The ADVISOR

Focus on Community Banking Issues

Third Quarter 2022

ECONOMIC ENVIRONMENT

Recession Risks Mount as Fed Continues Tightening

A quarter ago, it had become clear that inflation was not "transitory" as the Federal Reserve had previously asserted, and that aggressive and sharp rate hikes were needed to stabilize consumer prices. This has since played out, with the FOMC having raised the Fed funds rate by a total of 150 basis points since the March meeting and another 150 basis points expected within the July, September, and November meetings. Consumer sentiment is falling, and Americans are tapping into savings and revolving credit for necessities such as rent, food, and fuel. These dynamics have complicated the Fed's difficult position of fighting inflation while attempting to avoid a slowdown. In our view, a "soft landing" has become increasingly unlikely, and a near-term recession is probable. While the current landscape is unique in that the Fed is more transparent and wields more influence than in decades past, history does not favor a soft landing. Of the 15 tightening cycles since the 1950s, 10 resulted in a recession. Predictive models echo this sentiment, as Bloomberg's recession probability algorithm estimates a 38% chance of a downturn within 12 months and a 100% chance within 24 months. Looking ahead, second quarter corporate profit margins and earnings revisions should be a barometer for how quickly a recession materializes; these results will provide clarity to the true impact of producer price inflation on margins.

Has Inflation Peaked?

Inflation expectations and the effects of rate hikes on monthly consumer price increases will remain the main driver of Fed policy for the remainder of 2022 and into 2023. While June's 9.1% year-over-year CPI increase marked another 40+ year high, many economists estimate that inflation has reached its peak. In 2022, the primary drivers of CPI increases have

EPG RATE FORECAST

July 2022

MARKET RATE	Actual (%) 6/30/2022	Projected (%) 6/30/2023	Yr1 Δ	Projected (%) 6/30/2024	Yr2 Δ
FedFunds	1.75	3.25	1.50	2.75	-0.50
Prime	4.75	6.25	1.50	5.75	-0.50
3mthTsy	1.72	2.98	1.26	2.10	-0.88
6mthTsy	2.51	3.03	0.52	2.20	-0.83
1yrTsy	2.80	3.08	0.28	2.30	-0.78
2yrTsy	2.92	3.14	0.22	2.40	-0.74
3yrTsy	2.99	3.19	0.20	2.45	-0.74
5yrTsy	3.01	3.19	0.18	2.50	-0.69
10yrTsy	2.98	3.20	0.22	2.60	-0.60
30yrTsy	3.14	3.30	0.16	2.70	-0.60

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.

Features

- *Economic Environment:* Recession risks climb as we near peak inflation.
- *Fixed Income Strategy:* The Fed continues to have outsized impact on the bond market.
- *Equity Strategy:* Have we hit bottom?
- *ALM Strategy:* Deposit competition heats up.

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ECONOMIC ENVIRONMENT

been energy and food prices, but both have declined since the end of June. After reaching $122 per barrel on June 8, WTI Crude has fallen beneath $100 to represent a near 20% decline in just over one month. Wheat futures have declined in tandem from $10.93 per bushel on June 6 to about $8 per bushel. Core CPI, which excludes more volatile food and energy prices, has provided evidence that inflation may have already seen its peak. While June's YoY Core CPI reading of 5.9% exceeded estimates, the metric peaked in March at 6.5% and has been edging lower in the months since.

Despite these positive signals, the Fed has limited control over major CPI determinants such as food prices and supply chain imbalances. To the consumer, food is among the most pivotal components of inflation, but contractionary Fed policy has not driven its recent price decline. Favorable weather has raised expectations for wheat output, and demand for the commodity has fallen given the high premiums of wheat over corn. About 20% of wheat production is traditionally fed to animals, but farmers are now choosing to feed cheaper corn to their livestock. However, this may reverse quickly as export restrictions on Ukrainian wheat will likely weigh on winter crop yields. This ties into supply chain bottlenecks, which were created from pandemic-related restrictions and exacerbated by the war in Ukraine. The Fed has been forced to overcompensate for these issues by raising rates more aggressively, and this may contribute to the possibility of a policy overshoot and subsequent recession.

