The ADVISOR

Focus on Community Banking Issues

Fourth Quarter 2022

ECONOMIC ENVIRONMENT

The Fed is All In

During the third quarter, the Federal Reserve was tasked with controlling historic levels of inflation while balancing economic growth and employment stability. This has not changed, but what has changed is the Fed's willingness to accept a harder landing to squash inflation. The FOMC has raised the Fed funds rate by 75 basis points at three consecutive meetings, and their policy language does not indicate an impending end to the tightening cycle. Since reaching a 9.1% year-over-year rate in June, the CPI has fallen marginally to 8.2% and has remained above 8% for seven consecutive months. In his September press conference, Chairman Powell reaffirmed the Fed's commitment to bringing inflation down to 2% and acknowledged this would require a sustained period of below trend growth and a softening of labor market conditions. Minutes from the Fed's September meeting explain this stance by stating that additional rate hikes would help prevent "far greater economic pain" caused by high inflation.

In our view, a "soft landing" is becoming increasingly unlikely, as each elevated inflation and strong employment report only raise the probability of a Fed overshoot. There is no question that 2% year-over-year inflation, whether looking at CPI or the Fed's preferred measure of PCE, necessitates either a mild economic contraction followed by an extended period of low growth or a rapid and deep recession where the unemployment rate rises dramatically. It appears the Fed would prefer the latter scenario, as it is likely that a material rise in the unemployment rate would occur before inflation reaches 2%. We see the unemployment rate finally responding to rate hikes in 2023, which will increase the odds of a "hard landing" and push the Fed towards a policy reversal.

How Entrenched is Inflation?

Even with the FOMC having already raised rates by 300 basis points this year, the September CPI report confirmed that inflation remains stubbornly elevated

EPG RATE FORECAST

November 2022

MARKET RATE	Actual (%) 10/13/2022	Projected (%) 10/31/2023	Yr1 Δ	Projected (%) 10/30/2024	Yr2 Δ
FedFunds	3.25	4.50	1.25	3.00	-1.50
Prime	6.25	7.50	1.25	6.00	-1.50
3mthTsy	3.70	4.05	0.35	2.05	-2.00
6mthTsy	4.30	4.00	-0.30	2.10	-1.90
1yrTsy	4.40	3.95	-0.45	2.15	-1.80
2yrTsy	4.45	3.65	-0.80	2.20	-1.45
3yrTsy	4.45	3.60	-0.85	2.25	-1.35
5yrTsy	4.20	3.40	-0.80	2.30	-1.10
10yrTsy	3.95	3.25	-0.70	2.35	-0.90
30yrTsy	3.90	3.20	-0.70	2.40	-0.80

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:* The Fed remains focused on inflation
- *Fixed Income Strategy:* The Fed will continue to have an outsized impact on financial markets
- *Equity Strategy:* Setting the stage for future equity market performance
- *ALM Strategy:* Liquidity and funding costs remain the focus

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ECONOMIC ENVIRONMENT

and broad-based. Core prices again rose at the fastest pace in over 40 years, food costs are 11% higher than a year prior to offset a drop in gasoline prices, and still-elevated labor costs are fueling services inflation. Geopolitical factors continue to complicate the inflation outlook as well, with the Russia/Ukraine war still disrupting key commodity supplies and OPEC+ agreeing to reduce oil output. Furthermore, the combination of soaring mortgage rates and low (but rising) housing inventories has contributed to a high cost of homeownership.

Although many components of inflation are proving stickier than expected, dynamics related to rental costs and supply chains do paint a more optimistic picture. One signal that inflation may trend lower into 2023 is the heavy impact of high rent inflation in the most recent CPI readings. CPI shelter inflation tends to lag market prices by a year or more because the data attempts to capture the price of all rents paid, rather than just newly signed leases. Therefore, most data points in the basket of leases only reset once per year. A new report from Realtor.com shows that in September, median rental prices in the 50 largest U.S. metro areas grew at their slowest pace in 16 months and registered a $12 month-over-month decline. September's slowdown in rent growth will not show up in the CPI until 2023 due to the lag, so there is certainly potential for the top line number to be distorted given that shelter makes up a third of the overall CPI.

