread to SOFR of more than 120 basis points. This yield compares favorably to other AAA rated assets, with a positive spread to SOFR projected under all interest rate scenarios. In the base case, the floater's average life is approximately 5 years, which helps mitigate duration risk for interest rate sensitive balance sheets. Agency MBS also offer attractive yields, and have the potential for price appreciation as rates decline. With the recent back-up in rates,

discount priced MBS are available with more than 50 basis points of price protection before prepays are likely to increase. Additionally, discount to par MBS will prepay slower than current coupon securities in an environment headed towards lower interest rates, allowing investors to lock in attractive yields for an extended period. Investment grade credit spreads continue to remain below long-term historical averages, and at this time do not offer a worthwhile risk-return trade off. Comparably, Municipal bond spreads also remain below historical averages due to demand for longer term call protection in an inverted yield curve environment. ◆

EQUITY STRATEGY

Rates higher for longer? Implications for equity investing

Investor sentiment has shifted from one of optimism for Fed driven rate cuts in 2024 to one of a delay for rate cuts to as late as early 2025. While this is based on recent economic data showing a resilient economy to already elevated rates, a "higher altitude" view of the economy is reflecting a slowing of activity. Thus, the question that is raised is "if rates stay higher for longer, does this lead to equity markets being lower for longer?"

It is important to note that while recent pullbacks in equity prices have certainly reflected investor fears of higher rates, geopolitical turmoil has also played a role. The concerns related to an expanding and protracted Israeli war with Hamas and others such as Iran certainly were evidenced by recent volatility in the equity markets. These concerns seem to have abated – the fear gauge is dropping. The assumption that the Fed will likely need to delay what was communicated as a timeline for rate cuts during 2024, based on recent data remains the primary influencer of market volatility.

The concern over higher rates for longer is really the key driver of anticipated equity investment volatility over the coming months. "Bad news has been good news" for many equity sectors when looking at weakening economic data leading to assumptions of more aggressive rate cuts, and therefore lower rates leading ultimately to positive impact on corporate earnings.

Do historically higher rates mean historically lower returns?

It is important to look at history to determine if in fact, periods of historically higher rates lead to periods of historically lower equity returns. According to data from BMO Capital Markets looking back to 1990, during periods of higher bond yields, the S&P posted an average price return of 13.9% compared to an average gain of 6% during periods of rates dropping. While this one comparison is important for context, underlying this is the conclusion that earnings were such that they did not disappoint investors during such periods, and in fact the higher rate environment most likely reflected an underlying robust economy.

Is the equity investor's focus undertaking a "pivot" from rates to earnings?

A critical question to pose at this time is, "with the timing of Fed rate cuts being actually less certain, since a delay is the last step before cuts, do the equity markets pivot from rate-focused to earnings-focused?" Given the latest perspective of the Fed "needing" to be patient and not rush to cut rates so as to avoid "reigniting" inflation, this may finally end the anticipation and obsession on rate cuts and lead back to a more fundamental view by equity investors that is focused on earnings and forward-looking realistic guidance.

What is an important assumption for equity portfolio Investment in the coming months?

When looking at the economy from a macro perspective, U.S. economic data is showing that the rate of increase in activity in manufacturing and service sectors is slowing. This would support the view that while the Fed may wait until the fourth quarter of 2024 or early 2025 before beginning to cut rates, the likelihood of rate hikes is, while not impossible, remote at best. The stronger than expected growth trends are positive for the economy and corporate profits in the immediate term, however, an economy that while strong is moderating will likely create volatility in price movement of individual issues. Multiples, considered by many to be elevated by historic standards, and corporate earnings, either announced or projected, must meet or exceed what these multiples imply. For example, according to "Bloomberg Intelligence,"

EQUITY STRATEGY

the "Magnificent Seven" largest US stocks' profit lead is set to shrink in 2024. In particular, the forecast for the Seven's year over year net income growth has declined to roughly 20% which is far closer to the 10-15% that the S&P 500 is being forecast. In the fourth quarter of last year, the Seven had growth expectations of closer to 50% plus year over year compared to last for the S&P 500.What this means is that not only do companies need to meet and beat consensus estimates for earnings but also provide believable guidance as to how they will meet the 2024/25 operating environment – reflected in earnings forecasts that satisfy equity investors. The unknown is, "will profit growth from a stronger than expected economy improve and more than offset the concerns of higher than expected interest rate levels, or will the higher rates and the negative impact they may bring on the economy ultimately wipe out the shorter-term lift to earnings and overall depress earnings?"