Probability of a Fed Reversal and EPG's Rate Forecast

In recent weeks, Fed Chair Powell has reiterated the FOMC's commitment to extinguishing inflation through rapid and sizeable rate hikes. This has been reflected in the Fed funds futures market, which has completely priced in a 75 basis point hike in July. While we expect 150 basis points of tightening across the next three meetings, our view is that these hikes will push the economy into recession sooner than forecast, which will then prompt a pause and subsequent reversal of contractionary policy. Following consecutive months of greater than expected inflation, the Fed will be aggressive to reach a higher terminal rate more rapidly than the FOMC had planned prior to this data. With the Fed raising rates so quickly, they will not be able to gauge the effect of a singular rate hike on inflation before hiking rates again, which creates an imperfect target for the FOMC. Therefore, the anticipated aggressiveness raises the likelihood that the Fed will overshoot the terminal rate needed to contain inflation, thus damaging growth and creating a recession. EPG's projection is for the Fed to reach a terminal rate of 3.50% by November 2022, after which the economy will fall into recession. We then expect the Fed to react quickly to a pullback in growth by cutting rates by 25 basis points in June 2023, then continuing with quarterly 25 basis point cuts until reaching a long-term rate of 2.75%.

Will the Labor Market Stay Robust?

While we do see a recession on the horizon, the labor market is still a position of relative strength for the U.S. economy. In June, nonfarm payrolls increased by 372,000 and the labor force participation rate actually declined to 62.2%. Interestingly, the labor market's continued strength has provided a runway for the Fed's aggressive tightening cycle. With the economy adding hundreds of thousands of jobs every month and the unemployment rate remaining steady at 3.6%, the Fed has been able to raise rates without violating its

mandate of maximum sustainable employment. The graph below illustrates this relationship, where inflation and the unemployment rate have moved in opposite directions since the beginning of 2020.

If job growth trends downward, however, the Fed may face pressure to end its tightening cycle sooner. This could soon become a possibility, as weekly initial jobless claims are rising and economists are projecting a weaker pace of hiring in July. For now, the labor market is still tight, with 2 available jobs for each unemployed worker (vs 1.6 open jobs per unemployed worker pre-pandemic). The economy is in the unique position of a historically strong labor market amid recession fears and contractionary Fed policy, so upcoming data will be critical as to the direction of these opposing forces.

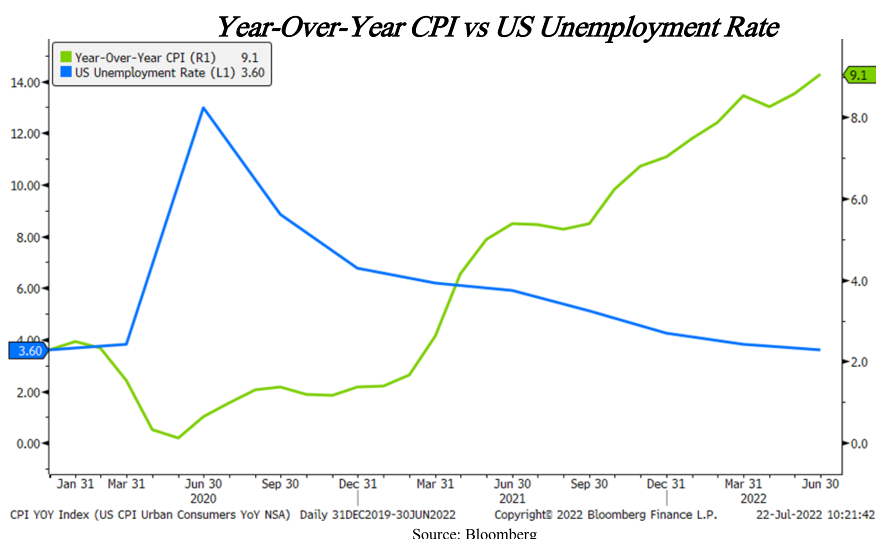
Housing Begins Responding to Higher Mortgage Rates

In the first quarter, housing prices continued to accelerate in the face of rapidly increasing mortgage rates, a dynamic that seemed counterintuitive on the surface. After all, mortgage rates and housing costs are inversely correlated, as prospective buyers can borrow more money when borrowing costs are low. At the time, homebuyers raced to buy with the view that rates would rise even further. Coupled with a lack of inventory resulting from existing homeowners' reluctance to sell after presumably locking in a sub-3% rate, prices rose. This trend appears to be reversing over the last month, however, as mortgage applications fell to the lowest level in over 20 years for the week ended July 15. According to the National Association of Realtors, sales of previously owned homes fell 5.4% from May and are down 14.2% from June 2021. Further, homebuyers are backing out of deals; Redfin data shows that 60,000 home sales fell through last month, representing nearly 15% of all homes that went under contract in June.

