The ADVISOR

Focus on Community Banking Issues

Third Quarter 2020

ECONOMIC ENVIRONMENT

An economy transformed

The U.S. economy has been permanently transformed. Or, at very least, it has entered a unique period of transformation because of the COVID-19 pandemic. Many trends that were in place have accelerated while many assumptions about the sources of economic growth have been destroyed. However, significant opportunities for economic transformation lie ahead. According to Cliff Kupchan, chairman of the Eurasia group, pandemics have historically "tended to jolt the system," compressing and further accelerating the arc of events. "There's pressure on all trends, and only the strongest, most vibrant continue. Only the fittest survive. You have a Darwinian moment for trends."

Shutdown has no comparison

The current self-induced shut down of the economy was without precedent. Initially, as fear took hold in almost every aspect of our culture, people looked for past comparisons to get a sense of what may happen. Unfortunately, no reliable comparisons existed to historic events, as past pandemics did not induce a government response resulting in a national economic shutdown. Past recessions were not helpful as guides, nor was the Great Depression. The inability to categorize this event led to increased apprehension about the future.

No boom, no bust

We emphasized in the second quarter Advisor that the U.S. economy was in a healthy position before the COVID-19 pandemic arrived. A lack of excesses in either capital, real

Features

- ***Economic Environment:*** U.S. economy transformed by unprecedented events
- ***Fixed Income Strategy:*** Rate Repression likely to keep yields low for extended period
- ***Equity Strategy:*** COVID-19 has altered the way we work and consume—look ahead for opportunities
- ***ALM Strategy:*** Transitioning ALM from crisis to "new normal"

EPG RATE FORECAST

July 2020

MARKET RATE	Actual (%) 6/30/2020	Projected (%) 6/30/2021	Yr1 Δ	Projected (%) 6/30/2022	Yr2 Δ
FedFunds	0.25	0.25	0.00	1.00	0.75
Prime	3.25	3.25	0.00	4.00	0.75
3mthTsy	0.13	0.30	0.17	1.05	0.75
6mthTsy	0.13	0.30	0.17	1.05	0.75
1yrTsy	0.15	0.35	0.20	1.10	0.75
2yrTsy	0.15	0.45	0.30	1.15	0.70
3yrTsy	0.17	0.55	0.38	1.15	0.60
5yrTsy	0.29	0.75	0.46	1.25	0.50
10yrTsy	0.66	1.25	0.59	1.75	0.50
30yrTsy	1.41	2.00	0.59	2.50	0.50

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.

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estate, or labor markets is unusual prior to a crisis. We argued that since there was no boom, there would be no sustained bust, just a 2-3 quarter "adjustment" to renewed 2% GDP growth. We believed that if we created this economic crisis by our policy response to the pandemic, we could develop policies to reverse that economic crisis. That has now happened… sort of. We now expect over 5% GDP growth next year, but that is after a contraction of a similar magnitude this year.

Liquidity delivers

Learning from past mistakes of the financial recession a decade ago, the sources of liquidity from the Federal government were directed to small businesses and individuals, in addition to municipalities, states and corporations. Banks did not receive special federal assistance due to their financial strength and instead provided support to federal programs, lending directly to small business. Over $3 trillion has been made available so far. In addition, the Federal Reserve pulled out all the stops, offering trillions in liquidity dollars in a myriad of programs. This has resulted in what could have been a more sustained contraction to be dramatically shortened.

Different strokes for different folks

Further good news is that in many locations we developed strategies to combat the risks of spreading the COVID-19 illness. Nevertheless, our lack of preparation for the crisis, as well as the uncertainty of exactly what we were dealing with combined with a lack of a consistent national approach, has allowed the virus to gain a foothold in every state in the U.S. The densely populated cities that initially experienced the pandemic developed very strict protocols to limit the virus spread, and this has dramatically slowed the growth of COVID-19 in those locations. However, other states and municipalities that did not utilize these strategies are now experiencing a rapid acceleration in cases. This trend is also true globally, with some countries containing the virus while others that failed to act soon enough now experiencing a dramatic acceleration. Now as we open the many partially or completely shuttered businesses in the U.S., the virus is potentially free to move again.

Thus, COVID-19 will be with us for quite some time, and as we adapt to doing business in this new world, the economic landscape will change before our eyes. Until a vaccine is available to most Americans (and most people living worldwide), we are likely to see an extended period of adjustment transforming the American economy.

What about the international scene?

Is growth abroad likely to surprise to the upside, pushing rates higher? This is very unlikely. In the developed world, growth levels in Europe remain depressed. For example, Germany, the powerhouse of Europe, faces challenging growth prospects on multiple fronts. Germany's historic export machine is exposed to weaker global growth and a new world order, as countries favor their own domestic manufacturers and corresponding supply chain. This trend was already occurring prior to the COVID-19 outbreak, as nationalistic polices favoring domestic suppliers took hold around the world.

