The ADVISOR

Focus on Community Banking Issues

First Quarter 2022

ECONOMIC ENVIRONMENT

The Key Issues Remain the Same

A quarter ago, the economy faced a number of pressing issues, including inflation, a tight labor market and headwinds from higher energy prices. And, let's not forget, the constant overhang of COVID and the possibility of future waves or new variants. Fast forward to present, and the same issues persist, although you could easily make the case that each is now more severe than just a few months ago. In addition, however, we also have a much more hawkish Fed, translating to more aggressive action regarding the taper, monetary policy, and potentially the size of their balance sheet (more to follow on that subject shortly).

Inflation is the Focal Point

While inflation was a significant concern last quarter, the Fed was still attempting to cling to its 'transitory' language. Since then, with inflation continuing to climb higher, the Fed has dropped that notion and the problem has become a topic of national discussion. The Consumer Price Index jumped 7% in December on a year-over-year basis, the fastest increase since 1982. Whereas last quarter inflation looked to be leveling off (with CPI readings in the mid 5% range from June to September), it has accelerated to readings above 6% in the last three months, to multi-decade high levels.

Inflation has traditionally been described as 'too many dollars chasing too few goods' and that remains the case today. However, as with last quarter, the driver remains 'too few goods' rather than demand, even though demand is certainly robust. The much discussed turmoil in global supply chains remains a significant constraint on global trade, and worsens with each COVID outbreak in a goods-producing country when factories are shuttered or workers become ill.

Features

- *Economic Environment:* It's all about the Fed and Inflation.
- *Fixed Income Strategy:* Investing today with rates about to rise.
- *Equity Strategy:* 2022 will look much different than 2021.
- *ALM Strategy:* Updating your ALM framework for a changing environment.

EPG RATE FORECAST

January 2022

MARKET RATE	Actual (%) 12/31/2021	Projected (%) 12/31/2022	Yr1 Δ	Projected (%) 12/31/2023	Yr2 Δ
FedFunds	0.25	1.25	1.00	2.00	0.75
Prime	3.25	4.25	1.00	5.00	0.75
3mthTsy	0.06	1.00	0.94	1.75	0.75
6mthTsy	0.19	1.10	0.91	1.85	0.75
1yrTsy	0.39	1.25	0.86	1.95	0.70
2yrTsy	0.73	1.45	0.72	2.05	0.60
3yrTsy	0.97	1.60	0.63	2.15	0.55
5yrTsy	1.26	1.85	0.59	2.40	0.55
10yrTsy	1.52	2.25	0.73	2.50	0.25
30yrTsy	1.90	2.50	0.60	2.75	0.25

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.