The data suggests that prospective homebuyers are choosing to rent given the elevated cost of borrowing. Even with record-high rental costs across the nation, a report from Realtor.com suggests that the average monthly mortgage payment for a starter home is now $561 higher than the cost of

renting in the same geographical area. In 2021, this differential was only $171, a result of far lower mortgage rates. After starting the year at 3.11%, mortgage rates have climbed to nearly 6%, which has made the monthly payments unaffordable to many who would be in the market otherwise. For example, the monthly payment on a $750,000 30-year fixed rate mortgage at 3.11% is $3,207. At the current average rate of 5.84%, the monthly payment balloons to $4,420. To achieve the same monthly payment of $3,207 at a 5.84% rate, the prospective homebuyer who could previously afford a $750,000 mortgage can now only borrow $544,202. In the coming months, home prices should trend lower as the housing market continues to feel the effects of elevated borrowing costs. ◆

Year-Over-Year CPI vs US Unemployment Rate



Source: Bloomberg

FIXED INCOME STRATEGY

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The Fed has Become More Aggressive With Rate Increases

Entering the year with the Fed still operating under the assertion that inflation would be "transitory," the FOMC was only planning to raise rates 3 times during this calendar year. Once the Fed realized that inflation was no longer transitory, they signaled to the market that they changed their stance on monetary policy, and markets reacted quickly as rates increased across the yield curve. The recent inflation data is the highest in the U.S. since 1981. The FOMC has now raised short term rates by 150 basis points, and we project that they will hike another 75 basis points at the July meeting. Chair Powell also mentioned during the June press conference that the FOMC projects that after another aggressive tightening, the economy should start to show signs of slowing and a less aggressive approach may be warranted later this year.

Is It Possible Rates Have Peaked?

The second quarter has been volatile, with continued upward pressure on interest rates as the Federal Reserve continues raising short term rates in their attempt to contain inflation. Fixed Income markets have remained volatile, and interest rates rose by over 50 basis points during the 2nd quarter across the Treasury curve. The catalyst for elevated interest rates continues to be the inflation data coupled with actions taken by the Fed to get the U.S. economy back to the target of 2.0%.

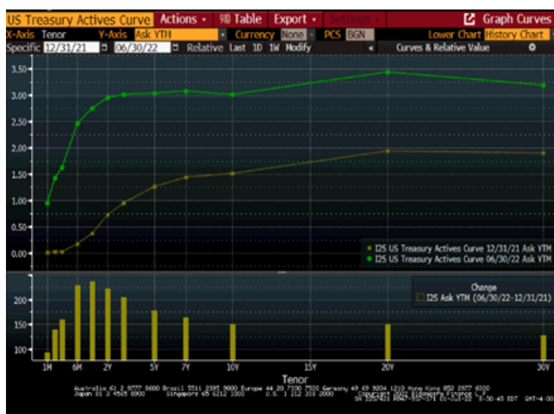
With the year-over-year Consumer Price Index registering at 9.1% in June, the market has priced in a more active Federal Reserve. At the June press conference, Powell clarified that it is possible to continue to see another aggressive rate increase to Fed Funds again at the July meeting.

On June 22nd Chairman Powell told Congressional lawmakers that the FOMC is committed to reducing inflation to the target rate of 2.0%. We interpret this as higher rates on the front end until there is compelling evidence that inflation is declining. However, there are already signs that the economy is slowing. Gross domestic product was negative during the first quarter and is on pace to be flat during the second quarter. With this economic landscape and the longer end of the yield curve already hovering near 3.0%, there is an increasing possibility of a recession in the next 6-12 months. While aggressive rate hikes may contain inflation, they will also slow growth and raise the unemployment rate, ultimately making a soft landing difficult to achieve. Therefore, it is increasingly likely that we may see rate cuts as soon as mid-2023, and the terminal rate for Fed funds may turn out to be lower than the market anticipated as long term rates continue to maintain a range of 2.75% - 3.25%.

