Weekly Review—June 19, 2020

As mentioned in our March 27 Weekly Commentary, the business model of banking is inherently full of risk. Whether it's credit, interest rate, liquidity and/or price risk, we purposely take risk to make money. While most community bankers are quick to state that income is largely driven by credit risk, those that have the responsibility of managing the institution's net interest income (NII) understand that the shape of the treasury yield curve plays a key role in optimizing earnings. As stewards of NII, the Asset/Liability Committee (ALCO) has the responsibility to maximize NII throughout the stages of the business cycle. Stated differently, the goal of asset/liability management is to maximize net interest income regardless of changes in interest rates. (Side note: I would be remiss if I didn't mention that this important goal must be done within the confines of acceptable levels of risk as defined by management.) Positioning the balance sheet to maximize NII in all stages of the business cycle requires treasury professionals to understand how their balance sheet volume and mix (cashflows) will change in different rate environments. As cashflows change, so do earnings.

In normal economic conditions, the treasury curve is positively sloped whereas short-term interest rates are lower than longer-term rates. This normalized curve makes it easier to maximize NII as banks use short-term funding to purchase longer-term assets – loans and/or investments. A flat treasury curve – where there is no material difference between short-term interest rates and longer-term rates – puts pressure on NII as both sides of the balance sheet reprice at basically the same rate. This lack of spread weighs on NII. Long-standing inverted curves cause NII to contract even faster as the institution's cost of funds could; in theory, exceed its longer-term asset yields.

The unprecedented decline in interest rates combined with changes in the shape of the curve have taken a toll on net interest margin. Over the last 18 months, we've seen the impact to bank margins associated with the shift from a normalized treasury curve to a flat curve to an inverted curve back to a normalized curve only to have the Fed drop short-term rates on near zero.

With earnings under extreme pressure, where do we go from here? Using the ALM model, your institution can run multiple earnings simulations based on management's expected path of interest rates. As a tool, the simulation model will quantify the impact to earnings based on an unlimited number of rate paths. Based on model output, ALCO can develop appropriate strategies to change balance sheet volume, mix and rate to increase NII. Feel free to contact CMG's ALM team if you wish to further explore how the simulation model can be used to proactively manage earnings.

Dennis Zimmerman Jr.
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NEW ISSUE MUNICIPAL CALENDAR			
Date	Amount ($)	Description	Maturity
06/22/2020	$850,000.00	ST FRANCIS KS UT GO BQ NON-RATED	2021-2040
06/22/2020	$2,350,000.00	ST JOSEPH MO COP BQ A RATED	2021-2025
06/23/2020	$26,696,000.00	TULSA OK MET UTIL REV AA1/AA+	2021-2031
06/23/2020	$11,250,000.00	NORMAN OK GO AA2	2021-2040

ECONOMIC CALENDAR				
Monday 6/22	Tuesday 6/23	Wednesday 6/24	Thursday 6/25	Friday 6/26
Existing Home Sales	New Home Sales	MBA Mortgage Applications	GDP Annualized QoQ	Personal Income
Chicago Fed Nat Activity Index	Markit US Manufacturing PMI	FHFA House Price Index MoM	Initial Jobless Claims	Personal Spending
			Wholesale Inventories MoM	U. of Mich. Sentiment

KEY INDICES

	Current	Last Month	One Year Ago
Prime Rate	3.25	3.25	5.50
Discount Rate	0.25	0.25	3.00
Fed Funds Rate	0.09	0.05	2.38
IOER	0.10	0.10	2.35
1-Month Libor	0.19	0.17	2.39
11th Dist COFI	0.74	0.88	1.14
1-Yr. CMT	0.19	0.17	2.04
Dow	25,871.87	24,206.86	26,504.00
NASDAQ	9,946.12	9,185.10	7,987.32
S&P 500	3,098.01	2,922.94	2,926.46
Bond Buyer	2.16	2.56	3.51

MUNI AA—BQ

3 Mo.	0.18
6 Mo.	0.27
1-Year	0.30
2-Year	0.33
3-Year	0.35
5-Year	0.51
7-Year	0.79
10-Year	1.03
30-Year	1.84

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

	Treasuries	Bullets	NC-6 Mo.	NC-1 Year	NC- 2 Year
3 Mo. Bill	0.14				
6 Mo. Bill	0.16				
1-Year Bill	0.17				
2-Year Note	0.18	8	18	15	
3-Year Note	0.22	10	29	25	16
5-Year Note	0.33	18	45	41	32
7-Year Note	0.54	25	52	81	71
10-Year Note	0.72	46	62	60	54
20-Year Bond	1.25				
30-Year Bond	1.50				

CMO Spreads to Treasuries

	PAC	Vanilla
1-Year	N/A	+60
2-Year	60	70
3-Year	77	85
5-Year	85	95

MBS Current Coupon Yields

GNMA 30 Yr.	1.51%
FNMA 30 Yr.	1.65%
GNMA 15 Yr.	1.01%
FNMA 15 Yr.	1.10%

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.