Emerging markets

Remember the BRIC's? They were the backbone of support for the global economy during the financial recession. That is clearly not the case today. Brazil, Russia, and India were all

struggling economically before the pandemic and have all failed to cope with the COVID-19 crisis. Russia seems to be turning a blind eye, while Brazil and India are seeing a dramatic acceleration of cases and seem poorly prepared to manage the associated health risks. China has shut down its economy as it aggressively responds to new outbreaks, and continues to struggle with the transformation from an export to a domestically driven economy.

Trend shifts

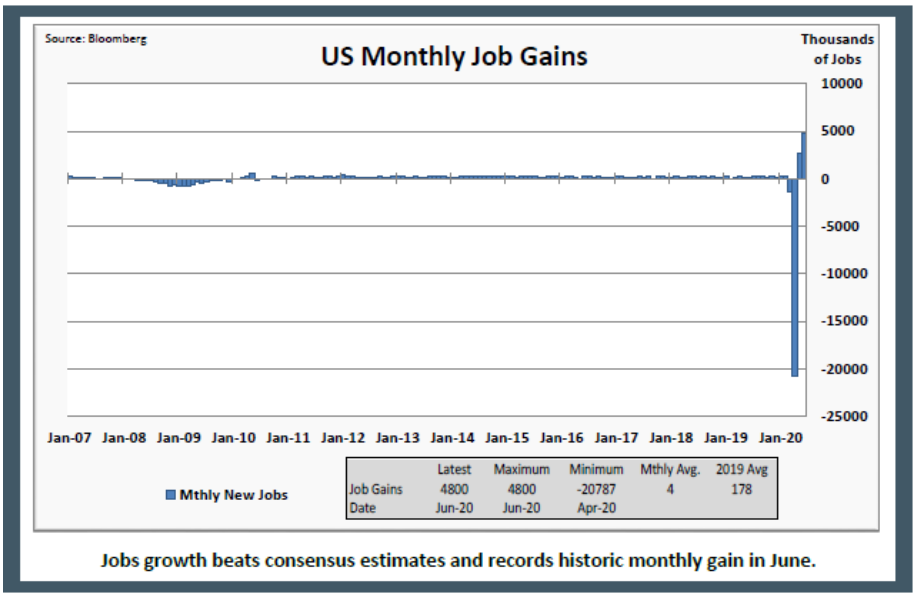
As we entered 2020, several trends were in place, while others have accelerated. Online shopping, having grown rapidly over the past number of years, has taken off again, doubling in little more than a quarter. Social media's role in our daily lives has accelerated as virtual meetings on Zoom or "GoToMeeting" have replaced in-person meetings. COVID-19 has provided technology a tremendous opportunity to transform work and our everyday lives. In addition, the trend to "economic nationalism" has caused a collapse in global trading volumes as countries are forced to rely more on domestic supply and demand versus looking abroad.

In addition, new trends have emerged since the arrival of COVID-19, and should remain in place at least until there is a vaccine, and potentially much longer. Businesses are realizing that they do not necessarily have to pay for expensive office space anymore. Working from home is now assumed to be a viable business strategy. As jobs are being rethought and restructured, young people are leaving cities like New York looking for the safety of the suburbs, or simply returning to their parent's homes unemployed. As some individuals work from home, restaurants and select local businesses are benefiting as similar businesses located near now empty office spaces suffer. Commercial real estate, as well as employment opportunities, are in a unique adjustment period.

"The End of Cost?"

Peter Zeihan, a well-known geopolitical analyst, lays out a fascinating argument for a continued massive global spending spree by governments. He called this multi-year trend "The End of Cost" and his argument is as follows. The already $3 trillion of spending announced by the Federal government is likely just the beginning of fiscal stimulus, all of which is supported by not one dime of a new government revenue stream; every bit is deficit spending. So far, this debt has been absorbed by the Fed, but an equal amount has been funded by other investors, mostly foreign.

He argues that coronavirus is not only a crisis, but is the type of crisis that necessitates unprecedented government action. Over a two week period, "Congress



Jobs growth beats consensus estimates and records historic monthly gain in June.

passed more legislation of substance than in the previous ten years," and the feeling was strikingly bipartisan. He is not suggesting that we have entered a "kumbaya moment" but instead that the concept that the cost of these programs matters appears to have vanished. There is a political side to this willingness. In the past, fiscal conservatives had a role to play in shaping policy, but have all but disappeared with the restructuring of the Republican Party, making the next few years a time for 'big-ticket' ideas no matter who is elected in the fall. There are plenty of them, such as infrastructure spending, universal basic income, defense expansion, universal health care, green "New deal"…all potentially requiring trillions of new deficit spending.