Fixed Income Investing

Interest rate volatility has resulted

Yield Curve



Source: Bloomberg

Term	12/31/2021	6/30/2022	▲
6 Mo	0.17	2.45	2.28
1 Year	0.38	1.74	1.36
2 Year	0.73	2.95	2.22
3 Year	0.96	3.00	2.04
5 Year	1.26	3.04	1.78
7 Year	1.44	3.07	1.63
10 Year	1.51	3.01	1.50
20 Year	1.93	3.43	1.50
30 Year	1.90	3.18	1.28

in wider spreads in all sectors when compared to similar duration Treasury securities. The Fed, as the 2nd largest owner of Agency MBS, during the height of their purchase program had been buying over $100 billion in MBS on a monthly basis. They concluded the purchase program early in the 2nd quarter and are currently in the first phase of winding down the monthly reinvestment of their $8.5 trillion portfolio, starting in June by reducing $20 billion in Treasuries and $17.5 billion of Agency MBS. The plan to be completely rolled out in September allows for $60 billion in Treasuries and $35 billion in MBS to roll off the balance sheet on a monthly basis.

The Fed's footprint in both markets has had an impact on interest rates and spreads. Mortgage spreads have widened by over 50 basis points this year on the anticipation of the Fed exiting the mortgage market, combined with interest rate volatility. The market has already priced in rate hikes as longer term Treasury yields are close to where the terminal Fed funds rate is projected to be at the end of the year. Agency MBS yields now look more attractive as the sector has repriced to attract additional buyers to absorb a larger portion of supply with the absence of the Federal Reserve.

The interest rate volatility has also added a significant yield advantage to participants in the Callable Agency sector. Early this year Callable Agencies were trading with only a few basis points of additional spread over the implied Treasury curve. We are now seeing 5 year non-call 1 year structures with over 75 basis points of additional spread, and 10 year and longer non-call 1 year structures offering in excess of 150 basis points of additional spread to Treasuries. In other words, the recent rate volatility has created multi-year wide spreads in this sector. If long term rates ultimately stabilize within this range, the reduction in volatility will cause Callable Agency spreads to tighten. Therefore, we believe it is advantageous to deploy a portion of the portfolio's cash into fixed income by locking in high absolute yields in the current market.

We continue to monitor the Municipal market as the sector has become more attractive as an additional investment alternative based on current valuations. During the first part of the year there were 19 consecutive weeks of Municipal outflows, totaling over $50 billion in risk reduction in the sector. With interest rates up nearly 150 basis points on the long end of the yield curve to start the year, tax exempt yields currently range

between 4.25% - 4.75% and can add diversification to current portfolios.

A Little Early for Bullet Structures

While the long end of the yield curve has the Fed fully priced in, many economists are now calling for a hard landing, creating a recession. In comparison to callable securities, more bullet like bonds have not underperformed nearly to the same degree. Current spreads on bullet like structures have held in when compared to Treasury securities. It could be simply that the Federal Reserve has been purchasing Agency MBS and U.S. Treasuries, thus Agency Debentures, FNMA DUS bonds, and other bullet like structures have benefitted from the widening that other sectors have absorbed this year as a result of the Fed. We believe additional clarity on inflation reaching its peak will help our decision as we approach the end of the current tightening cycle. Until then we will be patient on adding bullet like alternatives, as an inverted yield curve mitigates curve roll down, and spreads continue to look attractive in other asset classes. ◆

EQUITY STRATEGY

EQUITY STRATEGY

Equity investing: "wait for it… now?"

When looking at the movement in the major indexes for 2022, a key observation has been that a generalized approach to "buying the dips" has not benefited the equity investor. Many argue that the equity market volatility that has been seen in 2022 is a result of not just the anticipation of the Fed damaging the economy through raising short term rates, but also from the impact of a variety of macroeconomic and geopolitical factors that were building prior to and during the pandemic of 2020/21.

With this backdrop, determining how the various influencers on future equity investment performance will likely impact the equity market and individual stocks must incorporate a view of history and how bear markets develop and move through their life cycle.

The S&P 500 dropped 20.6% during the first half of 2022, marking the worst performance for the index in over 50 years.

The NASDAQ's returns were even more abysmal, posting a -29.4% return over the same period, placing 2022 in the record books as the worst start to a year on record for the NASDAQ. On June 16, the S&P and NASDAQ hit bottom for 2022. Both have since rallied, with the NASDAQ up 7.6% and the S&P up 6% in the last month. But with skyrocketing inflation, large Fed rate hikes looming, and threats of a recession, can an investor have a confident view that the stock market has already bottomed out?

