



# The ADVISOR

## Focus on Community Banking Issues

Third Quarter 2024

### ECONOMIC ENVIRONMENT

#### A Quarter of Conflicting Data

After years of a booming post-pandemic U.S. consumer economy, data is beginning to reflect the impact of last year’s monetary tightening. The key question is now whether the negative economic momentum is enough for the Federal Reserve to reduce its policy rate. Disinflation, as well as weakening employment and spending figures have caused economists to expect rate cuts as soon as September, but Fed officials have hesitated to comment on the possibility of near-term cuts. While the data has certainly been encouraging to those hoping for cuts, it has been sporadic and inconsistent. For example, consumer spending appeared to be weakening in May before un-

expectedly roaring back last month. In our view, the Fed will likely be patient to act, with the goal of avoiding a reversal in inflation by cutting too quickly. Officials have remained consistent in the message that at least a full quarter of deterioration is needed to consider cuts, so September action is possible if supported by July and August’s data. Even though a trend is appearing, we still believe more time is needed to determine whether a lower Fed funds rate would be restrictive enough to control inflation.

#### Inflation: Back on Track

Thankfully, the worrisome trend of sticky (and rising) inflation seen in the first quarter appears to have reversed. After increasing in December, February and March, Headline CPI decreased in three consecutive months to 3.0%, the lowest annualized reading since last June. Core CPI followed suit

by declining to 3.3%, and forward-looking inflation expectations have dropped as well; Powell called the June report “really good,” and the investment community has taken the stance that Fed officials are gaining confidence that price increases are sustainably decelerating.

In his appearance before the Senate Banking Committee this month, Powell also acknowledged that recent prints have shown “modest further progress,” a shift in tone from previous remarks this year where he cited a “lack of progress.” Month-over-month inflation was 0.2%, 0.5%, and 0.4% in July-September 2023, so monthly prints roughly in line with this May & June (0.0%, -0.1%) would significantly decrease the annualized rate, another encouraging sign.

EPG RATE FORECAST					
July 2024					
MARKET RATE	Actual (%) 6/30/2024	Projected (%) 6/30/2025	Yr1 Δ	Projected (%) 6/30/2026	Yr2 Δ
FedFunds	5.50	4.25	-1.25	4.00	-0.25
Prime	8.50	7.25	-1.25	7.00	-0.25
3mthTsy	5.36	4.20	-1.16	3.90	-0.30
6mthTsy	5.32	4.15	-1.17	3.80	-0.35
1yrTsy	5.11	4.10	-1.01	3.70	-0.40
2yrTsy	4.75	3.90	-0.85	3.60	-0.30
3yrTsy	4.55	3.80	-0.75	3.65	-0.15
5yrTsy	4.38	3.75	-0.63	3.70	-0.05
10yrTsy	4.40	3.65	-0.75	3.75	0.10
30yrTsy	4.56	3.70	-0.86	3.80	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:** Is the recent weak data enough for the Fed to act?

**Fixed Income Strategy:** Be patient, rate cuts are on the horizon.

**Equity Strategy:** Are we witnessing the rise of value investing?

**ALM Strategy:** Balance sheet management as we near Fed action.





# ECONOMIC ENVIRONMENT

## What's Really Going on with the Consumer?

Without question, the U.S. consumer's resilience is among the most surprising contributors to the increased likelihood of a "soft landing." Over the previous quarter, however, cooling labor market data and elevated reliance on credit card debt caused many economists to predict spending would taper off in the second half of the year. With this backdrop, expectations for retail sales in June were weak, as economists projected a -0.3% decline. Yet again, consumers dispelled concerns, as retail sales were flat for the month and May's number was upwardly revised by 0.3%. Beneath the surface, a growing divide is becoming more evident;