What is the strategy for equity investing given this possible transition of equity investor focus?

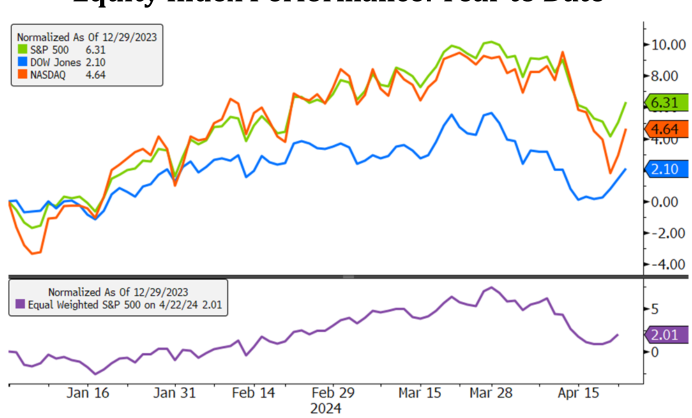
When looking to build and confirm equity portfolio strategy during this potentially volatile period of the months ahead, community bank equity portfolios should continue to incorporate several broader based, balance sheet level perspectives.

First, understanding and being comfortable with the longer-term investment horizon for investment grade total return driven equity selection is important to "see beyond" what might be a period of changing earnings forecasts and resulting elevated price volatility. Comfort levels are achieved and maintained by clarity around how changing equity values affect certain metrics such as month to month income since the change in value of equities flows through to the income statement and related performance measures. Shorter-term volatility in stocks can create shorter term volatility in earnings and certain capital calculations. A "range of acceptability" for volatility allows ongoing equity investment strategy during such periods.

Second, a realistic and relevant period for measuring performance is critical for equity investment strategy during potentially volatile periods. Performance is measured through not just the return as driven by dividend and appreciation but also relative to the cost of funding the equity. Currently, the cost of funding equity purchases is at 5% or higher, on the margin. A perspective of longer-term accretive spread looking out over 3-5 years is an important assumption that must be held, and underlying this, is the view that cost of funding will drop based on historic yield curve trends long-term and likely Fed action shorter-term.

Finally, understanding the long-term nature of the equity portfolio and its fit into the institution's particular business model drives both sizing and timing of equity portfolio activity. Alternative uses of funding, additional alternative sources of income, and alternative longer-term contributors to capital all help prioritize equity investment strategy, within the overall balance sheet management perspective. ◆

Equity Index Performance: Year to Date



Source: Bloomberg

ALM STRATEGY

Addressing the 'Higher for Longer' Rate Environment for the Balance of 2024

Now that we are officially in the 'higher for longer' operating environment, how does that impact balance sheet strategy for the remainder of 2024? Are there tactics that can be implemented in the short term to mitigate the impact of continued higher rates? Although most would prefer Fed easing to happen much sooner, we need to prepare, and expect, that the Fed Funds rate will remain near current elevated levels for an extended period.

Strategic Approach in the Current Environment

Actual year-to-date results for 2024, as well as projections for the remainder of the year, are near the lowest we have seen in quite a long time. Although there are a number of key drivers of the suboptimal performance metrics, funding costs jump out as the number one concern.

Funding Environment / Options

Although migration from cheaper non-maturity deposits to higher cost CDs continues, the pace seems to have slowed. However, the decline in NMD concentrations over the past year or so has left institutions with a more expensive, and more rate-sensitive deposit mix overall. The fight for CD money continues and is in a similar place to where we were a quarter ago, with 'higher for shorter' pricing dominating the industry. Higher yield savings and money market offerings have been effective at retaining funding, but generally not at generating significant new dollars (without cannibalization) in short order when needed. There also seems to be a renewed focus on commercial deposits, and although this is nothing new, institutions appear to be more aggressive about pricing with regards to the overall relationship, specifically offering better loan terms in order to secure the much needed funding. A component of this strategy requires help from the Fed, as an underwater loan rate offered to bring in operating account money looks much better over time as rates fall, making the existing loan rate more appealing in comparison.