ECONOMIC ENVIRONMENT

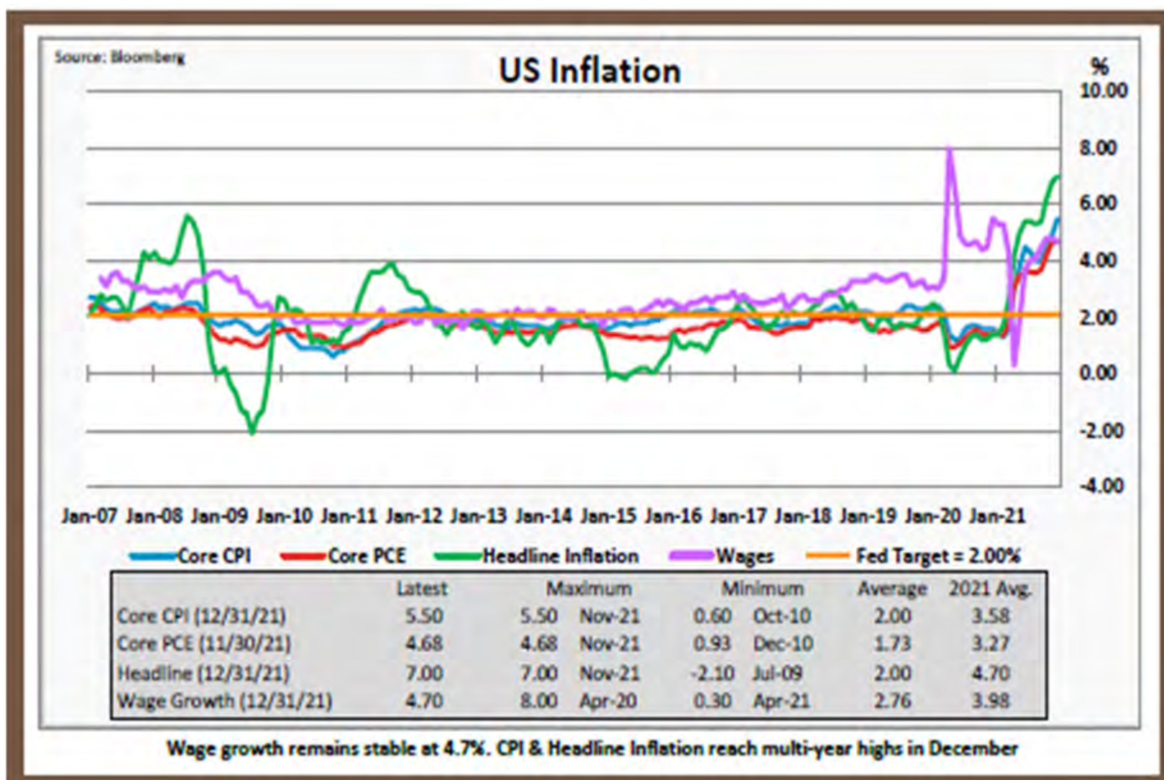
For example, the recent lockdown in the Chinese city of Anyang, with a population of over 5 million people, will fortunately be unlikely to impact the U.S., as the factories in that area supply the Chinese market. However, the next lockdown could easily take place in a city with large exporters, leading to a further global slowdown of goods.

In addition to inflation readings that have increased significantly over the last quarter, we now have a Fed that is considerably more hawkish than it was only a short time ago. In fact, according to CME Group, Fed Fund Futures currently indicate an 84% probability of a 25 basis point rate hike at the FOMC meeting in March, followed by a 37% chance of an additional 25 basis point hike at the May meeting.

Likely Fed Action and the Impact on the EPG Forecast

So, will the Fed hike in March? The market seems to think so, but it seems early given the timeline of the taper. Although the Fed is likely to be much more aggressive confronting faster inflation than at any point in most of their careers, a hike in March would coincide with the end of the taper, allowing the Fed no time to assess the impact of ending bond purchases before moving immediately into tightening mode. Allowing even one quarter after the end of the taper would help the Fed to gauge market sentiment, and more specifically the impact on the shape of the yield curve. As a result, we believe that the Fed will hold off in March, instead opting to start in June, but with an initial 50 basis point hike. While the 50 basis point action in June will land the Fed Funds rate at the same place as 25 basis point hikes each in March and June, it will allow for extra time for taper analysis.

After the initial forecasted 50 basis point Fed hike in June, we project 25 basis point hikes quarterly until we reach a terminal rate in the low-mid 2% range. This indicates a tightening cycle that runs into the third quarter of next year, likely ending in September. The longer end of the curve will likely continue to rise, but at a slower pace than the shorter end, leading to a flatter curve as the 10-year Treasury reaches 2.25% by the end of



	Latest	Maximum		Minimum		Average	2021 Avg.
Core CPI (12/31/21)	5.50	5.50	Nov-21	0.60	Oct-10	2.00	3.58
Core PCE (11/30/21)	4.68	4.68	Nov-21	0.93	Dec-10	1.73	3.27
Headline (12/31/21)	7.00	7.00	Nov-21	-2.10	Jul-09	2.00	4.70
Wage Growth (12/31/21)	4.70	8.00	Apr-20	0.30	Apr-21	2.76	3.98

Wage growth remains stable at 4.7%. CPI & Headline Inflation reach multi-year highs in December

2022, then inches up to 2.50% by the end of 2023. With the shorter end driven by Fed rate hike activity while the long end is driven by inflation expectations, investors at the longer end will feel more comfortable buying longer duration assets with the Fed aggressively attacking inflation.

