Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

January 8, 2021

What a Difference a Year Makes

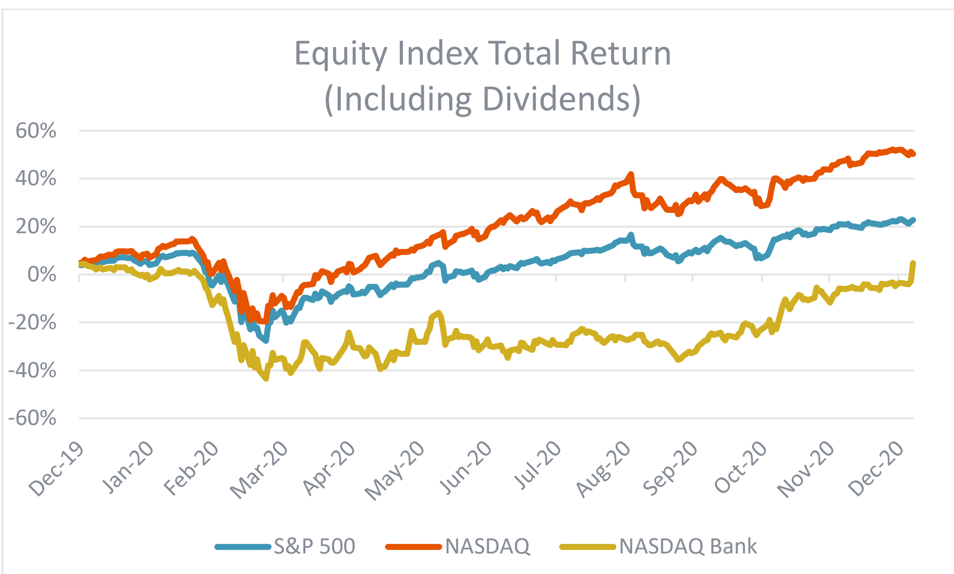
*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

2020 was remarkable. This we all know. Rather than recap all of the ways in which the year surprised everyone, we want to start 2021 by analyzing the performance across various financial markets that most affect community banks, and the path those metrics took over the past 365 days. Then, next week, we will come up with some strategies to combat some of the more ominous trends, and to take advantage of the more favorable ones.

Yield Curve Reactions

Bank Stocks

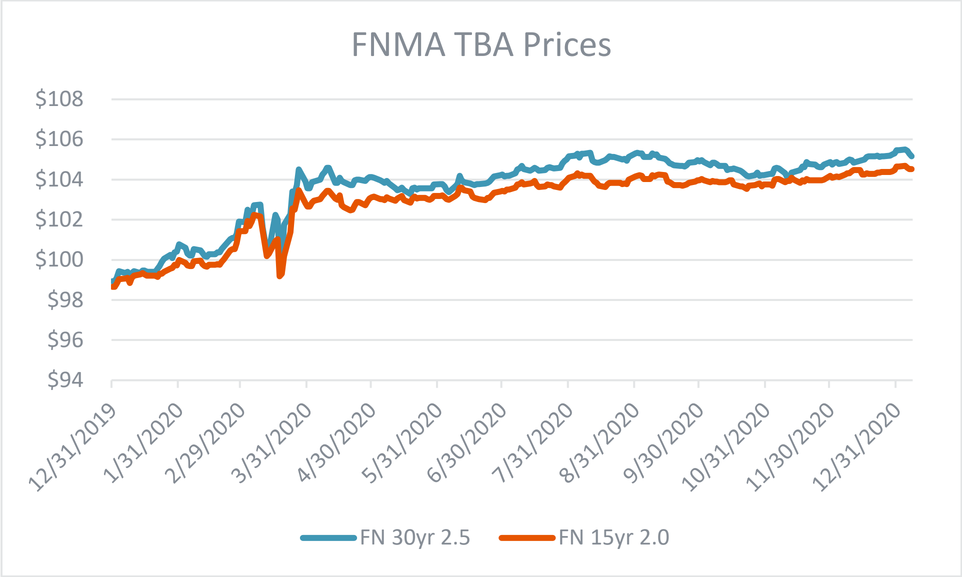
Poor performance early in the year was mainly driven by credit concerns as uncertainty around COVID-19 impact on the economy began to mount. Credit fears have somewhat subsided as borrowers see better clarity on cash flow trends and vaccine news leads to optimism of an eventual end to the volatility. Bank stock performance since March has reflected the market's shifting concerns over rates, margin compression, and changes in balance sheet mix:



Source: Bloomberg, L.P.