At the beginning of the tightening cycle, a prevailing concern was that rate hikes would be ineffective in combating one of inflation's root causes: supply chain disruptions. Whether or not this was true, these pandemic-induced disruptions appear to be lessening. The New York Fed's Global Supply Chain Pressure Index (GSCPI) has dropped for five consecutive months, and while still far from its historical averages, the recent trend suggests rapid improvement.

EPG's Rate Forecast and the Likelihood of a Fed Pivot

We continue to view a policy overshoot forcing the Fed to cut rates in 2023 as the most likely outcome, as the economy has not yet felt the effects of rate hikes that have already occurred this year. During his September testimony, Powell stated that it will be early 2023 before the Fed's actions have made a material impact to the economy and inflation falls towards their 2.0% target level. Ultimately, we believe the Fed will continue aggressively hiking rates without knowing the effects of previous rate increases. The September CPI and employment reports reinforce this thesis, but the data has altered the path to reaching the pivot point. We anticipate the Fed to raise rates by 75 basis points in November, 50 basis points in December, and 25 basis points at the February 2023 meeting to conclude the tightening cycle.

Our updated view estimates a terminal Fed funds rate of 4.75% in the first quarter of 2023, which is consistent with the current Fed funds futures contract and the Bloomberg economists' survey. While we expect inflation to subside in 2023, this will come at the cost of a weaker labor market and diminishing economic growth. Anticipation is growing and expectations are solidifying that this will lead the U.S. economy into a deeper recessionary environment sooner. In our view, this environment will lead to the Fed halting rate hikes in early 2023, followed by a brief pause before reversing its course in September 2023 with a 25 basis point cut. We then project additional 25 basis point cuts at both the November and December meetings, leading to the Fed funds rate normalizing at 4.0% entering 2024.

When (or Will) the Labor Market Weaken?

Throughout the current tightening cycle, the labor market has remained a pillar of strength for the U.S. economy. Nonfarm payroll gains have been steady, the unemployment rate has trended lower to 3.5%, and perhaps most interestingly, the labor force

participation rate actually declined in September. Conventional logic asserts that high inflation should incentivize individuals to re-enter the workforce to counteract cost of living increases, which should lessen the worker supply/demand imbalance, thus slowing wage growth and ultimately reducing inflation. This has not happened, and the September decrease in the labor force participation rate, while small, implies that workers on the sidelines still require higher wages to rejoin the labor force.

Why does this all matter? While the labor market's strength has allowed the Fed to continue aggressively raising rates without jeopardizing its mandate of maximum sustainable employment, each positive jobs report increases the probability of a Fed policy overshoot. As stated previously, the economy has not yet realized the full impact of the 300 basis points of tightening that already occurred, so the influence that further rate hikes would have on the labor market is still unknown. However, issues may arise if demand for goods and services continues to fall while wages remain elevated. This scenario would put companies in the difficult position of considering potential layoffs while already understaffed.

Is Credit Risk Understated?

In a scenario where growth and employment contraction is required to reduce inflation, the question remains as to whether consumer and commercial credit will be affected, and if so, to what degree. It is clear that elevated inflation has forced Americans to pay for necessities on credit, with total consumer credit having increased by $32.2 billion in August to the highest levels in history. Outstanding credit card balances registered the third largest monthly increase on record, and higher interest rates on these balances during a period where inflation continues to run hot is a concerning development. In response, large U.S. financial institutions with significant retail banking operations are boosting loan loss provisions, with JP Morgan increasing reserves by $1.5 billion and Wells Fargo setting aside $784 million. Corporate credit spreads are only marginally wider than the 25-year average and do not appear to be reflecting a high probability of credit issues

in the near future, although they have widened somewhat in 2022.

While the market appears to be pricing in a low but rising possibility of corporate credit deterioration, consumer credit appears to be of greater immediate concern for large lenders. ◆

Bloomberg US Aggregate Corporate Average Option-Adjusted Spread

Source: Bloomberg

FIXED INCOME STRATEGY

FIXED INCOME STRATEGY

The Fed Will Continue to be Aggressive with Rate Hikes

The third quarter has given investors plenty to digest, with influential employment and inflation data for the Fed to interpret as they have become more data dependent with monetary policy. While the unemployment rate has hovered near 50-year lows, the Consumer Price Index continues to maintain levels well above the 2.0% target rate. Even with the headline CPI down slightly from its peak in June of over 9.1%, both bond and equity investors are waiting for the interest rate increases to impact the highest inflation the U.S. has had since the early 1980's. During the September FOMC press conference, Chair Powell reiterated that the Federal Reserve is committed to bringing inflation back to their long term 2.0% target level. With this commitment to normalizing inflation, Fed officials confirmed that it will likely come at the expense of economic growth and an elevated unemployment rate.