What Could Go Wrong?

With a more aggressive Fed comes a number of potential concerns, the most likely being an overshoot driven by the need to catch-up, as many feel they are already 'behind the curve.' Although a quarterly hike of 25 basis points does not sound excessive, it will come on the heels of the end of the Fed's bond buying program, and may be coupled with a managed decline in the size of their balance sheet, dubbed 'quantitative tightening.' The Minutes from the December FOMC meeting indicate that members are already discussing this, and if it comes to pass, would provide a significant additional impact on the markets and the yield curve. However, one possibility would be that the Fed anticipates the flatter curve that will result from rate hikes, and will use quantitative tightening to offset that impact, effectively allowing the Fed to tighten while providing upward pressure on the longer end of the Treasury curve. This tactic would require consistent oversight to effectively balance the flattening impact of the rate hikes with the steepening impact of the bond sales. The Fed understands the weight its words carry, and the mere mention of quantitative tightening may be enough to offset a portion of the downward pressure on the longer end of the curve.

The most likely outcome of the Fed overtightening is an economic slowdown, which will then force a reversal of a portion of the hikes. For example, remember back to December, 2018 (which seems like a lifetime ago!) when the Fed raised the Funds rate 25 basis points, the ninth hike of that size in that cycle. The market responded immediately, with stocks falling to 12 month lows, indicating that investors believed that the Fed overshot and was out of touch with current market sentiment. It was then forced to cut rates only a few months later, in the summer of 2019.

Let's Not Ignore the Job Market

Have you tried to hire anyone lately? If so, good luck! The U.S. labor market remains historically tight, with 10.6 million jobs currently open coupled with only 6.3 million unemployed people, according to the Labor Department. Even if every unemployed person accepted a job tomorrow, we remain 4.3 million workers short of business needs, up from 2.7 million a quarter ago. This shortage is driving up wages, as companies fight for workers. With an Unemployment Rate of only 3.9%, companies are being forced to pay-up for talent to meet rising demand as consumers want to resume normal, pre-pandemic activities. To this point, the CEO of Goldman Sachs, David Solomon, stated recently that "There is real wage inflation everywhere in the economy. Everywhere." This statement was driven by Goldman's 31% year-over-year increase in personnel expenses, compared with Q1 of 2020.

Job growth has slowed the last five months, which is expected when we approach full employment with a sub 4% jobless rate. To boost job growth, people need to be enticed to reenter the labor market. The Labor Participation Rate rose modestly in 2021, from 61.4% in January to 61.9% at year end, but remains well below the pre-pandemic level of 63.4% in February 2020. Given today's tight labor market, it seems that wages have not yet risen to the level that will attract enough of the workers that currently sit on the sidelines. Unfortunately, that is not what companies would like to hear as they continue to face hiring challenges. ◆

FIXED INCOME STRATEGY

Listen to the Fed

The Federal Reserve has effectively told investors that they will begin reducing their balance sheet soon after they start raising interest rates. In terms of timing and degree, there are compelling and logical reasons supporting a March lift-off for raising rates, most notably surging inflation, as well as the psychological benefits of knowing the Fed is in front of the problem and not continuing what many feel has been a pattern of doing "too little too late." In fact, if the Fed does not maintain and enhance its credibility in its battle against inflation, rate hikes may have little if any impact on longer term rates and could lead to a flat or inverted yield curve. As of now, the likely degree to which rates will be raised is within the range of 75 to 125 basis points in 2022, and 75 to 100 basis points looking out into 2023.