Certain types of wholesale funding, although expensive, remain attractive compared with overnight funding near 5.5%. A case can be made for each of the following, as a modest component of a larger funding strategy:

Option Advances: For a modest amount of call risk, this funding source can provide a much needed benefit to strained margins. For example, a 3-year non-call 3-month advance was recently priced near 4.35%, about 100 basis points under overnight funding. With the Fed likely on hold until much later in 2024, combined with a modest easing cycle thereafter and potential terminal rate of 4%, this could be margin positive for nearly half of the original term. Plus, if the Fed stops at 4% on the way down, it may be only slightly underwater for the remainder of the term. If called, it could be rolled into another advance, or potentially not if deposit growth improves. A case can also be made for a small allocation to 5-year funding, as long as the rate is under 4% and you believe the Fed is likely to stop at 4%. In this case, the advance could remain margin positive / neutral through most of the 5-year window. This is certainly not a long-term solution, but more a stopgap that buys time until the operating environment improves, when the potential above market cost (assuming advance not called) can be more easily absorbed vs. the need to help margins today.

Brokered CDs: Although rates on short-medium term funding are only slightly below overnight funding, Brokered CDs do not use up precious borrowing capacity. With most institutions trying to lower borrowing concentration, these may be appealing, even if they look and act like borrowings.

Lending

Before the most recent runup at the longer end of the Treasury curve, competition for Commercial Real Estate lending had pushed rates into the 6.50%-6.75% range for many institutions. However, more recently that range appears about 50 basis points higher on average, with some able to generate activity a bit above that. Most institutions remain active with deals available, although some continue to pull back by pricing themselves outside of the market.

The theory is the same as the last few quarters, even with the Fed now on hold for longer than previously believed. Although overnight funding remains near 5.50% and will likely be there for some time, a high credit 5-year CRE loan at 7% remains attractive. Although the spread is below normal levels, that should improve as rates decline later in 2024 and into 2025, and from a pure rate standpoint, this may be the last, best time to lock-in attractive yields before the decline. Unless your borrowing concentration is prohibitively high, lending at 7% seems a more beneficial alternative to paying down wholesale funding or maintaining excess liquidity.

Similar to last quarter, the residential mortgage market remains slow, with people who want to move still 'trapped' in their homes by their low rate, pandemic era mortgage. This has led to a pickup in Home Equity activity, but certainly not enough to offset the lack of mortgage demand. This has resulted in increased CRE competition as institutions realize that if they want to grow their loan portfolios in 2024, it will not be in the mortgage area.

Financial Performance and Expectations for 2024

On the whole, business plans for 2024 assume very modest growth for loans and deposits, with many forecasting declines over the next year. In addition, the financial projections indicate historically low earnings, including many institutions bracing for losses this year. Driven by continued NMD migration and higher-for-longer rates, coupled with still high (but declining) borrowing concentrations, many are already significantly behind budget for 2024, with likely little possibility of making up lost ground. The question now becomes, how important is it to hit budget, and based on that answer, what are we willing to do to get there?

The answers to those two vital questions could drive strategy for the remainder of this year, but also more importantly, impact earnings for years to come. For example, consider the 5-year Option Advance discussed previously-compared with overnight funding costs, it could save 150bp or more for a sizable portion of funding, which could be enough to push earnings from marginally negative to marginally positive. However, that benefit supplements current earnings by essentially 'stealing' from future earnings; if rates decline more than expected, that advance will likely extend, leaving you with above market funding, potentially for years.

At times, fighting against the tide of an adverse operating environment may be a very challenging endeavor, while at other times it could be worse, leading to decisions that provide favorable short-term results but adversely

impact the longer-term. This may be one of those times. ◆

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