With an active FOMC as a backdrop, interest rates continue to be volatile due to uncertainty of economic conditions, and concerns on the Fed's ability to end this tightening cycle with a soft landing. During the third quarter, the 10-year Treasury traded in a wide range, hitting a low on August 1st of 2.57%, and towards the end of September touching 4.0% before finding support. The driver pushing long rates lower early in the quarter was the belief that inflation would become contained and the longer end of the yield curve was pricing in rate cuts in early 2023 on recession fears. Although rate cuts are still being priced into the market in 2023, the recent inflation data remains elevated and the Fed also increased its terminal rate forecast, boosting interest rates across the yield curve to new highs. The volatility also stems from some technical dynamics on risk and return from investors, including the trajectory of when and where Fed funds will reach its terminal rate and the damage felt to the economy along the way. During the September statement, the Fed raised its terminal rate to 4.60% in 2023. Market participants accepted the rate increase, but with a greater dependency on upcoming inflation and employment data. Many economists believe that when the Fed reaches its equilibrium rate it will be short lived, as it will likely cause millions to be unemployed, creating a significant downturn in the economy. Another technical dynamic establishing the higher level of rates is from the Treasury auction cycle. Recent auction levels across the yield curve have

Yield Curve

Source: Bloomberg

Yield Curve Changes Year to Date

Term	12/31/2021	9/30/2022	Change
6 Mo	0.17	3.90	3.73
1 Year	0.38	3.93	3.55
2 Year	0.73	4.28	3.55
3 Year	0.96	4.29	3.33
5 Year	1.26	4.09	2.83
7 Year	1.44	3.98	2.54
10 Year	1.51	3.83	2.32
20 Year	1.93	4.09	2.16
30 Year	1.90	3.77	1.87

not been met with strong demand from both domestic and overseas investors. During the last week of September, a 2 year Treasury auction had overseas demand drop by more than 10% from the 2 year auction at the end of August. Longer duration auctions have also seen weaker demand, because ultimately investors want to be rewarded for taking on additional interest rate risk in an environment with an active Federal Reserve, combined with the monthly reinvestment program coming to an end.

Quantitative Easing to Quantitative Tightening

The Agency MBS market has entered a transition from QE to QT. The Federal Reserve has been purchasing and or reinvesting monthly reinvestment from their portfolio since March of 2020. The Fed's retained portfolio has grown to $8.3 trillion, comprised of $5.6 trillion of Treasuries and $2.7 trillion of Agency MBS. This is the most the Fed has ever owned outright as a percentage of the outstanding market. In June the Fed implemented phase one of quantitative tightening (allowing $30 billion of Treasuries and $17.5 billion of Agency MBS to roll off) to coincide with a policy of increasing the Fed funds rate. During the pandemic the Fed had been purchasing in excess of $100 billion Agency MBS per month, and the MBS markets found this policy quite favorable. MBS became a favored asset class as spreads came off their pandemic highs as the Fed was stabilizing interest rates with outright purchases of U.S. Treasuries and Agency MBS.

Now that we are in a period of quantitative tightening, and the Fed is no longer reinvesting any of its monthly cash proceeds, investors are wondering who will have the appetite for fixed income securities to replace the Fed. With an uneconomical buyer of bonds now out of the market in an environment with rising rates, heightened inflation, and economic growth concerns, the investment community is acting more patiently with investment needs. We have seen this play out in auctions as well as secondary transactions. The results of the Fed's actions have caused interest rates to rise and Agency MBS spreads to widen, becoming a more attractive alternative for investors.