The Shape of the Curve is About to Change

However, while the Fed will begin raising rates, certainly by June, with a view that the terminal rate is likely to be in the 2.00 - 2.50% range, the longer end of the curve is expected to have difficulty getting much lift and may remain fairly close to current levels. This could translate to the 10-year Treasury, currently near 1.80%, moving to a yield of perhaps 2.00 - 2.50%. This is even as we see rising prices, structural challenges such as supply chain disruption and continued, albeit slowing, robust consumer demand.

A flattening yield curve is therefore a possible if not probable result, the same challenge which was faced during the early 2000's with Fed action.

2022: Parameters for Fixed Income Decision Making

Thus, with this as a backdrop, investing in 2022 must incorporate and anticipate a changing, not just rising, yield curve. The likely shape of the yield curve will dictate how far out one can invest while being appropriately compensated for the associated risk. Choosing preferred duration will be a critical element in reinvestment of cashflow coming from the investment portfolio, as well as utilization of any additional liquidity not absorbed by other activities on the balance sheet. Fixed income investment performance will be measured in several ways, including interest income, price volatility (i.e. liquidity source) and perhaps most importantly, the expected spread when incorporating an increasing average cost of funding (i.e. depositors demanding higher rates on their deposits). The trade-off among income, price volatility and spread varies from financial institution to financial institution, driven by differing corporate priorities as well as the overall risk tolerance of the management team.

Unlike 2021, when rates were historically and absolutely low and therefore had no where else to go, the question of if and when rates would rise was a primary driver. Today there is certainty that we are about to see rates rise. Combined with this certainty is a continued expectation that financial institutions will retain most, if not all, of their excess stimulus-based liquidity and as a result, the question becomes "If rates are going up, do we continue to sit in cash?"

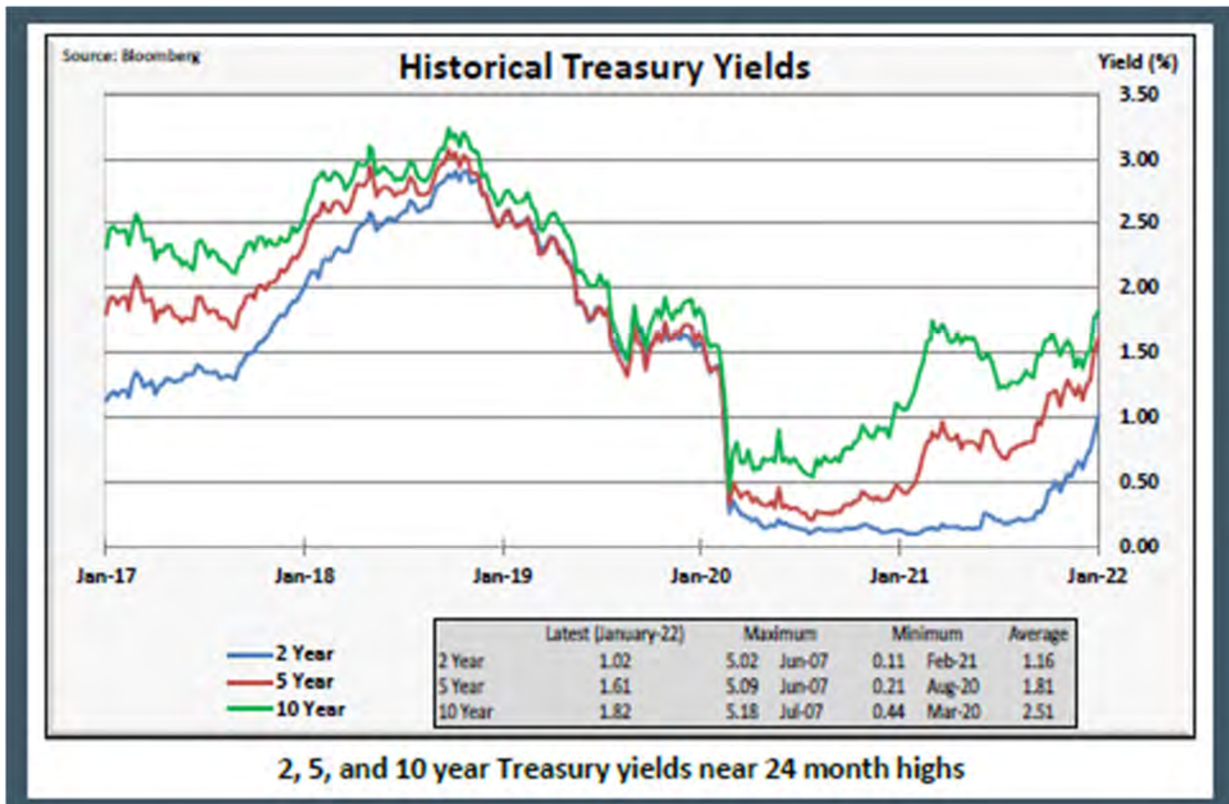
What About Cash?