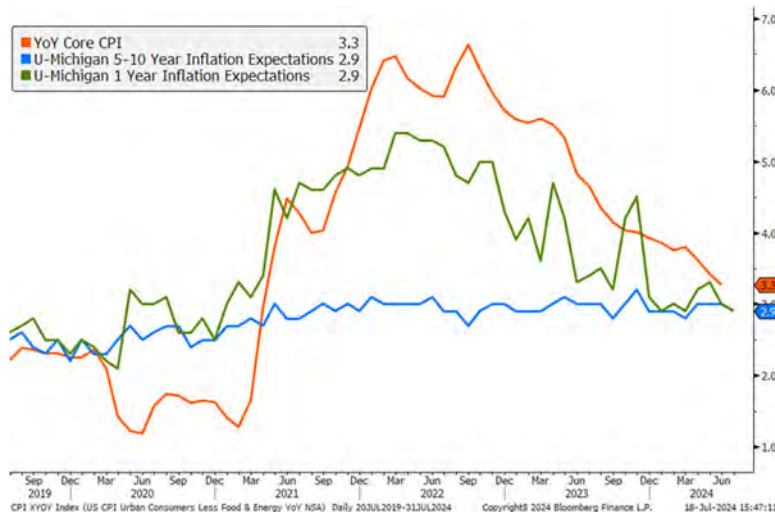
high-earning consumers continue to show significant demand for travel, dining and entertainment, while lower-income consumers are feeling more stretched. This has been reflected in several recent corporate earnings reports, such as McDonald's, Target and Walmart, causing a reinvigoration of the "value menu" at many major fast-food chains attempting to retain customers. A closer look at June's retail sales report supports this, revealing that consumers are limiting discretionary services spending at food and drink establishments, while increasingly directing goods spending toward categories where prices have fallen in recent months (nonstore retailers, furniture, building & garden materials, etc.) This implies that some consumers hesitated to spend beyond their means within these categories during the first half of the year, and if disinflation persists, this increase in "catch-up spending" could continue through year-end. While the consumer still appears strong overall,

a further slowing of wage growth represents a key risk; June's annualized pace of 3.9% was the smallest since June 2021 and declined from 4.1% in May. The current level of wage growth is still above trend (3-3.5% is consistent with 2% inflation over the long term per Reuters), but a possible continuation of the downward trend is worth monitoring.

## Labor Market: Early Innings of a Retreat

At surface level, the labor market is sending mixed signals. In a vacuum, a 206k payroll gain in June and 177k three-month average are strong numbers, yet the unemployment rate ticked up to 4.1% and has now risen by 0.7% since April 2023. While weaker, however, both of these measures still compare favorably with the 30-year averages of a 124k monthly nonfarm payroll gain and 5.6% unemployment rate. So, is this labor market still acting as the backbone of a resilient U.S. economy, or is it an indicator of an upcoming slowdown? This is a difficult question to answer, because a slew of downward payroll revisions suggests the level of job growth over the past year may have been overstated. Alternative indicators support a cooling labor market, as the quits rate has fallen to its pre-pandemic level, and the Consumer Confidence Index implies that consumers feel jobs are less plentiful than in 2019. Data from Indeed shows the number of new

## Short and Long Term Inflation Expectations Have Fallen Below 3%



## ECONOMIC ENVIRONMENT



full-time postings is declining, and that part-time jobs now account for most postings across the majority of sectors. One thing is clear: a labor market showing contradictory data represents some level of cooling from the yearslong boom following the pandemic. So, could further labor market deterioration lead to cuts? Based on Fed commentary and market sentiment, possibly. Interestingly, Chair Powell emphasized downside risks to the labor market in recent weeks, stating that the June jobs report showed labor market conditions had “cooled considerably” and that officials are “well aware that we face two-sided risks.” These comments imply the Fed is now placing equal weight on the employment portion of its dual mandate, a shift from the previous two years where price stability was the explicit priority.

### *EPG Rate Forecast: Cuts Not Imminent, but on the Horizon*

While the market has quickly pivoted to expect policy action in September, the Fed itself has been reluctant to provide many indications of this. Recent comments from Fed speakers have been more supportive towards easing, but the language from the June FOMC statement contradicts a September cut. After forecasting an additional, third 2024 rate cut last December, the Fed revised its dot plot last month to now project only one cut this year, implying that Fed governors do not yet feel the inflationary trend is sustaina-

ble enough to justify cutting as soon as September. We feel a downward revision from three to one is significant and representative of the voting members’ sentiment, and therefore were surprised the market seemingly has discounted this stance. Granted, the June FOMC meeting occurred prior to another encouraging CPI print and negatively revised jobs report, but the rapid market reversal seems overly optimistic. Currently, the Fed funds futures market is indicating a 99% probability of a 25 basis point cut in September and is pricing in about 64 basis points of total cuts this year. For reference, the probability of a September cut was rangebound between 50-60% from May-late June and was about 61% on July 1, showing just how quickly this shift in sentiment occurred.