It will come as no surprise that with higher interest rates, mortgage refinancing demand stands at 20 year low levels, as mortgage rates have never been as far out of the money as now. During the pandemic, mortgage rates were at all-time lows, allowing existing homeowners to refinance at the fastest pace the mortgage market had ever seen. The mortgages produced in 2020 and 2021 are now over 200 basis points out of the money, minimizing the incentive for the homeowner to refinance at current rate levels. As a result, spreads in the Agency MBS market have widened as interest rates rose this year.

Before QE1 was implemented, the mortgage market was dominated by asset managers and the GSE's. These investors were relative value players that invested to fulfill total return benchmark mandates.

	Latest (Oct-22)	Maximum		Minimum		Average
2 Year	4.44	5.02	Jun-07	0.11	Feb-21	1.23
5 Year	4.18	5.09	Jun-07	0.21	Aug-20	1.86
10 Year	3.94	5.18	Jul-07	0.44	Mar-20	2.52

Now the dominant participants in MBS act more like a spread investors, comparing asset yields to their cost of funds. This is a different relative value mindset from traditional relative value investing, as investors (such as banks and credit unions) have been patient, willing to hold excess liquidity as they wait to invest.

Fixed Income Investing

The interest rate volatility observed in the 3rd quarter has created opportunity across fixed income sectors. Yields across the curve traded in a range of more than 125 basis points during the quarter. From a low risk perspective, the front end of the Treasury curve has yields hovering just over 4.0%, up 350 basis points from the beginning of the year, with predictable cash flows. The Callable Agency sector offers above historical yield enhancement over Treasuries with the recent volatility. A 5 Year Non-Call 1 year structure currently yields near 5.25%, an additional 125 basis points of spread over a 5 year Treasury, while everything beyond 10 years is yielding above 5.65%. That said, as attractive as the sector may look, with a forward outlook implying a recession and lower yields in 2023, we would be apprehensive on only adding callable structures. Our view is that yields will have dropped by this time next year, and although you are rewarded today with yield enhancement, the bonds could be called away, forcing lower reinvestment yields.

A combination of bullet like structures with Agency MBS, appears attractive, spreading interest rate risk across the yield curve. With the backup in rates this year, longer term Agency MBS yield in the mid 5% range, with shorter MBS just under 5% and Hybrid ARMs just over 5%. The majority of Agency MBS are currently priced at a discount to par, which will benefit investors when the interest rate cycle reverses course, as there is over 75 basis points of protection before the underlying loans can be refinanced into lower rates. Additionally, select DUS bonds now offer approximately 100 basis points of additional spread to Treasuries and can complement existing holdings with lower rates predicted on the horizon. ◆

EQUITY STRATEGY

EQUITY STRATEGY

The reality is setting in

As we progress through October, third quarter earnings announcements have begun in earnest. The impact of inflation, the Fed's aggressive (though delayed!) inflation fighting response of raising rates, and a variety of events have and will continue to materially impact earnings results and maybe more importantly, earnings estimates going forward. With this being said, the impact of the Fed's tightening cycle continues to be the primary news that almost all equity investors are watching… for now.

Various types of inflation data, as well as surveys such as the University of Michigan consumer sentiment index will guide the overall psychology of equity investing outlook since all eyes continue to be on the Fed. In particular, the focus on when the cycle will shift and a point on the horizon when the Fed will stop raising rates is what is foremost in equity investors' minds. This was made clear when we saw the impact of a speech by Fed Chaiman Powell from the Jackson Hole conference which illustrated the Fed's tough stance on inflation and recognized that unlike their earlier "confidence" in a soft landing (i.e. no recession), it seemed apparent that "suffering pain", was the Fed acknowledging the likelihood of a recession. The stronger dollar, continued high inflation readings, and higher cost of capital continues to amplify a belief that as far as Fed action, the worst is not behind us.

Inflation and inflation fighting are starting to take its toll on equity performance: Is all the bad news priced in?

Profit estimates are beginning to decline as the impact of a slower economy/likely recession sets in. While too early to determine the extent profits will weaken, the expectation is that current earnings estimates will be subject to further reductions – an estimate is often adjusted to reflect current data and updated trends. This has led to equity market participants reacting negatively to any challenge to earnings growth, as was seen recently with Federal Express and Nike's announcements. The negative market reaction in these names was not simply because of current earnings performance, but due to a combination of negative management guidance, downward analyst revisions, and a view that it will become increasingly more difficult to meet any estimates provided.