Even as one is projecting Fed Funds to rise over the coming year to as high as 1.00 - 1.50%, an average yield of 50 - 75 basis points is likely for the coming 10 month – 12 month period. With shorter term Treasuries having reached yields from 0.35 - 1.30%, a blend of 6 month to 3 year Treasuries could produce a yield of approximately 85 basis points with a cash flow/maturity pattern that could align with Fed action and therefore move up with continual reinvestment of maturities. This also allows for short term and ample liquidity as maturities occur, in the event deposit outflows are experienced. Even 3 months ago, Treasury yields could not support such a strategy for excess funds.

Rates May Peak at Historically Low Levels

While all are expecting Fed and related market action to move rates higher, Fed Funds ultimately "settling in" under 2.50% with longer Treasuries under 3.00% not only reflects a flatter yield curve, but also rates that remain historically low. This certainly supports an additional investment dynamic which is to be aware and vigilant in setting an entry point to begin purchasing bullet type fixed income investments. Locking in yields that, while low, reflect attractive spreads to alternatives and to cost of funding will provide portfolio diversification and protect against a possible decline in rates, no matter how unlikely. The recent rise in rates has made that downside protection, in the form of bullet investment structures, more attractive when compared with maintaining excess cash at current low levels.

If the Fed is able to successfully address inflation and reach their 2.00% target without pushing the economy into recession, then pressure for rates to continue upward will be removed. In fact, there are rational scenarios that would lead to rates remaining flat or actually declining in 2024. However, that is a long way off when looking at all that is occurring in today's world but certainly important to keep in mind. ◆



	Latest (January-22)	Maximum		Minimum		Average
2 Year	1.02	5.02	Jun-07	0.11	Feb-21	1.16
5 Year	1.61	5.09	Jun-07	0.21	Aug-20	1.81
10 Year	1.82	5.18	Jul-07	0.44	Mar-20	2.51

2, 5, and 10 year Treasury yields near 24 month highs

EQUITY STRATEGY

2021: One Step Back to Go Three Forward!

Equity markets had an exceptional year in 2021, continuing the recovery from the 2020 correction which reflected the conscious decision of world governments to shut down economies to slow the spread of the pandemic and all of the damage this inflicted on the economy. 2021 drove forward delivering a total return of 29%, the third year of double digit returns and clearly reflecting a bull market. 2021 performance was led by cyclical sectors such as energy, financials and technology.

With this backdrop, we enter 2022 with a cautious and changing view. Many potential pressures on equity performance are bubbling to the surface, creating downward pressure on investor outlook, impacting sentiment and therefore equity price movement. Equity investing is about confidence in today's information combined with visibility into tomorrow. Any material event or pressure that "clouds the view" into the future is a potential risk to equity market performance. Today, there are several.