Bear Markets: A Historical Perspective

A bear market is typically defined as a decline of at least 20% off an index's high. Over the past 65 years, a total of 10 bear markets have occurred ranging in length from one month to 2.6 years with the average bear market resulting in an S&P 500 decline of 35.7%. The worst return during this time period was during the 2007-2009 financial crisis when the S&P declined 51.9%. On the next page is a summary of the prior 10 bear markets which includes the length of the bear market, the percentage S&P 500 decline during the period, as well as the bear market recovery time.

Recession vs Bear Market

A bear market often, but not always, precedes a recession. The stock market is said to be forward-looking, and thus can be a leading indicator to the economy. The bear market doesn't cause the recession but instead is a strong indicator that a recession is on the horizon. Investors use many macroeconomic indicators such as GDP growth, inflation, interest rates and unemployment when making investment decisions. A recession is defined as negative GDP growth over two consecutive quarters. Of the past 10 bear markets, seven coincided with a recession. However, over the most recent seven bear markets, six coincided with a recession, indicating that the correlation between a bear market and a recession is increasing.

Have We Hit Bottom Yet?

With the understanding that equity investing is a "looking forward" discipline, investors search for insight and triggers that will signal when a bear market will likely end and positive upward movement in equity positions resumes. In most instances, a bear market nears its end when investor selling activity is strong, dramatic and overwhelms buying activity. This can result in "capitulation." What is capitula-

EQUITY STRATEGY

Bear Market	Length of Bear Market in Months	Did it Coincide with a Recession?	S&P 500 Decline (%)	Length of Recovery in Months
Aug 1956	15 months	Recession	-21.6%	11 months
Dec 1961	6 months	No Recession	-28.0%	14 months
Feb 1966	8 months	No Recession	-22.2%	7 months
Nov 1968	18 months	Recession	-36.1%	21 months
Jan 1973	21 months	Recession	-48.2%	69 months
Nov 1980	20 months	Recession	-27.1%	3 months
Aug 1987	3 months	No Recession	-33.5%	20 months
March 2000	31 months	Recession	-49.1%	56 months
Oct 2007	17 months	Recession	-56.8%	49 months
Feb 2020	1 month	Recession	-33.9%	5 months

Source: LPL Research & CFRA FactSet

The chart below shows the S&P 500 for the last 30 years and gives a helpful "picture" of market activity and those bear market periods that have occurred over the last 30 years.

tion exactly? Investopedia defines capitulation as "a dramatic surge in selling pressure… that marks a mass surrender by investors." By defining capitulation and understanding its elements, one can have a better understanding of when the bottom of a bear market may be forming.

Capitulation: Both technical and fundamental

Technical analysts track a number of metrics to help determine when capitulation occurs. Below is an explanation of some of the best (but not all) of the capitulation indicators used in determining bear market lows:

Equity-Only Put/Call Ratio: This ratio is used to quantify investor sentiment. The higher the number of puts relative to calls, the greater the possibility that the market is nearing a bottom. A ratio of at least 1.00 and upwards to 1.15 signals we are near the bottom. The current level of this ratio suggests the market has farther to fall as it peaked in mid-June around 0.90 and is now below 0.60.

Equity Fund Outflows: Another investor sentiment metric, high equity fund outflows is a bearish sentiment. The more bullish people are about the markets, the more inflows you'll see in equity funds. Whereas, the more bearish the sentiment, the more outflows you will see. Equity fund outflows have been low over the past few months, and in some recent weeks, inflows have actually occurred. This indicator suggests that the market has further to fall before capitulation happens.

VIX Levels: The VIX, also known as the "fear" index, is the CBOE volatility index which measures investors' expectations of near term volatility based on the prices of stock index options. The higher the VIX, the greater the level of fear and uncertainty in the market. A value above 30 is considered tremendous uncertainty, but a level above 40 is needed for capitulation. The VIX hit a 2022 high of 34 on June 13, 2022, but since then levels have been slowly falling to the mid-20s, closing at 24.5 on July 15, 2022.

52 Week Lows: A surge in new lows means investors are selling stocks at virtually any price, which is a strong signal full panic is underway. We have yet to see an adequate number of 52 week lows being reached to indicate capitulation has occurred.

200 Day Moving Average: Used by investors to determine the trend and direction of the market, this capitulation indicator is triggered when less than 20% of S&P 500 stocks are trading above their 200-day moving average. In mid-June, this indicator was triggered when less than 17% of the S&P 500 were trading above the 200-day moving average.