Year over year consensus earnings per share growth estimates for the S&P 500 are now at 3%, a historically weak number, with risk of further reduction to such outlook being highly probable. In fact, this lackluster number incorporates the component of historically strong growth in the Energy sector. Without Energy, EPS growth is actually estimated to contract by 3% and profit margins to contract by over 130 basis points, according to Goldman Sachs analysts. This possible "stagflation like" scenario sets the stage for continued anticipation of negative fallout and thus continued volatility in the equity markets. A 'risk off' focus in the equity markets could be assumed to have taken hold based not just on obvious market declines but also since over the last 35 weeks, according to Bank of America global research, there have been net outflows from the equity markets and portfolio manager cash positions have risen to the highest levels in 20 years.

It has also been stated that CEO confidence in the next six months for the economy and its support for corporate profits is at its lowest level since 1980. With the S&P 500 forward price to earnings ratio now at 16, down from 22 at the start of the year, it appears that the markets have brought prices of equities closer to reflecting this much more realistic and sober view of the economy, with equity prices reflecting the challenges to profitable growth. While 16 times earnings

EQUITY STRATEGY

is certainly a reduction in valuation compared to the beginning of the year, as a way of context, during the 2007-2009 financial crisis, S&P 500 was trading at approximately 10 times earnings.

Are we at the point of equity market trend shift: Is the upside actually greater than the downside going forward?

It appears that equity investors are now becoming more concerned with avoiding additional losses versus missing out on potential gains. While the initial "buy the dip" was clearly put into action by many investors after each downside market move, current activity seems to be more muted and thoughtful with a concern of minimizing damage and keeping "powder dry." Various gauges of consumer and investor sentiment are materially more negative and resigned to a difficult economic environment over the coming months. Expectations are clear that almost all analysts and forecasters agree that a recession is effectively inevitable, even with tight labor markets and a muted, limited price volatility housing market. (Values decline but to a limited degree as homeowners maintain employment and sit tight versus forced selling.)

However, it is also clear that any possibility of the Fed pausing rate hikes in the future and any subsequent rate reductions due to data or Fed comment will be met with a strong equity market recovery. The question is whether the damage to the economy and corporate earnings due to current Fed action will be so great that it will overwhelm investor sentiment, i.e. interest rates peaking will no longer be enough to bring buyers back to the equity markets.

Cycle shifts lead to buying opportunities: Deliver what the consumer needs and values

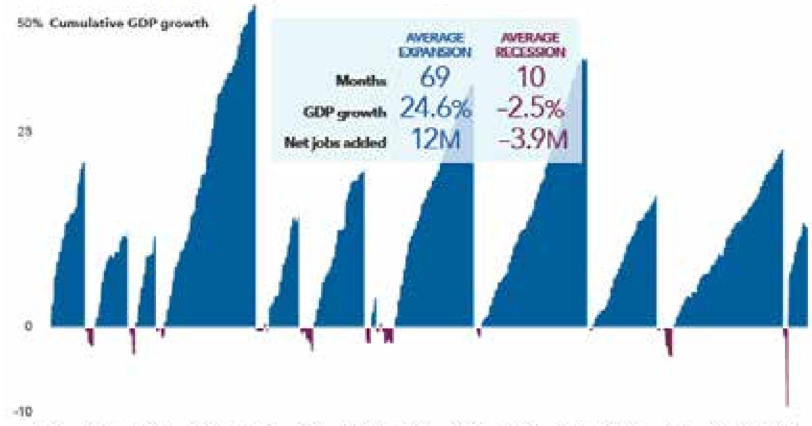
We are in a new economic and market cycle. Prior to this year, the last cycle was one of growth oriented monetary and fiscal policy, low cost of capital, stock price momentum, deleveraging, globalization, and insatiable consumer demand. Now, deglobalization, tight labor supply, environmental impact focus, profit margin pressure, and perceived high equity valuations compared to future earnings streams characterize the current environment that confronts the equity investor – a recessionary environment with uncertainty as to the damage it will create.