Due to conflicting economic data and a Fed that wishes to avoid perception of political/election related influence, we continue to project the first rate cut in December. We still maintain a long-term terminal rate forecast of 4.0%, which represents a mild economic slowdown that spurs several additional 25 basis point cuts throughout 2025. We certainly believe the Fed is getting closer to a point where it feels comfortable reducing rates, but the economy has not yet reached the Fed’s threshold of “many” months of data supporting a sustained disinflationary trend. ◆



# FIXED INCOME STRATEGY

## FIXED INCOME STRATEGY

### *Be Patient, Rate Cuts are on the Horizon*

It may come as a surprise as the U.S. economy heads into the second half of 2024, but the anticipated policy landscape now seems better synchronized with Fed officials and the investor base. This represents quite a change from the start of the year, when the Fed initially projected three interest rate cuts, while Wall Street economists and the futures market were both projecting as many as six interest rate cuts this year. After an unexpected interruption to begin the year, inflation remained “sticky” for the first few months. May and June’s lower results across the board on the Consumer Price Index, Producer Price Index and Personal Consumption Expenditures all boosted investors’ confidence that inflation was back on track and that rate cuts had be-

come more likely later in the year. Meanwhile, the employment component of the dual mandate remains strong, with the unemployment rate near historic lows at 4.1%. For the better part of 2024, Nonfarm Payroll results have beat expectations, validating that even in an attempt to slow the economy with aggressive tightening, the impact has had a minimal impact on employment. Therefore, the economy appears stronger than many had expected it to be mid-way through 2024.

The June FOMC decision to leave rates unchanged was of no surprise to the Investment Committee. However, the revised forecast from three potential interest rate cuts to one was more aggressive than anticipated, implying the possibility of maintaining a higher-for-longer interest rate path. However, Powell and Fed Governors have commented that the next policy action is lowering the funds rate, which helped drop longer term rates back below 4.25% over the last few weeks. The Fed continues to wrestle with the timing of the first rate cut, with Powell also commenting on

the latest economic data suggesting that inflation remained elevated the first four months of the year. The recent inflation data has been encouraging and inflation is now back on a downward path, but Powell also made it clear that they would like more confidence inflation has been contained before they begin the next easing cycle.

The Investment Committee continues to maintain the view of data dependency regarding policy and that officials will have a difficult time cutting interest rates as soon as September. Our rationale is broad based and our forecast remains that the first rate cut will be in December, as a September cut implies too quick a deterioration of economic activity. Although that is possible, we believe the economic data continues to provide policy makers flexibility with regard to rate cuts. June was the first month to illustrate weakness in employment results, as monthly revisions continue to be revised lower while inflation finally trended lower again. If this trend continues in July and August it does open the door to the possibility of a rate cut in September. Policy makers have



Source: Bloomberg

Yield Curve Changes Year to Date

Term	12/31/2023	6/28/2024	Change
2 Year	4.25	4.75	0.50
3 Year	4.00	4.55	0.55
5 Year	3.85	4.38	0.53
7 Year	3.88	4.37	0.49
10 Year	3.88	4.40	0.52
20 Year	4.19	4.66	0.47
30 Year	4.03	4.56	0.53

## FIXED INCOME STRATEGY



been consistent with wanting to see more progress towards a 2.0% inflation rate and one month does not validate a consistent trend, however, the June inflation results continue to support rate cuts as month over month CPI fell to -0.1%, the first decline since May of 2020. We believe the July and August data will dictate whether September will be in play for policy, which in the near future will likely keep longer term rates range bound. As we get closer to a policy change, rates across the yield curve should drop and then stabilize, but for the time being, we do not expect the Fed to act as quickly as the futures market implies because the economy still remains intact.

### *Treasury Supply/Auctions*

The yield curve has been inverted for nearly two years, and although short term rates will likely drop later this year, it may be more difficult for longer rates to drop significantly from current levels. Ten Year Treasuries are in a range near 4.25%, while overnight funding costs are approximately 5.50%. The long end of the yield curve has been pricing in a recession scenario since July of 2022, and it seems more likely that we are headed for a softer landing. Given that backdrop and a 125+ basis point spread between funding and ten-year Treasuries, how much lower can the long end drop with a softer landing? In general, Treasury auctions have become larger over the last year and duration demand has been thin, with banks' appetite a fraction of what

it once was and the Fed only investing in short term bonds. Unless the Fed were to modify quantitative tightening or bank liquidity were to increase significantly from here, it should minimize the technical demand for duration and prevent what typically would have been a meaningful drop in longer rates when an easing cycle begins.

