Capital Markets Group

Weekly Review—January 17, 2020

At this point, the Fed is expected to maintain its overnight benchmark rate at 1.75% (upper-bound) through most of 2020 as policy makers continue their "economy is in a good place" message. Yet, Fed Chairman Powell told Congress last fall that "the new normal now is lower interest rates, lower inflation, probably lower growth…all over the world not just in the U.S." As a result, he said, the Fed is revisiting current monetary policy framework by looking at tools that will help stimulate the economy once interest rates go to zero. While a soft economic landing is expected, the idea that the Fed is preparing for possibly lower rates should cause treasury professionals to re-examine their current asset/liability (ALM) strategies. Depending on your institution's current ALM risk profile, the below list of select ALM best practice ideas might be worthy of consideration:

Best Practice Ideas - Loans

- Continue to originate loans funded with core deposits and/or bond portfolio run-off – Nothing new here as this fundamental idea is the basis of the community banking business model!
- As the change in business cycle nears, net interest margin will be primarily driven by the actions taken today on the earning-asset side of the balance sheet.
- Consistent with the late stages of the credit/business cycle, continue to proactively manage the bank's credit risk. Borrowers that have struggled with profitability/cashflow in recent years will likely be more challenged as the economy continues to slow. On substantially weaker credits, it may be prudent to either manage them up or manage them out – depending on the bank's risk appetite.
- Selectively extend loan duration to help protect earnings against lower rates.
- If not already, consider incorporating prepayment penalty language into longer-term loans. This may help mitigate the decline in earnings normally associated with lower interest rates.

Best Practice Ideas - Investments

- When adding duration, understand how embedded optionality in select investments can impact their overall performance. Limit negative convexity. Depending on the investment, include principal lock out protection when possible.
- When redeploying earning assets, shifting duration out of the bond portfolio into the loan portfolio will likely improve margin. Over time, shifting duration out of bonds into loans will mitigate any increased EVE volatility associated with extending asset duration.

Best Practice Ideas - Funding

- Depending on the balance sheet's current risk profile, consider shortening liability duration in preparation for potentially lower interest rates.
- If not already, flatten standard CD offering rates consistent with the current shape of the treasury curve.
- Continue to proactively manage deposit rates to attract and retain relationships, and in conjunction with overall funding needs.
- Rather than offering CD Specials, offer a second, more aggressively priced MMDA to only the most rate-sensitive depositors on a case-by-case basis. The bank's current MMDA product should continue to be the bank's primary MMDA product. This higher-priced MMDA product allows the bank of meet the needs of its most rate sensitive depositors without impacting the entire MMDA pool. **By shifting depositors from CDs to NMD products, the bank can better manage its COFS if/when short-term rates decline.**
- In terms of wholesale funding, adding optionality via callable brokered CDs or putable FHLB term advances gives management the ability to reduce funding costs if/when rates decline.

As previously mentioned, **the appropriateness of the above-listed ideas is largely dependent on your institution's current ALM risk profile.** Feel free to contact CMG's ALM team if you wish to further explore ways to help protect earnings and capital from downside risks.

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NEW ISSUE MUNICIPAL CALENDAR			
Date	Amount ($)	Description	Maturity
01/20/2020		DR MARTIN LUTHER KING JR DAY (BANK HOLIDAY)	
01/21/2020	$4,675,000	VALLEY CENTER KS UT GO BQ AA-	2021-2044

ECONOMIC CALENDAR				
Monday 1/20	Tuesday 1/21	Wednesday 1/22	Thursday 1/23	Friday 1/24
		MBA Mortgage Applications Existing Home Sales	Initial Jobless Claims Leading Index	Markit US Manufacturing PMI

KEY INDICES	Current	Last Month	One Year Ago
Prime Rate	4.75	4.75	5.50
Discount Rate	2.25	2.25	3.00
Fed Funds Rate	1.54	1.56	2.40
IOER	1.55	1.55	2.40
1-Month Libor	1.66	1.74	2.51
11th Dist COFI	1.04	1.10	1.06
1-Yr. CMT	1.54	1.54	2.57
Dow	29,348.10	28,267.16	24,370.10
NASDAQ	9,388.94	8,823.36	7,084.46
S&P 500	3,329.37	3,192.52	2,635.96
Bond Buyer	2.56	2.74	4.19

MUNI AA—BQ	
3 Mo.	0.87
6 Mo.	0.90
1-Year	0.92
2-Year	0.96
3-Year	0.97
5-Year	1.00
7-Year	1.17
10-Year	1.44
30-Year	2.14

Treasuries & New Issue Agencies *(Spread to Treasuries)*	Treasuries	Bullets	NC-6 Mo.	NC-1 Year	NC- 2 Year
3 Mo. Bill	1.55				
6 Mo. Bill	1.55				
1-Year Bill	1.53				
2-Year Note	1.56	3	11	3	
3-Year Note	1.58	3	55	15	
5-Year Note	1.63	6	41	33	18
7-Year Note	1.75	17	44	37	24
10-Year Note	1.84	29	62	52	42
30-Year Bond	2.30				

CMO Spreads to Treasuries	PAC	Vanilla
1-Year	N/A	+42
2-Year	45	56
3-Year	55	68
5-Year	68	78

MBS Current Coupon Yields	
GNMA 30 Yr.	2.37%
FNMA 30 Yr.	2.64%
GNMA 15 Yr.	1.98%
FNMA 15 Yr.	2.22%

About the Author, Dennis Zimmerman

In 2015, Dennis joined Commerce Bank's Capital Markets Group as Manager of Asset/Liability Services. With his leadership, the Capital Market's ALM team provides asset/liability management consulting services to community banks.

Prior to joining Commerce, he was employed for nearly 26 years at one of the largest privately-held banks in Kansas. In addition to managing a $775 million bond portfolio, his Asset/Liability Chairman responsibilities included managing margin, interest rate risk, liquidity and capital. Prior to becoming the bank's Finance Treasury Officer, he was a Registered Investment Representative and Supervising Principal in the bank's Capital Markets division.

As a seasoned professional, Mr. Zimmerman offers a comprehensive understanding of bank finance treasury, fixed income, complex financial analysis as well as regulatory and operational awareness. As a banker, he understands the challenge of balancing shareholder expectations within appropriate levels of risk.