As this bull market now stretches into its third year, returns are being muted when digging a little deeper into performance. This "stretching out" of a trend and momentum, based on underlying fundamentals not necessarily moving in tandem, tends to create higher likelihoods of muted performance as the trend continues. In the latter half of 2021, what was 90% of companies trading above their 200 day moving average fell below 60%, according to Yardeni Research as reported by Forbes Advisor. In addition, according to Goldman Sachs research, five stocks accounted for over half of the S&P return from April onward (Microsoft, Google, Apple, Nvidia and Tesla). The most important dynamic occurring today is what most of us have known for months- inflation is here and roaring forward. It appears the few of us who were not aware of this included the Fed! With the assumption that inflation typically means a growing economy, and this combined with massive liquidity injected into the system as a strategic response to the pandemic, longer term outlook for equity investing remains upbeat and expectations are optimistic. It is, after all, a reflection of long term global wealth creation.

2022: Be Careful What You Wish For

We have begun the year with leading indicators telling us "things look good, really good." The economy no longer needs stimulus support and due to strong household and corporate balance sheets, the impressive economic cycle should continue. Profits continue to grow and an abundance of consumer demand exists, due to dollars available to fund purchases and meet pent up demand.

However, too many dollars chasing too few goods and services causes purchasing power to decline as prices rise and costs go up faster than earnings and pricing power. Maintaining profit margins and ultimately sales/revenue growth is the challenge in such an environment. This is where the Fed comes in. In theory, by being able to see further along the horizon and anticipate when and how to balance the benefits and risks of inflation is a critical platform upon which the Fed does its job. However, few believe they were able to do this successfully and thus, we are now entering a period of adjustment as the Fed pivots to tightening by shrinking their balance sheet, removing their extraordinary influence on the bond market, and raising short term rates, with many saying 75 to 125 basis points over the next twelve months, with an additional 75 to 125 basis points looking out through 2023. The seen and unforeseen consequences of the Fed coming "late to the party" and the impact such an aggressive stance can have on the economy is what equity investors are having difficulty divining. There is always a risk that fearful investor outlook, fueled by a lack of leadership from the Fed, and a corresponding sense of uncertainty about collateral damage, could create a self-fulfilling prophecy of negative investor outlook that applies downward pressure on equity markets.

As a result, safe or safer harbors are being sought, even before the Fed has actually started to act. This is taking the form of repositioning into those industries that could outperform in this kind of environment, including shifting equity holdings into asset alternatives such as interest bearing investments and inflation hedge strategies. Again, longer term positioning of a diversified equity portfolio with a total return structure is a prudent and attractive strategy that guides "big picture" thinking. In the immediate term and looking out over the next two years, volatility due to a rising rate environment and the potential damper this will place on economic growth and visibility is here.

EQUITY STRATEGY

The Fed Pivots: How Do We?

While not advocating a wholesale restructuring of equity portfolios, a fresh review of the methodology and processes used to develop "buy, hold, or sell" actions is the first step in responding to this environment. It is unlikely that market movement and if necessary, recovery, will be a "rising tide lifting all ships." The impact of rising rates and shifting consumer sentiment are two key elements to incorporate into any equity position review. Existing equity positions need to be analyzed to ensure that the holding horizon corresponds to weathering through the projected volatility and remains a core holding looking out into the longer term. This is consistent with conservative investment policy guidance. Next, confirming that a possible market/ portfolio correction of 10, 20 or 25% occurring within a 6 month timeframe does not materially impact the investor's business or life is critical. If so, reduce exposure overall in order to "weather any possible storm" without one challenge creating another.

Know When to Hold, Know When to Fold

A total return focus, including secure realistic dividend yields, is a guiding parameter for investment in this environment. Understand that during periods of extreme economic stress, dividend growth rates can shrink, but since 1970 dividend yields have grown several percent per year on average. They remain an important contributor to long term performance in equities.