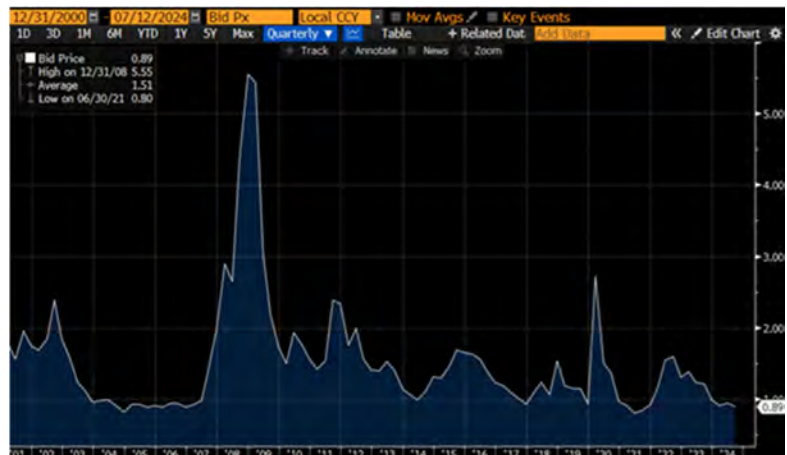
### *Fixed Income Opportunities*

While credit markets continue to shrug off potentially weaker economic conditions, spreads remain firm. Over the last few years, the curve inversion and demand for bullet-like structures have minimized opportunities within credit markets at accretive yield levels. Comparably, Municipal bond spreads also remain below historical averages due to demand for longer term call protection with an inverted yield curve.

Opportunities continue to exist within the Agency mortgage market, in both fixed rate and floating rate securities. Agency Floaters remain near historically wide spread levels above SOFR and

complement existing portfolio holdings of primarily fixed rate securities, while helping to manage interest rate risk from an ALM modeling perspective. Although rate hikes are likely behind us, the risk across the banking sector continues to be concentrated in the higher interest rate scenarios. As rates decline, they will reset lower, but with terminal rates across Wall Street economists expected near 4.0%, the additional spread (compared with historical levels) should allow for continued attractive yield levels. Projections for Agency fixed rate discount MBS remain attractive even as rates decline, as they offer upside price potential and favorable prepayment characteristics when interest rates drop. ♦

U.S. Corporate Investment Grade average OAS Since 2000



Source: Bloomberg



## EQUITY STRATEGY

### *EQUITY STRATEGY*

#### *The Rise of Value Investing?*

#### *The Fed continues to be at the forefront*

With the expectations of many investors that the Fed will begin reducing short term rates in September, with a potential of 5 cuts or more, there has been a shift in where equity investment dollars have been flowing. “Value” search has become a key dynamic when looking at both the consumer and the investor. The implications of this on how one looks at the markets and makes investment decisions are significant and do not just lead investment sentiment but may be a forward-looking gauge as to the uncertainties of overall economic activity, both in the short and medium term.

#### *What is the Fed’s goal when it begins reducing rates?*

A critical question that must be asked when contemplating likely Fed action is, “for what reason is the Fed looking to reduce rates?” The June CPI release increased the likelihood of Fed rate cuts, and this dynamic has motivated investors. From an equity investor’s standpoint, a slowing economy is the platform upon which the Fed will decide when to cut rates. A “proactive” stance by the Fed of cutting rates to stay in front of the

degree of economic slowdown and ensure a “soft landing” significantly differs from a “reactive” stance of trying to shift the trajectory of a material slowdown in the economy and a resulting recession, through rate cuts. Market expectations of an easing cycle through July of 2025 would indicate more of a focus on avoiding a volatile boom/bust scenario and is also leading investors to shift into positions that will benefit from more aggressive Fed rate cuts.

The US job market is now, after much delay, showing a slowdown. The unprecedented environment of multiple job openings for every individual looking has moderated with fewer job openings in the marketplace, and in certain sectors, layoffs are occurring. Given this though, most analysts anticipate low unemployment continuing, even with fewer job openings and associated reductions in upward wage pressure. Data is showing decelerating inflation, and the combination of low unemployment even as the job market cools, with some price relief finally benefiting consumers is underlying an investor focus of where to allocate investment dollars in equities, versus reducing or eliminating exposure to equity holdings overall.