New jobs

Interestingly, we could be setting up for a mini-boom in the overall economic recovery as we reopen. The great financial hardship from shuttering the economy assures that we will not repeat that process anytime soon. Businesses already assume that the virus will likely accelerate in the fall, so they must determine how to run their businesses in this new world. New jobs will emerge as others disappear. It will be interesting to see if out of this crisis we shift policy as a nation to focus on the quality of workers' jobs and needs versus just shareholders and employers.

Inflation ahead?

Even though unemployment may remain somewhat elevated during this period, as GDP reaccelerates, cyclical inflation is likely to return as the massive liquidity the Fed pumped into the economy acts as a platform for accelerated growth. The Fed says it will remain on the sidelines and not raise rates as growth takes hold or inflation rises. Instead, they seem laser-focused on the unemployment rate, which they forecast to remain above 5% through 2022.

However, the Fed is likely to pull back some of its rate suppression tactics. We expect them to announce that they no longer need to provide unlimited support to bond markets through their purchases of securities as GDP rebounds. This should set up for an acceleration in the already steepening yield curve, pushing the ten year over 1%, and eventually towards 2%, mirroring the curve shape from the financial recession of the past. We could eventually see a two to ten year spread approaching 2%.

Continuing claims tell the story

We will continue to focus on continuing claims versus new weekly claims, as they are a better indicator of how many people continue to collect unemployment insurance. Headline news focuses on new claims, which continue to remain well above 1 million per week, which reporters simply add to the prior totals of new weekly claims to obtain a number reflecting over 50 million who filed unemployment claims at least once. However, continuing claims remain in a downward trend, and are now roughly 18 million. We believe that focusing on continuing claims versus new claims provides a solid indication of a return to growth and the health of the labor sector. This should provide an indication of when the Fed may adjust policy. The COVID-19 recession is likely over but an economic transition/transformation of uncertain magnitude is replacing it. Stay tuned. ◆

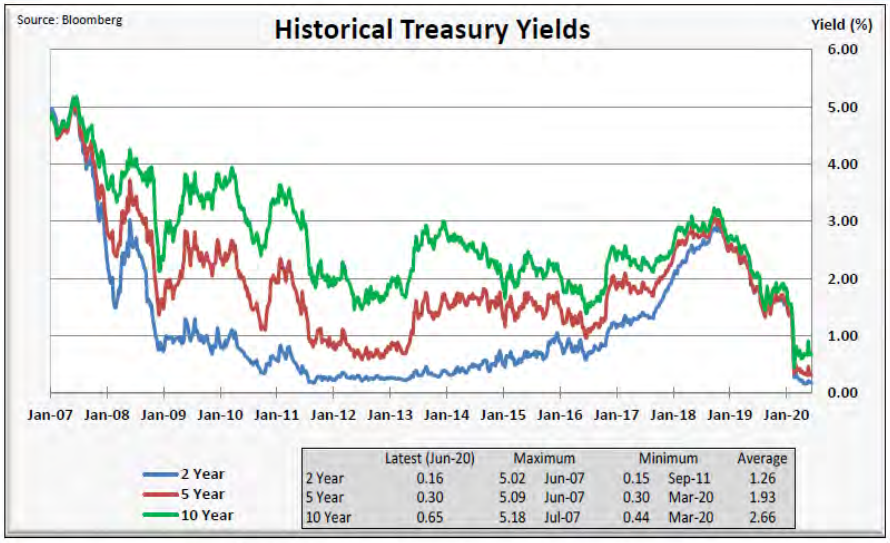
FIXED INCOME STRATEGY

The Fed is on hold until the "economy recovers to pre-crisis levels." Rate repression is the main characteristic of the fixed income market today, and is likely to continue to impact the interest rate environment for some time. How long? Based on the Fed's recent comments from their June meeting, they wish to err on the side of caution. What does caution currently mean to the Fed? They will wait for their dual mandate to be re-achieved…full employment with inflation approaching their target of 2%. That means unemployment averaging below 4% and inflation above 2%. GDP levels and momentum are not their current concern. According to their recent forecast for the economy (they are notoriously poor forecasters, generally predicting more growth and inflation than actually occurs), unemployment and inflation will remain stressed through 2022.