This focus is not new. The investment policy frames not only the objectives and value that an investment grade portfolio of diversified equities provides, but also a strategy of total return investing. With this being said, is it really about "waiting out this period of uncertainty" or is there a strategy responding to this market? This strategy could include culling positions that might otherwise meet all policy and "best practices" considerations, but are viewed as being least ready or structured to meet a rising rate, more volatile economy. This would be reflected in not so much shorter term decline in price but deteriorating fundamentals and rising likelihood of a stagnant future as measured by position in its industry, earnings, and various market share measures. Target prices are one way that such perspective is consolidated into a view.

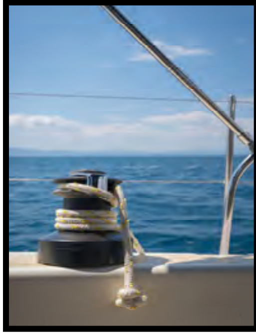
Next, based on a general view of maximum exposure to equity investment overall, "freeing up" cash to move from potential equities not best positioned for this market into better aligned holdings guides sizing of new purchases.

Buy the Dip…. Which One?

Patience is a valid strategy. As we have seen just in the last few weeks, the market behavior for this year is different than prior downturns/buy the dip opportunities of recent years. Buying on the dip has not been able to resurrect the markets so far, and individual issues have not yet been able to shift into recovery mode. There are bigger dynamics at work. The severity and degree of Fed action, continued damage from pandemic induced supply issues, massive societal behavior shifts, geopolitical risks, and overall sentiment will combine to continue to place downward pressure on equity performance in the coming quarter. This is likely even as corporate earnings are mixed but overall quite good.

Economic data and related corporate earnings outlook incorporating some understanding on how Fed actions will impact growth and buying power is what is needed. Most would argue developing this understanding could be months away. ◆

S&P 500 Index dips slightly, still trading near record highs



ALM STRATEGY

ALM STRATEGY

Updating Your ALM Framework for a Changing Environment

EPG has laid the groundwork for ALM strategy over the last several quarters of ADVISOR publications. From excess liquidity implications and redeployment tactics to funding strategies around term extension hedging and non-maturity deposit program enhancements, processes have been identified in preparation for transitioning into a post Covid environment. What if anything has changed? The Fed's pivot mid-November has potentially accelerated the timetable for previously discussed ALM strategies, made others less appealing, and opened the door to exploring new ideas. This quarter's ADVISOR will effectively update current ALM thinking as we roll into a new year with significant changes on the horizon.

Fed's Recent Pivot Creates a Much Different Environment to Start 2022

Interest rates have increased since our last publication and are poised to move higher. Most of the recent increase impacted the "belly" of the curve, with 2-5 year Treasury yields rising on average 25 basis points in Q3 and 50 basis points in Q4. Based on this 75bp rise, the market is pricing in multiple Fed rate hikes. The Fed's tapering program has started and is now fast tracked to conclude by the end of Q1, earlier than originally planned when just announced in November. Meanwhile, the 10-year Treasury has only increased 25bp above its 2021 average of 1.50% to start the new year. Still, at 1.75% it has pushed residential fixed mortgage rates to their highest level in two years. The pace of refinancings has slowed for several consecutive months, reducing the level of prepays. Against this flatter yield curve backdrop, the Fed must balance fighting inflation and risking recession as they contemplate a quicker ramp-up to policy tightening.

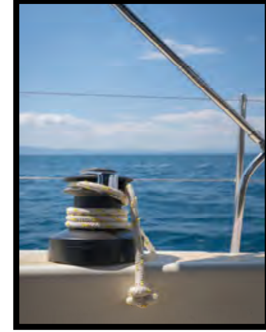
How Does This Impact ALM Strategy?