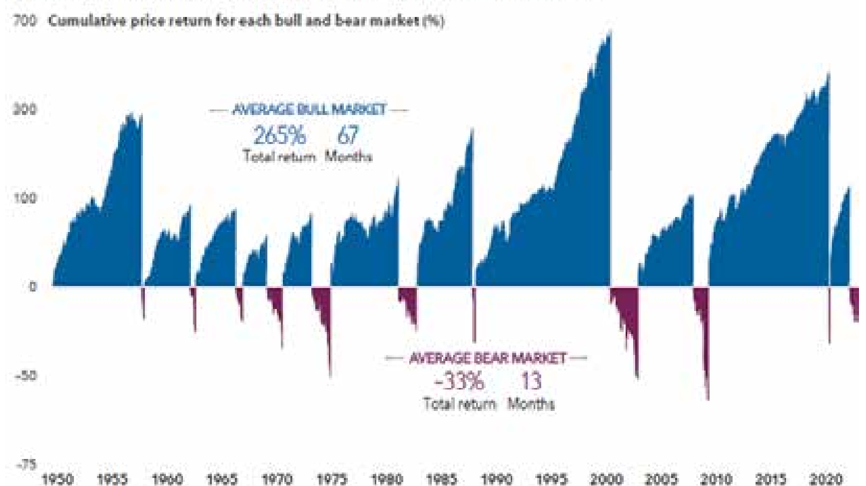
The last 10 months have been driven by an assumption that all future economic and equity market performance is based on the impact of changing interest rates – when rates are expected to go up, equity markets go down, and when rates are expected to peak, equity markets go up. The importance of the current earnings reporting cycle is that the actual impact of higher rates on the economy and therefore spending will begin to materialize. How disappointing third quarter earnings are and the scope of negative estimate revisions will determine additional downward movement of equity values in the near term. Longer term, there are now a number of indicators that would support selectively adding to equity portfolios as data is released in the coming weeks. Many quality equity positions are at -20%, -30%, or greater price depreciation levels from their 2021 highs. Companies that provide goods and services that the consumer will continue to need in a recessionary environment will show earnings resilience, even if at reduced levels from former optimistic pre inflation forecasts. Negative news and expectations are now being priced into current equity market values, having moved valuations and price earnings estimates into much more realistic and conservative levels. Finally, history shows that moving into recession begins the process of "rightsizing" expectations and ultimately "cleaning out" negative sentiment and creating "entry points" for equity purchase that are realistic and reflective of conservative estimates more

likely to have upside versus downside potential.

When recession occurs, recovery follows

As illustrated in the charts to the right, the positive momentum and performance that follows a recession tends to be of greater magnitude and more robust than the negative impact of the recession itself. This does not mean necessarily that recovery in the equity markets is always "a rising tide lifting all ships." Being positioned in those industries and names that will participate in the recovery is a prudent strategy to deploy. Understanding this cycle and the influence it will have on corporate earnings is critical for both adding to the equity portfolio and adding to those industries and specific names within those industries that will best perform in the ending phase of a recession and the corresponding recovery. ◆





ALM STRATEGY

ALM STRATEGY

The third quarter of 2022 seemed like the second quarter on steroids, as the trends that started last quarter accelerated sharply in Q3. The rise in deposit rates quickened significantly, while the liquidity environment that was tightening a few months ago is now as tight as it has been in years. However, the news is not all bad, as the current operating environment has produced wider margins, even as funding costs seemingly rise on a daily basis.

Liquidity and the Deposit Environment

The rise in Fed fund terminal rate expectations has driven funding costs higher, but mainly in certificates, and to a lesser degree, money market accounts. Some of the key questions at this point include the following:

- How high will overnight borrowing rates go?
- When will the Fed pivot and provide some relief?
- How much should we extend out borrowings, if at all?
- How aggressive do we need to be to attract CD funding?

As roughly 2/3 of our client base is currently borrowing, these are vital questions to address as the Fed closes in on another likely hike of 75 basis points in November. Although there is no one easy answer, they all depend in part on your expectations for Fed funds. Market expectations (as well as the EPG Forecast) project the 75 basis point November hike, as well as 50bp in December, bringing the Fed funds rate to 4.50% by year end. With another 25bp likely in Q1 of 2023, the terminal rate should land near 4.75%. However, given the speed at which the Fed has hiked rates, it is likely that they will overshoot (if they haven't already), pushing the Fed to pivot in September 2023 (our current forecast). That would leave a window of about 7 months with a funds rate of 4.75%. Assuming these events happen, let's take a closer look at the likely answers to the questions above.