Do you believe their forecast? Whether you believe the Fed or not, they are clearly conveying their willingness to let the economy run hot before they start raising rates again. Their aggressiveness in unlimited bond purchases has kept most yields well under 1% for U.S. Treasury and Agency notes. Only maturities over 15 years yield more than 1%, with the 30 year Treasury yielding 1.5% (the all-time low reached near 1%). This aggressiveness has been extended to virtually all areas of the fixed income market, unlike their initial foray into QE during the financial recession of the prior decade. Municipal and corporate debt were much more attractive on a relative and absolute basis during that period as it was unsupported by the Fed even though the funds rate was zero. The Treasury curve was much steeper during that period as well!

The recent steepening in the curve has pushed the 2-10 year spread to over 50bp and the 5-30 year spread to over 100bp. But few assets in the universe of high quality fixed income with likely durations less than 7 years yield more than 2%, while most yield closer to 1% or lower. We expect the yield curve steepness to continue over the next year and approach levels seen during the financial recession. A 2-10 year spread of 200 basis point is not out of the question. We will explain why in a moment.

One has to assume that the Fed is guided in its unemployment forecast by the expected uncertainty regarding the COVID-19 life cycle and the assumption of a new wave of cases in the fall, combined with an economic transformation process highlighted by workers working remotely and businesses trimming staff. Along with these trends are likely bankruptcies



	Latest (Jun-20)	Maximum		Minimum		Average
2 Year	0.16	5.02	Jun-07	0.15	Sep-11	1.26
5 Year	0.30	5.09	Jun-07	0.30	Mar-20	1.93
10 Year	0.65	5.18	Jul-07	0.44	Mar-20	2.66

Treasury yields fall following Fed's outlook for a slow recovery.

ahead when the PPP money runs out, especially in small and medium sized businesses that served workers physically working in an office space that may not be returned to. According to Fed forecasts, this may keep unemployment closer to 5-6% over the next 2½ years, but it is difficult to predict how accurate this will prove to be. But if the Fed needs proof that an elevated unemployment level is **not** the likely outcome…rate repression is here to stay.

As discussed in the Economic article, the international landscape seems unlikely to push the Fed to tighten sooner. The COVID-19 pandemic has led to inconsistent national policies regarding its containment, ensuring weak domestic growth, and minimal travel between countries exacerbates the weakness. These countries also are dealing with the drastic shifts in consumer and businesses behavior in reaction to a likely sustained presence of the pandemic risk.

What about inflation?

Many investors are currently asking whether the recent government borrowing spree will set off an inflation spiral. We do not believe it will, however, a cyclical bump in inflation is likely in the years ahead. The long lived trend to lower inflation is consistent with the long-term trend of lower annual GDP. This is driven by a number of factors, many of which are demographic, including lower birth rates, lower immigration and the baby boomer cohort retiring. Another factor that may be leading to lower growth potential is the rising trend in government debt.

Debt growth, money velocity and the secular trend to weaker growth

A long lived trend appearing to drive global GDP lower appears to be total global debt growth, which is positively correlated with a long-term trend in declining money velocity. When money moves it stimulates growth, but when money is stagnant economic growth is stagnant. The observed byproduct of lower velocity has been lower inflation, lower growth and lower rates, and is the opposite of the all too familiar 'crowding out theory' we learned in economics class. It suggested that as debt increased, particularly government debt, rates would rise. This assumed constant demand for debt met an increasing supply with the price set at an auction. Since the government would have to fund itself, it would pay whatever price was necessary to do so. The price of money, interest rates, would rise to a point that eventually drives the private sector out of the debt markets.

Yet debt growth has been going on since the end of WW2 and multiple Federal Reserve bailouts of the economy during recessions have functioned to minimize the "death" of debt. Thus, debt growth is not a new phenomenon but has been with us for a long time, and appears to be acting as a drag on growth that increases year after year keeping GDP, inflation, and rates low.

As money supply skyrockets velocity should stabilize

Currently, the Fed is dramatically increasing the supply of money. In the monetary equation where GDP equals M times V, M is money supply growth and V is velocity, the recent collapse in GDP is a function of the collapse in velocity. The monetary base is now being expanded as the Fed creates reserves to purchase newly issued Treasury debt. If velocity stabilizes during this period (as is likely) then GDP will increase with the growth in money supply. Inflation can temporarily recover on a cyclical basis in this circumstance but the long lived secular trends would need to change to shift from a long-term disinflationary or

deflationary secular trend to an inflationary one.

Path of rates

The fact that the economy currently has excess capacity and the concern that it might change in the future misses the point that the economy did not have excess capacity the last couple of years and inflation still remained well contained. Even with tax cuts, a tight labor market and a trade war, inflation remained low, but growth did as well.