Decline in Margin Debt: Margin debt, tracked and reported by brokers on a monthly basis, is the primary form of stock market leverage that is tracked and reported. Margin debt is money investors borrow from brokers to purchase stocks. A decline of at least 10% in margin debt on a year over year basis is a signal that capitulation is underway. For June 2022, total margin debt of $683.4 million was down over 22% from June 2021 of $882.1 million. Both margin debt and the NASDAQ peaked in November 2021. As stock prices decline, margin calls increase, thus creating one major factor decreasing leverage.

Capitulation doesn't happen at every bear market bottom, but when total capitulation does happen, it is unique and valua-

EQUITY STRATEGY

ble information that some investors believe predicts the market lows within short timeframes.

In the current bear market, the capitulation indicators above tell us that a "partial capitulation" has already occurred. However, partial capitulation is not a reliable indicator that the market has hit bottom, since in three separate bear markets, partial capitulation was followed by 22% further declines in those markets. Capitulation indicators are interesting to study and track, however, as with most metrics and tools, they should be used in conjunction with comprehensive and inclusive disciplines that are based on fundamental analysis at both a macro and industry/company specific basis and macro-oriented data, economic influencers, and related forecasting.

Looking ahead … It is still all about Fed action… for now

Technical analysis of equity market metrics is one of a variety of approaches that investors utilize to attempt to build visibility and confidence in anticipated stock market behavior looking forward. Of course, primary consideration is always placed on the fundamentals of economic activity and forecasts. With this focus, the important factors or events related to the economy and consumer activity are always being searched for, studied, and interpreted. Today, the Fed and its actions to combat inflation continue to be the primary factor that investors are assessing. Anticipating when the Fed will shift from "fighting inflation" to stabilizing an economy is another priority that will influence equity market activity and support a directional change in investor sentiment, in either a dramatic capitulation or a more gradual and nuanced shift in trend from selling to buying.

With the Fed meeting this week, market volatility is likely to continue as the majority of market and economic experts believe the Fed will continue to take a strong and proactive stance of raising rates to combat inflation. Recent stock market rallies during July have been driven not so much by improving economic or company specific data, but rather a view that the actions the Fed has taken have already negatively impacted economic growth and as the impact is measured, will allow the Fed to "pull back" from more aggressive, longer term rate hikes. Ironically, this in effect is saying that the higher the likelihood of a recession on the horizon, the more equity investors like it.

Recent data indicates the economy is slowing down. For example, the Purchasing Managers' Index has fallen to a 2 year plus low and jobless claims have risen to the highest level since November (remembering they are still at historic lows). Finally, the likelihood of a U.S. recession has grown to be an event that will likely occur by early next year, according to a number of analysts and research groups. With this information, the impact of such a slowdown on corporate earnings and the updated forecasts for the future are being closely watched and used for building equity "buy lists." These lists target positions that reflect not just a more defensive position to weather the last phase of a bear market position, capitulation activity, but also to perform best in a slow growth and or recessionary environment. Both of these elements are likely to happen in the coming quarter, and both, we believe, are compelling buy signals to amplify building equity positions accordingly. ◆

ALM STRATEGY

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The second quarter of 2022 forced significant, rapid change on community based financial institutions in the New England area. What looked to be a relatively long runway of low deposit rates combined with persistently high levels of liquidity early in the year has morphed into an environment of tightening liquidity and deposit competition.

Deposit Environment

Deposit competition has ratcheted up quickly, and we are now in the midst of a CD 'special' frenzy as institutions attempt to avoid overnight borrowing costs that jump each time the Fed acts. Even relatively short term borrowing costs for 6 month funding well exceeds 3%, making today's current CD rates look like a bargain in the low to mid 2% range. What are we seeing at this point?

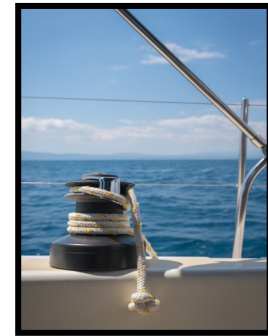
CD specials seem to fall into one of two categories. The first are shorter term, more defensive offerings that will likely maintain balances for depositors who realize that rates are up and want to be compensated, but are not so rate sensitive to actively shop around. This may take the form of an 11 month CD with a rate in the range of 1.25% - 1.50%. The second is a longer CD, generally around 2 years with a rate around 2% - 2.25% designed to be competitive with the better offerings available today and attract new money. Both of these frequently have high minimums to avoid cannibalization, although this is not always the case. The earlier issuers were able to fund at slightly lower levels, but now to stand out and bring in deposits quickly, a rate near 2.50% may be needed. There are select offerings available with maturities in the 3+ year range, but we have received feedback that there is little appetite to extend to 3 years or longer in the current environment.

