Community Bank Views - Trading and Market Update November 30, 2021

In this edition of the Community Bank Views, we speak with our Traders of the Capital Markets Group to get updates on how different types of fixed income securities have been trading recently and what to look out for in the coming year for your bank's investments.

Even though bank portfolios gauge performance by book yield, sometimes it's worth comparing the yield-to-worst (YTW), spread, and duration metrics found in market indexes to one's portfolio. Bloomberg has several indexes that provide the projected YTW, option-adjusted spread (OAS), and option-adjusted duration (OAD)for US Treasuries, Agencies, US MBS, and Municipal (both tax-exempt and taxable) markets.

Bloomberg US TR Index Comparisons by Sector

Index	Ticker	YTW	YTD Avg YTW	Trend	Option Adjusted Spread to Treasuries (bps)	Option Adjusted Duration (Projected)	Trend
Bloomberg US Short-Term Treasury Index	I09389US Index	0.16%	0.08%	Up	0.02	0.56	Down
Bloomberg US Treasury Total Return	LUATTRUU Index	1.13%	0.92%	Up	0.00	7.19	Flat
Bloomberg US Agencies Total Return	I09459US Index	1.07%	0.83%	Up	0.14	3.99	Down
Bloomberg US MBS Total Return	LUMSTRUU Index	1.96%	1.68%	Up	0.33	4.75	Down
Bloomberg Municipal Bond Index TR	LMBITR Index	1.14%	1.04%	Up	0.63	5.07	Down
Bloomberg Municipal Index Taxable Bonds	BTMNTR Index	2.23%	2.24%	Flat	0.73	9.56	Down

Source: Bloomberg LP, compiled by author **As of November 29, 2021**

US Government and Agencies - Pam LaRocca, Vice President – Agency and Fed Funds Trading

US Treasuries and Agencies are trending up in yields compared with year-to-date averages and duration is coming down compared with recent levels. This hints at the market's anticipation of rising rates over the near-term, likely through next year as the Federal Reserve decreases the level of quantitative easing.

What have banks been buying lately?

Volumes in agencies slacked off during the Spring and Summer (2021), but have picked back up lately, rivaling Q1. Earlier in the year, there was a stretch for coupon and duration was longer, with buying focused in the 7-12 year range. With the recent rise in rates, duration has backed off more toward the 3-7 year range.

- We expect this trend to continue in the near term future, as swap spreads on new issues remain flat to negative for shorter maturities (<3yr).
- There should also be opportunities to pick up spread in discounted callables as rates rise.
- There has been an increase in treasury trading as bullet spreads remain tight, especially in the 2-3 year area.

Agency MBS and CMO – Mark Mower, Senior Vice President – Mortgage Backed Securities Trading

US MBS YTW lies just below 2% as of the end of November and OAD sits under five years and trending lower. As with the Agencies market, durations are down compared to earlier in the year. If interest rates rise closer to 2%, MBS and CMO securities should see some duration extension but if purchased at a premium, should see a bump in book yields as premiums paid are amortized over a longer period.

What have banks been buying lately?

With treasury yields higher for most of the past three months, we've seen a couple general trends in Mortgage space.

- First, and most surprising, an increased level of interest in 10yr amortization pass throughs; mainly 10yr 1.5% pools. Customers have shown little to no interest in this 10yr product over the past couple of years, but we have seen a significant increase in volume over the past month. With a 3-year average life and a 10-year final maturity, this product has become a stable place to ride out both the uncertainties of a FOMC interest rate hike and the general market volatility due to COVID, growth, inflation, etc.

- The second trend is a generic move up in coupon. AsTreasury rates generally moving higher (prices on bonds moving lower), mortgage prepayment speeds have started to decline. This brings more comfort to higher coupon mortgage products. We've seen an up in coupon move in both CMOs and 20yr/30y pass through MBS. A coupon rate of 2.5% is attracting particular attention with the 10yr treasury in the 1.50% to 1.60% range.

Municipal Securities – Mathew Mower, Senior Vice President – Manager CMG Trading and Thomas Verstappen, Vice President – Municipal Trading

Municipal bond and taxable municipal bond index yields have been up to flat when compared to early 2021 and durations are decreasing. Municipals remain an important part of many bank portfolios – especially those with more reliance upon investment income contributing to net interest margin.

What have banks been buying lately?

- This year can be characterized by an overall shift from tax exempt and bank qualified municipals to the taxable municipal sector. Prior to 2021 our volume was over 75% BQ and tax exempt paper but that has shifted to around 60-70% taxable municipals.
- We think this is due to increased taxable issuance, low corporate tax rates and less attractive relative value ratios between tax exempt municipals and treasury bonds. Volume has been pretty consistent each quarter of 2021.
- As for tax exempt structures, we've seen our community bank partners interested in shorter maturities less than 3 years coupled with demand for approximately 10-12 year bonds, often times with larger coupons and shorter call protection (aka cushion or kicker bonds).
- On the taxable front, our demand has been in the 9-15 year space with less buying beyond the 2037 and 2038 range. 2.00% and higher coupons on taxable municipals seems to be the popular structure.

Conclusion

Throughout 2021, banks have increased their fixed income investments due to continued excess liquidity on their balance sheets, earning higher yields to help with margin compression. Recent shifts to shorter maturites align with market expectations of a rise in interest rates in the near-term. Reach out to your Investment Representative with any questions or strategies.

Matthew Maggi | Senior Vice President | Commerce Bank Capital Markets | matthew.maggi@commercebank.com