In terms of the path of interest rates, they should follow the trend in inflation. Thus, rates should eventually get a cyclical boost from the current expansion of the money supply. This could be more than some think, especially if the Fed continues to stimulate the economy with more fiscal stimulus. The election will result in likely infrastructure spending and possibly an entirely new health care system, regardless of which party wins, and that could require massive additional debt, requiring the Fed to create even more reserves. This would then increase the money supply with the creation of new debt, all potentially boosting GDP and temporarily pushing up inflation.

Eventually the deflationary trend would reassert itself if the structural forces discussed above remain in place. Interest rates will follow.

Fixed investment options in a world of rate repression: The Jumbo update

Although jumbo mortgage rates are near record lows, it can be difficult to qualify at this point, and even if you do, the rate will likely be well above the conforming rate. It hasn't been this difficult to obtain a jumbo mortgage in many years. Jumbo lenders such as Chase and Wells Fargo tightened their standards when the economy began weakening in mid-March and some stopped funding loans that exceed the amount the government will back.

That currently leaves smaller players and portfolio lenders in the market, although they typically are only lending to borrowers who meet stricter standards, like having extra cash reserves on hand, said Mark Goldman, a loan officer with C2 Financial. "There's a lot more risk for lenders when it comes to jumbo mortgages," said Goldman. "If you have a $300,000 loan go bad on you, that's a terrible thing, but if you have a $600,000 mortgage go into default, that's twice as bad."

A Mortgage Bankers Association index that measures credit availability for jumbo mortgages fell 54% from February, when the COVID-19 pandemic first started hitting the U.S. The index level in May showed the tightest jumbo credit conditions since March of 2016, according to the MBA data. Goldman said when he was looking for a rate quote for a jumbo loan applicant in the time before the COVID-19 pandemic, he typically would receive responses from as many as 46 lenders. Now, he is lucky to get a handful. "It's down to between zero and five," he said.

The spike in forbearances due to pandemic-related job losses is the main reason for the jumbo pull-back, Goldman said. "When the forbearances started mounting the mortgage market began shutting down, and a lot of the biggest players like Chase suspended operations," he said. "As we see the number of forbearances go down slowly, and there's a lot more people who can make their payments, the availability of jumbo mortgages is slowly returning to the market." Nevertheless, if we have entered a sustained period of economic transformation with elevated

unemployment, jumbo MBS rates will likely remain elevated.

This has created an opportunity

Given the current investment environment, we believe jumbo mortgage-backed securities continue to be the preferred investment alternative for excess liquidity. We favored Jumbo MBS last fall and early this year, with prices 1-2 points below traditional MBS, in the 101½ - 102 range. However, since the Fed intervened to support the MBS market, prices have sky-rocketed for conventional MBS, pushing them into the 105-106 range. Now, the lower absolute dollar price point for jumbo MBS (when compared to conventional MBS) is still roughly 2 points below, placing jumbo MBS pools around 103 to 104.

We do anticipate prepayment speeds for jumbo MBS to slow due to participation in forbearance and/or defeasement programs in the underlying mortgages. Estimated participation in these programs range from 15-20% for GNMA pools to 5-10% for FNMA/FHLMC pools. When borrowers take advantage of these programs, they are restricted form refinancing until the mortgage is current. And FNMA/FHLMC have agreed to allow these loans to remain in the MBS pool with servicers making principal/interest payments on behalf of the borrower. Thus, although the likely lifetime yield will be higher and average life will be longer, yield volatility will be a hallmark of owning these pools as month to month changes in prepayment trends over the life could be volatile. Recent trends in forbearance requests in June have accelerated after slowing in May.

Agency floaters as cash substitute

Discount priced Agency CMO floaters may make sense as cash substitutes with rates close to zero. The floor on most par priced floaters is 35 to 40bps, so the yield cannot go below that even if LIBOR or SOFR goes negative. The floater provides 32bps of yield per 100 basis point of price volatility and is priced near par, while fixed rate MBS pools with a premium under $104 provides around 5 to 7bps of yield per 100 basis points of price volatility. In other words, this is a low IRR option to pick up a small amount of yield. Nevertheless, with rates at current levels and reinvestment rates so low, the “cost” of holding cash is also low, providing banks flexibility to use cash strategically as opportunities arise. ◆

EQUITY STRATEGY

EQUITY STRATEGY

Beginnings of a new bull market

As fast as the markets fell during the month of March, the rebound was just as remarkable. The equity market rally left it just 6% below all-time high levels, and the second quarter was one of the best quarterly returns since 1950. Moves of 25%+ in 50 days are extremely rare, with the other three times since 1940 coming out of recessionary bear markets in 1975, 1982, and 2009. The Wall Street Journal rule of thumb often refers to the use of the +/- 20% threshold to determine "bull" or "bear" markets. We believe equity markets are exhibiting the emergence of a new bull market, with more gains ahead. Investors should look out on the horizon to determine where the opportunities are given that consumer habits and business spending has changed due to COVID-19.

