Capital Markets Group

Weekly Review—January 19, 2024

As mentioned in an earlier writing, I believe 2024 will continue to be a funding story for banks. The management of cost of funding remains critical to net interest margin performance (the difference between what banks earn on assets and pay out on liabilities). On the asset side, we continue to see lending take place, providing banks with relatively high interest rates on these assets and providing some protection to margin if interest rates decrease farther this year. The challenge ahead remains in finding the terminal rates for bank funding.

When the Federal Reserve began raising its benchmark overnight interest rate, financial institutions utilized a lag, or delay, in increasing rates paid on deposits. This is common and expected as core deposits are priced lower than money market funds or other more volatile investment products. Over the past 15 or so years, banks and credit unions became used to stable funding and as an added benefit, relatively cheap funding. Why? The Federal Reserve kept its benchmark rate close to zero for almost a decade. When the FOMC voted to raise overnight rates, it quickly had to lower them back down due to economic downturns or extreme shocks like the pandemic in 2020. This resulted in bank managers expecting the same old story going into a new decade. Even though inflation was rampant and at levels unseen since the 1980s, financial institutions were reluctant to increase the costs it pays for funding their lending and investing activities. As we rolled through 2023, lower costing deposits decreased and have been replaced with higher costing Certificate of Deposit rates and wholesale, or non-core funding products.

Bank investors have experienced a shock to the value of some of their bond holdings because of the rapid rise in interest rates, resulting in unrealized losses (paper losses) in their fixed income portfolios. This coupled with the shock of runoff of low-cost funding has caused some reluctancy in buying more bonds and further pressure on net interest margins. One answer provided by the Federal Reserve was the Bank Term Funding Program (BTFP). This program allowed financial institutions to pledged certain fixed income investments to the Fed at par – instead of the lower fair value – and receive funding at a market rate. As an emergency measure, the program is expected to expire on March 11th of this year. With the futures markets pricing in several rate cuts, the rate on the BTFP borrowings has fallen below 5% and incentivized banks to borrow below 5% and park some of the funding at the Fed and earn 5.40% - an arbitrage. This "trade" has ramped up over the past two months (see Bloomberg chart).

Cost of funds management remains critical to bank margins. Wholesale funding options will price lower faster than core deposits. And we can see how creative and agile bank managers can be when given an opportunity from interest rate movements and programs that provide a benefit. Look for similar dislocations in market rates to help manage costs on funding. Good luck and please reach out to discuss.

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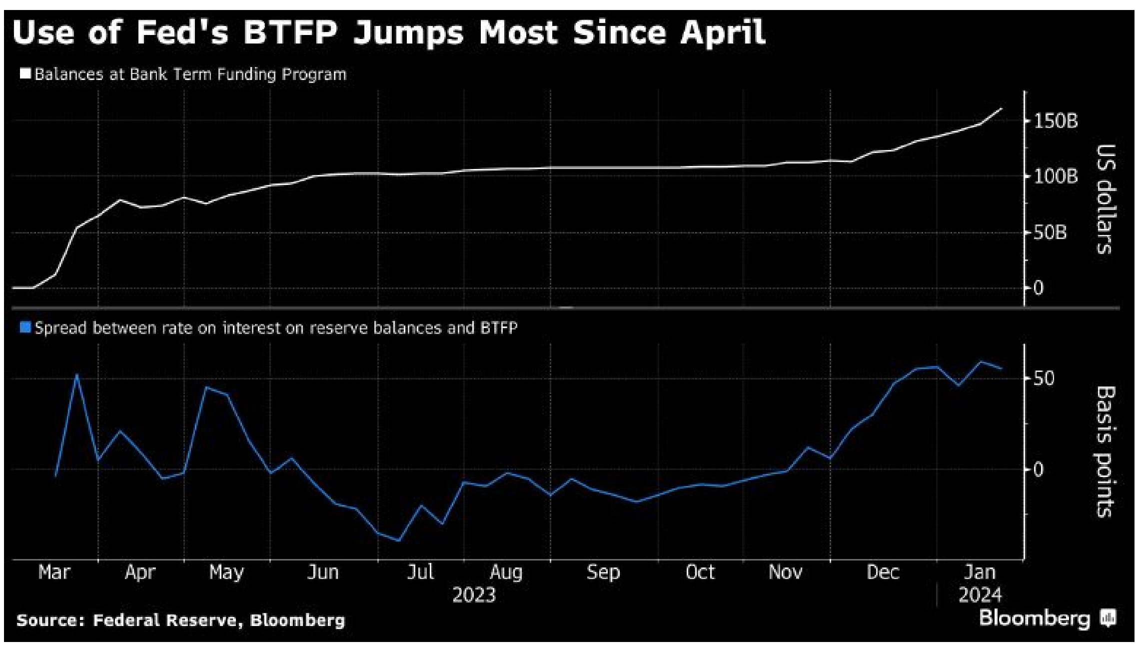