2021 was characterized by asset mix focus as excess liquidity persisted. While maybe not at peak levels, liquidity remains elevated and above average to start the new year. From one perspective this is beneficial heading into a Fed tightening cycle; however, if liquidity levels grow, it can be counterproductive. The concern over continued excess liquidity stems from the loan demand/growth challenge. How difficult will it be for banks to hit targeted budget goals? Higher and rising mortgage rates coupled with an extremely tight housing market does not bode well for residential mortgage volume in 2022. Could the competition for a smaller pool of assets "crowd out" smaller community banks?

How should banks counter this potential risk? Consider aggressive loan acquisition early in 2022. Plan to "front load" loan growth the first half of the year ahead of further slowdown. Pursue alternative sources to supplement volume. Don't wait until volume dries up to establish third party pipeline potential. In the interim, lag mortgage rates as the market rises to enhance competitive advantage in the likely smaller pool of available loans. While banks would all like higher loan rates, if you cannot get volume at the increased level, are you really better off? Barring success, banks may find the need to increase bond allocation. While the rise in the belly of the curve has made bonds more attractive, asset yield pressure would be intensified if substituting for budgeted loan targets.

Do You Have a Tummy Ache?

The aforementioned rise in 2-5yr Treasury yields has significantly increased wholesale term funding rates and introduced potential remorse at not taking advantage before the belly bloated. As discussed in last quarter's Advisor, the opportunity existed then to lock in funding as an IRR hedge for the next several years. Elevated liquidity at the time required a longer-term approach and implementation before the opportunity window closed. At the time, banks could lock in 3-5yr funding averaging <75bp. That same strategy will now cost 50bp more.



The program outlined at the time is still valid; however, banks may now want to forego the five-year term and shorten the ladder to average 2-3 year terms. It is certainly not too late to enact term extension hedging strategies, just not at the trough in rates. From a historical perspective, wholesale rates are still relatively attractive. Banks must weigh the need against existing liquidity levels and deposit flows, as even though wholesale rates remain attractive, the proceeds would likely squeeze margins while sitting idle in a lower yielding Fed Funds deposit account. The rise in the belly of the yield curve does make existing FHLB holdings more attractive for prepay. Prior analysis may have seemed cost prohibitive. Re-assess if still carrying excess liquidity. Banks may now be able to retire existing advances much closer to par and eliminate negative interest carry.

Timing is Everything

The Q4 ADVISOR encouraged review of NMD product offerings, recommending banks to consolidate older, grandfathered types and game plan for a new rate cycle. The timetable has sped up as the Fed was expected to be on hold until the second half of the year. With earlier rate hikes expected as soon as March, banks should accelerate product review and discussion about how marketing programs will be implemented as FRB policy shifts.

Expect Increased Regulatory Scrutiny in 2022

It may not seem like it but the last few years have been regulatory "light". Eased regulations under the Trump administration, excess liquidity, understanding around lower capital ratios, and sound credit quality all kept examiners at bay. What is changing? New supervisory heads to be filled at the FRB, FDIC, and OCC current open positions, all to be appointed by the Biden administration, will likely initiate a more progressive, consumer friendly environment. Coupled with upcoming new Fed governors, the landscape is changing to focus on enhanced competition, racial equality, climate change impact, and crypto currency. All of this may play out as earnings pressure increases now that PPP fees and other positive "noise" from last year dissipates.

Again, Timing is Everything

Earnings potential should be viewed from a short-term and longer-term perspective as the environment changes. NIM% should benefit initially in the wake of FRB rate hikes as liquidity & PRIME index assets rise while NMD product rates lag. It will take several tightening moves before deposit rates are materially impacted, making it much more likely to be a 2023 dynamic. Longer-term, funding costs would be pressured higher making the urgency of putting liquidity to work more vital. ALM strategy should therefore focus on asset management early in 2022 before a potential shift to more liability focus in the second half of the year. ◆

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