Elevated P/E levels justified

As investors ponder the path of the economic recovery, they have become more concerned about the markets. Many believe the market's rebound has driven stocks to levels that are deemed expensive. However, the combination of extremely accommodating monetary policy, lower rates for longer, and low inflation should keep valuations elevated, even if economic progress is extremely slow. Although coronavirus will continue to take a toll on the world economy, we are unlikely to see the sort of broad-based economic dislocations experienced back in March. Given the preventative measures that most have taken such as wearing masks and social distancing, combined with increased knowledge about the virus, the medical community is better equipped to deal with additional outbreaks.

Buy the dips

As long as the 2020 recession is relatively quick and short lived, history implies stocks should manage to recover their former peak in a relatively short period of time. It has been shown that stocks recover before the economy recovers, and the current recession appears to be fitting the typical pattern. Looking back at past recessions, stocks bottomed out sometimes early in the recession, sometimes during the middle and sometimes later. The average gain in stocks from the bottom trough to the end of the recession was 25%. The current recession started February 29, 2020, with stocks bottoming on March 23, 2020. Since that time, markets have staged a "V" shaped recovery, producing one of the best quarterly returns since 1950. Despite the view that stocks are overvalued, we see this moment as another rare opportunity where the S&P 500

S&P 500 Index trades with increased volatility.

EQUITY STRATEGY

yield of 1.89% is more than 100 basis points above the 10-year Treasury yield of 70 basis points. Though markets may be choppy near-term as the economy reopens, we view pullbacks as buying opportunities, and we remain confident about equities over the long-term. Markets have moved off the fear factor and are back to "climbing the wall of worry".

Accelerating trends

Pandemics are known for driving significant economic change, and we are seeing that unfold right in front of our eyes. Looking back at the environment before the pandemic, we can see how the pandemic has accelerated many of the trends that were already in place. Having been locked down for months, consumers and businesses have had plenty of time to consider some permanent changes to old ways of doing things. By understanding these trends, investors can better position their portfolios to benefit from these changes.

Shifts in housing

Before the coronavirus, only about 5% of Americans worked from home. Now, companies across the country are considering a permanent shift to remote work in the aftermath of the coronavirus outbreak. Facebook has announced plans to reconfigure operations over the next decade to enable up to half of its 45,000 employees to work from home. This move followed Twitter's announcement to allow employees to work from home indefinitely. LinkedIn Corp. executives are also seeing emerging trends that show remote work might become more widely accepted. The pandemic has revealed the viability of remote work for many businesses that were hesitant to expand the practice. As work from home becomes more pervasive, the path to get there has broad implications and opportunities. The areas we see most affected by this shift are consumer spending and housing.

The shift from urban to suburban living predated the pandemic. Demographic trends have supported this shift, but the pandemic accelerated the trend. Millennials recently became the largest demographic cohort in the country, and based on Argus research, there are over 80 million Millennials born between 1982 and 2000 with ages ranging from early 20s to late 30s. This generation is the largest in history, even larger than the Baby Boomers! Millennials have delayed marriage and starting a family, but this does not mean they have foregone having children. In a Pew Research Center survey, 60 percent said that being a parent is extremely important to their overall identity.

The pandemic has many homeowners questioning if urban life is the right choice for them. With the pandemic primarily located in and around major cities, we expect a significant percentage of homeowners and renters to move out of urban areas to more suburban areas. The pandemic has given single family homes a new sense of safety. There are no elevators or shared space, while generally providing some kind of private outdoor space. We expect single family home demand to increase meaningfully, a welcome tailwind for single family home builders in suburban areas.

Shifts in spending

More time at home will lead to more spending on homes. The health risk of traveling and the added layer of screening, etc.

during check-in will make travelers question whether it's really worth the effort, especially those with children. We expect there will be an increased demand for home improvements. After 9/11 there was a surge in home improvement spending as many homeowners opted to stay at home versus vacations away. 'Staycation' became the trend after 9/11 and is now gaining popularity again. With many summer camps closed this year, parents are finding creative ways to entertain their kids. Many homeowners are frantically looking to install swimming pools for the summer season.