#### *As always, the consumer matters*

Understanding the behavior of the consumer is critical when assessing the equity market over the remainder of 2024 and into

2025. The consumer, particularly in middle to lower income brackets, is shifting towards a focus on value spending. Inflation, while slowly abating, continues to place massive pressure on household budgets and this, combined with high borrowing costs and rising unemployment, is contributing to a softening economy. According to Goldman Sachs, each percentage point rise in the unemployment rate can lower overall spending growth by about 0.6 percentage points. For all these reasons, consumers are expected to spend less and look to obtain maximum value from each dollar spent. This is starting to be reflected in where spending is taking place, such as slowing discretionary spending as shown for example, in Target’s latest sales figures. Thus, with a softening economy and consumers not only spending less but also looking for value from those dollars spent, value seeking consumers are leading to value focused equity investors. Business spending, however, is expected to continue in the “soft landing” scenario that the Fed is currently focused on when enacting policy and associated anticipated rate cuts. Sectors that benefit from business spending, such as industrials, as well as select consumer and technology should be part of the equity investor’s priorities for value-oriented equity portfolio building and management. The anticipated shape of the yield curve also drives equity sector preference with lower short-term rates



# EQUITY STRATEGY

compared to longer rates benefiting industries such as banking, which is reflected in recent equity price movement of bank and financial services issues.

### *Rotation in Equity markets-from aspirational, transformative thinking to earnings focus*

With economic growth subsiding versus collapsing, and corporate earnings reflecting this, earnings data and fundamental strength of corporate balance sheets now guides equity investing, as seen by the recent selling pressure within technology and other industry groups investing in the future versus shorter term earnings focus. The story stock that is “transformative” such as in the area of artificial intelligence, is now being told that earnings matter and the investment in tomorrow, needs to be showing results today.

Positions in high P/E stocks are declining as investors take profits and reduce exposure. Until recently, any indication of the possibility of rate cuts by the Fed would lead to optimism and price appreciation in those equity positions that reflected high growth and exciting “stories.” Most recently, the opposite has occurred. Information Technology and Communication Services have been two of the most lackluster performing sectors in July.

### *Political impact on equity market rotation and value investment focus:*

When looking at a possible Trump administration, smaller domestic focused companies are being viewed as beneficiaries of the more “protectionist” trade agenda that the Trump administration would likely enact. An extension of the 2017 tax reform would also help corporate profits, but the “anti-China” trade stance of a Trump administration with associated tariffs has already created selling pressure in the semiconductor industry.

However, control of Congress is most critical. Many political analysts believe a divided Congress will likely ensure a status quo on policy as it currently stands. With the change in the Democratic ticket, it is still uncertain if any material changes would occur in the party’s priorities for the economy and markets.

### *Portfolio construction: Long term growth as the platform, with a shorter-term value focus*

A cooling economy, subsiding inflation, and a slowing employment picture are either reflecting or contributing to a short-term outlook for an earnings-challenged equity investor environment. Investment in industries and leadership positions that will continue to benefit from value-oriented consumer and business spending indicate that earnings stability and growth is a priority over the coming months for portfolio composition. Buying names that meet these dynamics with attractive valuations, whether at the bottom of technically oriented “price channels” or based on fundamental focus, is a timely strategy. Longer term, focusing on now out of favor, higher-growth, more volatile

### S&P 500 Month-to-Date Sector Performance

Groups (11)	Return
S&P 500 ECO SECTORS IDX	0.46%
All Groups	
S&P 500 REAL ESTATE IDX	6.08%
S&P 500 FINANCIALS INDEX	5.23%
S&P 500 UTILITIES INDEX	4.53%
S&P 500 INDUSTRIALS IDX	3.56%
S&P 500 MATERIALS INDEX	3.42%
S&P 500 HEALTH CARE IDX	2.73%
S&P 500 CONS STAPLES IDX	2.20%
S&P 500 CONS DISCRET IDX	0.41%
S&P 500 ENERGY INDEX	0.06%
S&P 500 INFO TECH INDEX	-2.87%
S&P 500 COMM SVC	-5.49%

Source: Bloomberg



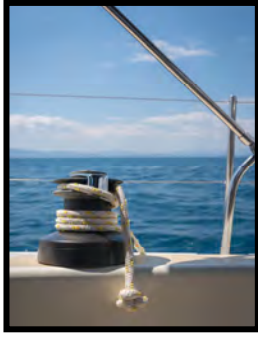
## EQUITY STRATEGY

sectors such as select technology and communications, watching for attractive reduced-price levels is part of the “blend” of ongoing portfolio management and construction.