A Fed driven change in strategy

As discussed earlier in the Economic article, the Fed has become even more aggressive lately after two consecutive CPI reports that exceeded expectations. Each time the Fed becomes more aggressive, the time to reach the Fed Funds terminal rates decreases while the likelihood of an overshoot increases. The implications, if you agree with the most current EPG forecast, mean that the Fed could potentially reach its terminal rate of 3.50% by the end of 2022. And, due to the lag between when the Fed tightens and when the impact is seen in the economic data, the Fed may reach its terminal rate before seeing much of the impact. This leads us to the inevitable overshoot and corresponding recession. Once this happens, the Fed will be forced to cut, projected to be by mid-2023. In this scenario, a 24 month, higher yielding CD may be too long, as you would want the flexibility to reprice that funding lower before the end of 2 years. So, the bottom line is that the most attractive CD may be 18 months or shorter, even if you have to slightly pay up given current market conditions.

Other funding vehicles

Even before the rise of the CD special in this cycle, Muni deposit rates increased earlier in 2022. However, that has essentially been it, as we have seen very little movement in traditional savings and checking account rates- some nibbling around the edges, but nothing of significance. The next likely account to reprice is higher yielding money markets, and we have seen evidence of a bit of that, but minimal at best. If institutions can sneak by with a combination of overnight FHLB funding, CD specials and the occasional brokered CD, then a potential Fed cut in the summer of 2023 may arrive before money markets have the chance to reprice significantly.



Have Loans Rates Peaked for this Cycle?

Immediately preceding the initiation of the Fed's tightening cycle, the longer end of the Treasury curve began to move higher, and once it started, it was off to the races. From the beginning of March to the peak in mid-June, the 10-year yield jumped from 1.70% to nearly 3.50%, but has since declined back to about 2.80%. It feels that markets have moved from a focus on inflation (as the 10-year yield was rising) to recession (pushing the 10-year yield back down), and these movements have a direct impact on residential mortgage rates.

If we believe that markets are now focused on recession as opposed to inflation, then continued aggressive Fed action will be seen as recessionary and apply downward pressure on rates. So, even if the Fed becomes more aggressive, that could be seen as a quicker ramp leading to falling rates, as opposed to driving rates higher. Due to this change in sentiment, we believe that longer term loan rates have peaked in this cycle, and combined with the likelihood of a recession (or at least a significant slowdown, if not technically a recession) by mid-2023, there may be a greater risk that the next major move in loan rates is down, rather than up. If this plays out, we could be setting up for the next prepay wave in about a year from today.

Within that framework, many of the loans that were written near the peak (around 6% or so for 30-year loans) could be refinanced within a year. For loans generated internally it won't be pleasant, but for purchased loans with potentially high premiums it will be much worse. Be cautious at the current point in the cycle about purchased broker loans, as you may end up with significant unamortized premiums if rates do fall as discussed. Taken a step further, you may actually be better off in the long run writing 30-year mortgages slightly under market rates than at full market rates (based on the Fannie Mae commitment rate). Would you rather hold a 6% loan for a year, or a 4.75% loan for a much longer period? Given the current state of the market, you may not have a choice, as few community based institutions are able to lend near the 6% level based on competition. Even at 4.75%, with marginal cost funding in the low 2% range (based on CD costs) and a likely continued lag in core deposit accounts, those loans are highly profitable, and should remain so through the current cycle.

What could go wrong?

The obvious answer here is a shift back in market sentiment from recession to inflation, however, there are additional items that warrant discussion. Lately we have seen some signs that point to end of cycle activity, as people rush to secure loans before activity dries up. One example is the 40 year fixed rate mortgage, which goes in and out of favor over time, but tends to resurface during real estate booms. The last time this happened was in early 2006, leading up to the financial crisis, but is now again gaining popularity. Stretching the loan term can cut payments marginally, while adding significant extension risk for financial institutions. This is certainly not an indication of impending doom, but possibly a sign that the housing market has gotten a bit ahead of itself. Sometimes the last loans written in a cycle are the best ones to avoid. ◆

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