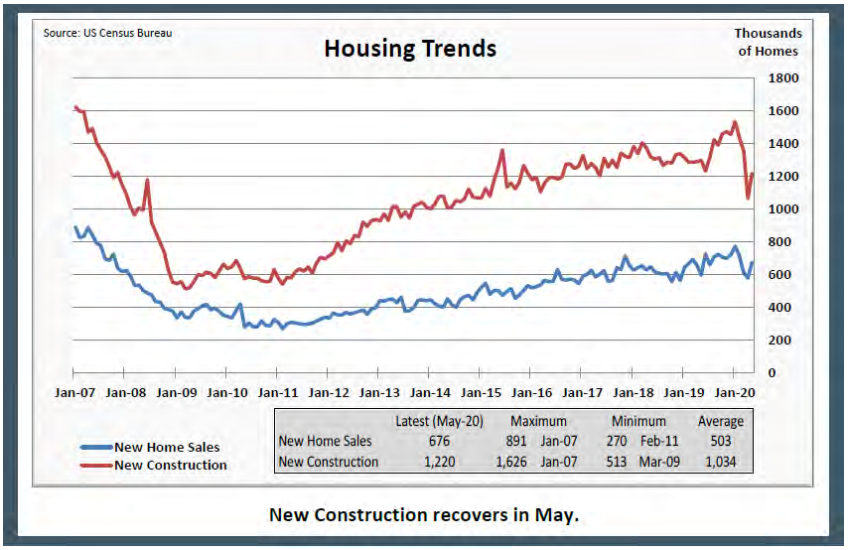
According to Zillow, 75% of Americans would prefer to continue to work from home at least half of the time, even after their workplace reopens. The ability to work from home will drive some of the discretionary spending into improving or reorienting our homes. Many will want to improve or set up a home office, which, in turn, will drive demand for items such as personal computers and printers. And the software companies that will help make this transition easier (allowing more collaboration and communication) will continue to see demand. While the recent surge is not sustainable, we expect the trend in home improvement will continue given the tight supply in housing.

Leaning in to the new norm

The COVID-19 pandemic has altered the way we work and consume, creating a ripple effect across nearly every industry. While this pandemic has severely damaged world economies, there are a number of businesses that are thriving amid this new 'normal' and from this, new companies will be formed. Take telehealth, for example, which struggled to get off the ground before the pandemic but is now gaining popularity. Since the pandemic outbreak, some insurers have waived the copays and visit fees for telehealth appointments to ensure that patients have access to doctors.

Medicare was previously very restrictive but because it now offers coverage for telehealth visits, it has seen explosive usage. Regulatory agencies are also warming up to the idea of digital healthcare, opening the door for new companies to capitalize on this trend.

Pandemic brings drastic changes and disruption to society. We are living through one of the most rapid transformations in history. Not only is this the worst pandemic in 100 years, but also the first pandemic in the digital information era. This is one of those rare moments for investors to capture and lean into the new world of opportunities. ◆



New Construction recovers in May.

ALM STRATEGY

ALM STRATEGY

This quarter's ALM discussion shifts focus slightly from immediate crisis management to an evolving new normal going forward. The start of Q2 saw the peak emergence of the pandemic locally as banks transitioned into a lockdown operation. As the quarter wound down, attention had shifted to reopening plans and how the economy would recover. In the interim, bank ALM efforts intensified around liquidity contingency planning given uncertainties related to loan payment deferrals, PPP lending, and permanence of deposit inflows. Q2 also experienced a continuation of deposit rate cuts initiated in late March following the Fed's emergency easing. With everything happening so quickly, as well as continuously evolving during the quarter, it is important to take a moment to step back and assess what to expect and how to manage ALM moving forward into the second half of 2020.

Navigating through the "Noise"

The developments of Q2 created many temporary balance sheet mix shifts and growth which have the potential to skew financial analysis over the next few quarters. Growth spikes related to PPP lending and accompanying deposit inflows have created elevated liquidity positions and increased asset size, in many cases. The impact will likely skew trend analysis and require appropriate review to ascertain the "real" capital, IRR, and liquidity positions moving forward. Bank management should separate the temporary imbalances recently created when making ALM decisions. Increased communication may be necessary with the Board to illustrate the potential short-term strain on capital ratios, the volatility with NIM% related to PPP fee timing, and the elevated liquidity levels skewing ratios and IRR measurements. Expectation is that much of these temporary imbalances will sort themselves out during the second half of 2020, including PPP loan forgiveness, renewed spending, and a general reemergence from the self-imposed closing of the economy.

ALM Process

The ALM process is the method for sifting through the "noise" so bank managers continue to have clarity around both current as well as future risk/return profiles. Measuring IRR has typically been considered the primary objective when utilizing simulation analysis within a bank's ALM process. While this requirement has not waned, other areas of importance have increased and should be a focal point for managing during the pandemic. Specifically, ensuring adequate stress testing is incorporated into the ALM process is paramount. Stress testing refers to more than the typical interest rate shocks. Increased prepay risk, stock portfolio MTM impact on earnings, and credit risk factors should all be incorporated into a comprehensive ALM process. What happens if there is a second wave of virus infections? How will businesses survive in a transitioning economy? The uncertainty of these questions can be manifested into the analysis through increased nonaccrual loan and provision expense assumptions. Scaled back business plans, as well as looking at the potential impact from a negative interest rate policy, are now part of the "new normal" ALM process. Regulators have also echoed the importance of using the available pro-forma analysis tool to help identify and quantify potential risk factors beyond simply IRR. EPG has worked with clients to ensure that both current and pro-forma analysis incorporates these types of stress testing so that both the short-term and long-term earnings and capital implications are understood.