*Value investing is part of an integrated investment strategy, not the only strategy*

It is important to note, that while the trend of earnings focus and value investing is rising, longer term economic forecasts would dictate that high-growth, transformative industries such as technology and communications will continue to be critical components in both the global economy and therefore, equity portfolio positions. Value investing is part of an ongoing integrated investment strategy, not the sole strategy. Equity investment time horizons, earnings drivers, and the forward-looking outlook for how earnings will be derived from a changing new economy continue to guide sector allocation and performance expectations. ♦





## ALM STRATEGY

### *ALM STRATEGY*

#### *Adjusting our Approach to Balance Sheet Management as We Near Fed Policy Action*

As recently as last quarter we discussed the ‘higher for longer’ operating environment, but how quickly things change! Fast forward three months and we now have a consistent downward trend in CPI data (however, not enough to imminently cut rates) combined with a slowing job market (although also not enough to warrant a cut quite yet) and weaker sentiment. How does this impact loan and deposit pricing, and what other factors remain at play?

#### *Addressing Concerns with Lending*

The current lending landscape differs tremendously from institution to institution, as each navigates the current operating environment a bit differently. There are, however, a few consistent themes across the industry.

#### *An Aversion to Residential Lending*

Financial institutions seem reluctant to add additional longer-term, fixed rate residential loans to their balance sheets. The main driver is the historically low level of prepayments since the Fed initiated its rapid tightening cycle, leaving many institutions overly concentrated in longer duration, lower

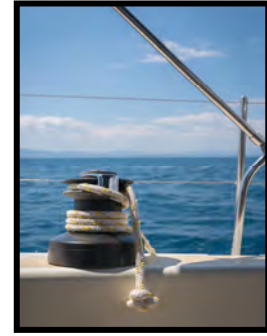
yielding pandemic era loans. Loans written today, however, provide rates about 400 basis points higher than those loans, which should make them far more attractive than their lower coupon counterparts. However, the fear is that as the Fed lowers rates, the loans written recently will prepay much quicker, leaving portfolios once again with mostly lower yielding loans two or three years from today. As a result, many have just decided to pass, and given current low inventory levels, it is easier to avoid this category than in the past. While very few have announced a complete exit from this type of lending, many are pricing themselves out through higher-than-market rates. The theory is that once the market improves, and concentrations decline, it will once again be an attractive asset class, but until that point, if a borrower wants to ‘overpay’ they will happily write the loan.

However, for those still lending, current rates remain attractive, especially given the likelihood of an easing cycle starting later this year. Hesitation to lend based solely on current spread may ignore the potential for wider spreads in the next few months, driven by lower overnight funding costs, but also by a potential increase in cheaper deposits. Once the Fed starts to cut, short-term Treasury rates should decline, making bank CDs relatively more attractive while easing some pricing pressure. In addition, if the economy slows toward the end of the year, consumer spending may decline, leading to increased non-maturity deposit balances.

For those holding off, even if liquidity improves early next year, mortgage rates could be 100 basis points lower. Would you rather lend at 7% now, even if it needs to be funded at 5.5%, or hold off until next year and lend at 6%? While the funding may be cheaper, the spreads may not be materially different, however, the decrease in funding costs will make the 7% loan much more attractive. Assuming rates will decline while the economy may weaken, this may be the last, best time to add assets at current levels. Waiting until next year to jump back into the residential market may be too late.

#### *Wide Variations in CRE Pricing*

As opposed to fixed rate residential lending, no one appears to be avoiding CRE lending. The issue that we hear consistently is that prices exhibit wider variations than normal from institution to institution. For example, the rough average range we hear today is 7%-7.25%, although we have seen rates in the low-mid 8% area, as well as heard from clients who lost deals to other institutions that were near 6%. This is impacted by assumed floors at some lenders, who have decided to not lend below a specified rate (generally in the low 7% range currently). That near 2.5% range in CRE pricing feels significantly wider than normal. For those expecting a more aggressive Fed (compared with market expectations) being more competitive on price makes sense-lock in attractive loans now at slightly under market rates and



wait for the funding cost to decline and boost margins (same theory as mentioned with residential mortgages).