NEW ISSUE MUNICIPAL CALENDAR			
Date	Amount ($)	Description	Maturity
01/24/2024	$2,455,000	PLATTSBURG MO-COPS BQ A	2025-2049

Economic Release	Data Period	Date	Survey	Actual	Prior
Empire Manufacturing	Jan	01/16/2024	-5.0	-43.7	-14.5
MBA Mortgage Applications	Jan 12	01/17/2024	NA	10.4%	9.9%
Retail Sales Advance MoM	Dec	01/17/2024	0.4%	0.6%	0.3%
Industrial Production MoM	Dec	01/17/2024	-0.1%	0.1%	0.0% (rev down)
Housing Starts	Dec	01/18/2024	1,425k	1,460k	1,525k (rev down)
Building Permits	Dec	01/18/2024	1,477k	1,495k	1,467k (rev up)
Initial Jobless Claims	Jan 13	01/18/2024	205k	187k	203k (rev up)
Continuing Claims	Jan 6	01/18/2024	1,843k	1,806k	1,832k (rev down)
U. of Mich. Sentiment	Jan (P)	01/19/2024	70.1	78.8	69.7
Existing Home Sales	Dec	01/19/2024	3.83m	3.78m	3.82m

KEY INDICES

	Current	Last Month	One Year Ago
Prime Rate	8.50	8.50	7.50
Discount Rate	5.50	5.50	4.50
Fed Funds Rate	5.33	5.33	4.33
Interest on Reserve Bal.	5.40	5.40	4.40
SOFR	5.31	5.32	4.30
11th Dist COFI (ECOFC)	3.12	3.09	1.86
1-Yr. CMT	4.84	4.95	4.63
Dow	37,863.80	37,557.92	33,044.56
NASDAQ	15,310,97	15,003.22	10.852.27
S&P 500	4,839.81	4,768.37	3,898.85
Bond Buyer	3.39	3.41	3.33

MUNI AA—BQ

3 Mo.	3.14
6 Mo.	3.10
1-Year	3.00
2-Year	2.72
3-Year	2.63
5-Year	2.46
7-Year	2.46
10-Year	2.51
30-Year	3.75

Treasuries & New Issue Agencies *(Spread to Treasuries)*

	Treasuries	Bullets	NC-6 Mo.	NC-1 Year	NC- 2 Year
3 Mo. Bill	5.35				
6 Mo. Bill	5.21				
1-Year Bill	4.83				
2-Year Note	4.41	3	82	81	
3-Year Note	4.20	2	85	82	81
5-Year Note	4.10	3	98	94	86
7-Year Note	4.16	22	106	99	89
10-Year Note	4.19	43	120	111	100
20-Year Bond	4.52				
30-Year Bond	4.40				

CMO Spreads to Treasuries

	PAC	Vanilla
1-Year	N/A	+50
2-Year	60	80
3-Year	90	100
5-Year	105	115

MBS Current Coupon Yields

GNMA 30 Yr.	5.37%
FNMA 30 Yr.	5.50%
FNMA 15 Yr.	4.88%

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The Weekly Review is a publication of the Capital Markets Group of Commerce Bank.