Liquidity and Funding Strategies

A combination of PPP loan proceeds re-deposited into banks and deposit inflows associated with stimulus and/or slowed spending during quarantine have all caused elevated liquidity levels in many community banks. Slower organic lending in some cases and/or increased loan payoffs as rates hit historic lows have added to the excess cashflow situation. Deposits have grown despite significant product rate cuts in many cases. For most, initial concern over strained liquidity due to loan forbearance and/or deposit runoff has been at least temporarily replaced with consternation about what to do with the excess cash. Banks are encouraged to identify, if possible, the origins of recent deposit growth and whether it is considered temporary or part of a new stable core funding base. Identified balance concentrations should be incorporated into pro-forma cash flow stress testing measurement.

During Q2, term funding strategies looked to "lock-in" or extend duration to ensure stability through the expected crisis period. As we now shift from immediate crisis to the "new normal", length of term funding should ensure a balance which promotes flexibility. Should non-maturity deposit growth continue despite historically low rates and/or become more permanent, banks want the flexibility to payoff both retail and wholesale term funding. CD pricing should be appropriate so as to not exacerbate excess liquidity positions. While maintaining a modestly elevated liquidity profile is still prudent during this period, banks should now shift focus to the earnings impact of holding excess balances.

Look to NIM% to support Loan Loss Reserve in 2020

Expect NIM% to be volatile in 2020 but experience an overall improving trend. Some community banks may have experienced temporary compression early in 2020 before recent deposit rate cuts took hold. NIM% should have increased Q2 from NMD rate cuts and lower cost rollover of term funding. Going forward, asset yield compression may intensify as refinancing and loan rate modifications become more prominent; however, term funding costs should continue to offset/ mitigate as they roll lower. Banks should also keep in mind that asset yields may continue to be artificially inflated as accounting rules are temporarily suspended regarding recognition of problem loans.

The importance of maximizing NIM% in 2020 is due to potential reversal in 2021. Banks are likely to receive the majority of funding cost relief in 2020 as further NMD rate cuts are exhausted and term funding matures. In 2021, asset yield compression is likely to continue without the corresponding offset from funding costs. In addition, the accounting moratorium on problem loans may be lifted, further depressing asset yields. Should NIM% compression emerge in 2021, banks will have less capacity to deal with potential lagging credit risk issues arising from a transitioning covid economy. Use the likely 2020 NIM% boost to "fund" the LLR this year and smooth earnings.

How to think about IRR?

Fed rate policy is likely on hold for at least 18 months. Greater clarity related to the strength of any economic rebound should be forthcoming over the next few quarters. In the interim, ALM focus is likely better attuned to maximizing NIM% in the short term with focus potentially shifting to IRR management depending on asset allocation strategy. How much IRR may increase over this interim will depend on the magnitude of

residential mortgage refinancing within a bank's portfolio. Are you retaining or selling mortgages? Current IRR profiles may be skewed by temporary excess liquidity and historically low rates. This may also temporarily mask increasing IRR over the next few quarters. EPG will work with clients to ensure that this is understood. Incurring added IRR during this period is a recommended tradeoff of remaining too defensive. Maximizing current earnings to protect against potential credit issues is considered a higher priority. Given the Fed's stated policy, remaining on the sidelines with excess liquidity will likely be more detrimental to earnings compared to any negative repercussions from taking on more exposure to future rising rates. Any IRR taken now which requires future attention can be handled through term funding extension at a later date. Be careful over extending beyond one year with term funding currently. Flexibility for shrinkage is important if a credit crunch develops and/or excess liquidity builds further.

While interest rates remain historically low, banks are likely to experience heightened exposure to Down interest rate scenarios. In many cases, banks may exhibit profiles exceeding policy risk limits. This is primarily a function of implied negative interest rates resulting from any assumed further decline. Asset yields can still drop to a much greater extent compared to funding costs. In addition, unless banks begin to assume "charging" customers for deposits, this relationship will be exacerbated as banks will be correspondingly "paying" for held overnight liquidity. Clients should not manage for negative interest rates at this time but instead document and explain the results for the board. The probability and context of a negative rate policy will be fully documented for clients through the ALM process. ◆

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