Compared with residential lending, CRE has a much more favorable prepayment profile, driven by prepay penalties that don't exist in residential. While the fear is that falling rates will shorten the lives of mortgage loans, that is mitigated significantly with commercial, especially in the first couple of years. Given the choice, most have been opting for CRE at 7% with a likely life of more than 3 years rather than a 7% residential mortgage with the same rate but a potentially shorter life. The other key issue at play is the weak loan growth seen at many institutions in the first half of 2024. For those trying to stick to budget (not everyone is), they realize that given the lack of residential mortgage activity, it must be done on the commercial side, resulting in banks fighting aggressively for every deal.

### *Key Takeaways from Client Comparison*

Every year, EPG conducts a client comparison by analyzing various data points across our client base, which can then be utilized for benchmarking and trend analysis. Although each institution is different, the aggregated data can provide an overview of changes in the operating environment that impact every financial institution. Possibly the best recent example is how the rapid rise in interest rates has altered depositor behavior. Due to intense competition in certificates of deposit (CDs), the proportion of non-maturity deposits compared to total deposits has

decreased significantly. In Q1 2023, our client average was 80.45%, whereas in Q1 2024, it dropped to 65%. This decline not only negatively impacts margins, but also modeled valuation, as longer duration non-maturity deposits are replaced with shorter duration CDs, and in the current market, the CDs are even shorter as institutions prepare for a Fed rate cut. To mitigate the outflow of non-maturity deposits, clients have increasingly opted for High Yield Savings Accounts (HYSA) and Tiered Money Market accounts. HYSA, for instance, now incur costs of 3.50% or higher to maintain those deposits, while rates for tiered money market accounts have risen to 4%-4.50% for top-tier balances. Despite these expenses, leveraging these accounts has proven effective in stabilizing the outflow of non-maturity deposits. It's anticipated that once the Federal Reserve begins easing, there may be a lag of 3-6 months on the impact to non-maturity deposit accounts. However, unlike CDs, the institution retains control over the rates of these accounts.

The industry has faced margin compression due to an inverted yield curve and limited liquidity. As loan demand decelerates and costs for deposits and borrowings rise, earnings have suffered adverse impacts. Net interest margin (NIM%) has declined from an average of 3.20% in Q1 2023 to 2.46%. Concurrently, return on assets (ROAs) has decreased from 0.64% to 0.50% on average. However, the 0.50% average may

overstate actual financial performance, as the median ROA of 0.33% is likely a better measure. The 50 basis point figure is driven by a small number of institutions with very strong ROA's driven by specific events such as equity gains and off balance sheet items. Clients have aptly described the current situation as "treading water," and regrettably, this challenging environment may persist for the next 6-12 months.

In an environment where the banking community continues to suffer tight margins driven by both higher funding costs and limited loan growth, callable advances remain an attractive alternative to boost margins. Consider the previous discussion of margins, specifically the impact of funding a 7% loan with 5.5% overnight funding. That 7% loan tends to look much more appealing when funded with a combination approach that includes sub-4% funding, lowering the overall funding cost to 4.75% (assuming a 50-50 funding split) while boosting the spread from 1.5% to 2.25%. In addition, if you agree with EPG's rate forecast of a 4% terminal rate for Fed Funds, the recent 3-year advance with a quarterly call at 3.96% indicates that at worst, you should be flat to funding costs even if the advance extends to its stated maturity. (Cont'd)

Tight liquidity industrywide has led to increased utilization of the Federal Home Loan Bank to a much greater degree over the past year. For example, the Q1 2023 Wholesale % on average was 6.5%, compared to Q1 2024 of 10.60%, however, similar to the ROA data above, this data may hide actual operating pressure.

When additional sources of external funding such as Brokered CDs are included, the 'real' wholesale % may be closer to 15%. This tighter liquidity environment impacts the ability to lend, depresses earnings, and leads to a balance sheet that is less flexible or able to take advantage of opportunities in the marketplace. We have seen

many institutions pass on quality loans that they normally would jump at, for fear of using up what precious little liquidity they have left. A decline in wholesale concentrations would be a welcome event and allow a return to a more 'normal' operating environment. ♦



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