How high will overnight borrowing rates go?

A 4.75% Fed funds rate would indicate an overnight borrowing rate near 4.75%, perhaps slightly under, given recent FHLB rates and spreads.

When will the Fed pivot and provide some relief?

If the Fed eases in September, overnight borrowing rates would decline in tandem, so relief should start immediately, however, the pace may be slow. If they cut rates in September, it would likely be by 25bp, so overnight funding costs will trend lower, but it may take some time to fall back to under 4%. The longer part of the curve may act more quickly, especially if investors sense that the Fed is nearing a pivot, or if economic conditions have deteriorated considerably.

How much should we extend out borrowings, if at all?

Extending at current rates is expensive, especially when compared with overnight costs and likely future costs given the projected funds rate over the next 12 months. If overnight borrowings are maintained, the costs should be roughly 3.25% until early November (FOMC meeting decision released on November 2nd), at which time the cost would rise to 4.00%. It would remain at that level for about 6 weeks, before rising to 4.50% on December 14th, and finally increasing to 4.75% on February 1st. At that point, overnight borrowings would remain at 4.75% until the Fed eases in September, a little less than a year from now.

Although these costs may seem to increase significantly, the highest cost during the period, 4.75%, still remains under the current one year FHLB bullet advance rate of 4.84%. So, in effect, extending to just one year takes the likely highest cost (actually 9bp higher) during the next 12 months and makes it a reality. On a $10 million advance, continuing to fund over-

night could save an estimated $27,000 vs. a 1 year bullet advance, while providing significant flexibility to repay the advance if liquidity improves.

How aggressive do we need to be to attract CD money?

About 6 months ago, a rate of 2% could attract CD funding, but as liquidity has tightening considerably over the last few months, the landscape has changed. Today, 3% is the new 2%, as clients have found that a rate around 3.25% is required to generate deposit growth. Money market rates are lower, in the mid 2% range, as depositors still place added value on the liquidity in a money market account.

The Good News

Although the operating environment grows more challenging, it is certainly not all bad news. Margins have improved this year, leading to a likely strong year for industry earnings.

Core Savings and Checking Accounts

While rates have risen sharply this year, core deposit rates have lagged tremendously, and although there has been some movement in these rates, it has been modest so far. It appears that financial institutions are trying to 'run out the clock' with these rates, hoping to hold the line until later in 2023 when the Fed cuts and relieves some of the upside pressure. Money market account rates, however, have risen substantially, and may continue to do so, in lieu of touching the savings and checking rates.

Loan and investment rates

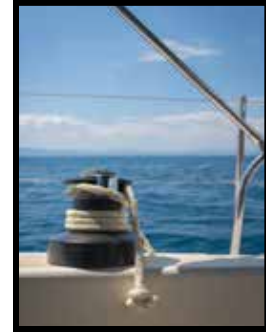
Finally, after years at near-historic low levels, loan and investment rates have jumped so far in 2022, providing needed relief to lenders. According to Bankrate.com, the national 30-year mortgage rate stands at 7.20%, up more than 400bp from pandemic levels not too long ago (although the local rate seems to a bit lower based on recent discussions).

Prime and Fed Funds

Although excess liquidity levels have dropped significantly and erased much of the benefit of higher Fed funds yields, institutions that still hold excess liquidity have seen a jump in income. It is no longer punitive to hold excess cash. The biggest benefit, however, has been the jump in Prime, which will likely be 7% in the near term.

What could go wrong?

Everything discussed previously is built upon the expectation that the Fed can eventually control inflation. If inflation remains stubbornly high, however, the Fed may be forced to increase rates beyond our terminal rate expectation, or hold rates at a higher level past the end of 2023. In this case, there may be added pressure on lower cost savings and checking accounts which could squeeze margins, but this would likely



be offset in part by a continued rise in asset yields. Potentially, the biggest impact could be continued tight liquidity, as many institutions have utilized a significant portion of their borrowing capacity, and could be forced to raise deposit rates even further if wholesale sources are not as readily available as they are today. ◆

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