Mortgages

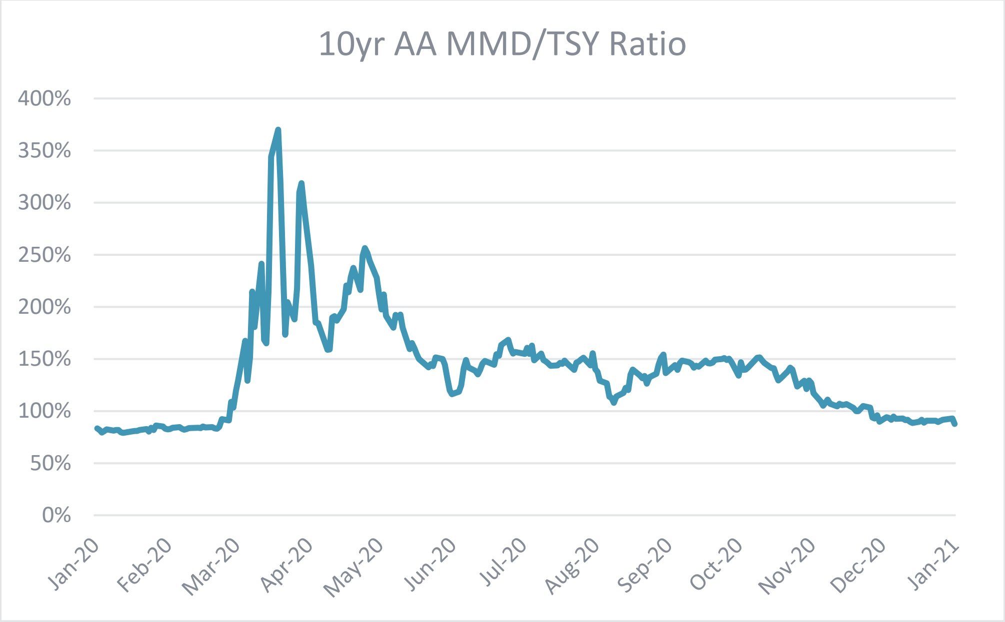
Making up the largest sector in a typical bank investment portfolio, mortgages in 2020 experienced volatility in both price and prepayment speeds. After an initial shock downward, price performance improved significantly after the Federal Reserve stepped in and began buying significant quantities of supply. The spread of 30yr fixed-rate mortgages over the 10yr Treasury dropped as mortgage rates hit historic lows, spurring a wave of refinancings. These refis, in turn, led to diverging performance in yield across portions of the sector, based on collateral composition and purchase price:



Source: Bankrate.com

Municipals

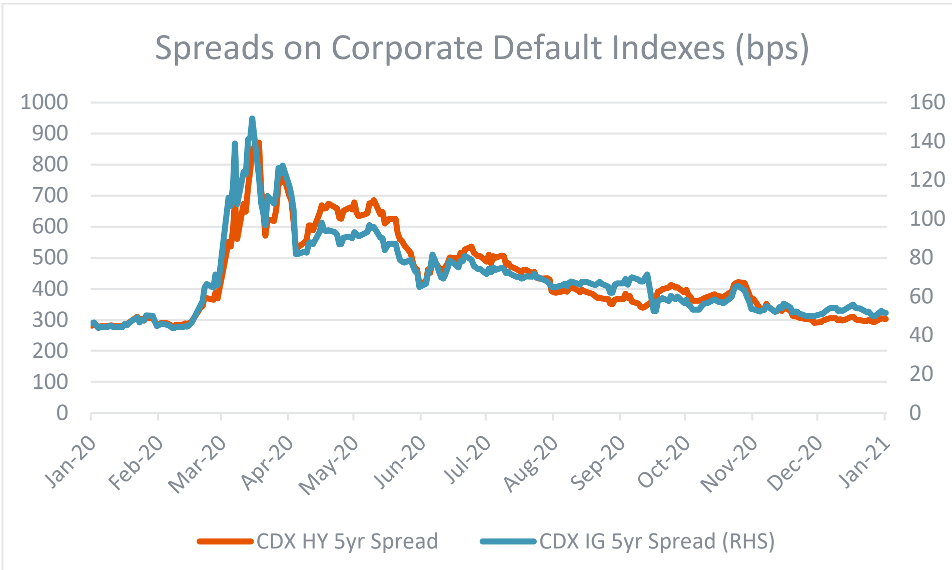
Municipals are one of the main ways that banks implement credit risk in their investment portfolios. The ratio of municipal yields to comparable Treasuries is a good measure for the municipal sector's relative value. 10yr AA Muni rates as a percentage of Treasuries blew out by over 250 percentage points in March and April as COVID-19 uncertainty raised market anxiety over municipalities to make good on their obligations. Market liquidity also put stress on valuations. Muni ratios have continued to creep in despite Treasury rates selling off into the end of the year, as ratios are now only 4 percentage points over where 2020 started.



Source: Piper Sandler

Corporate Credit

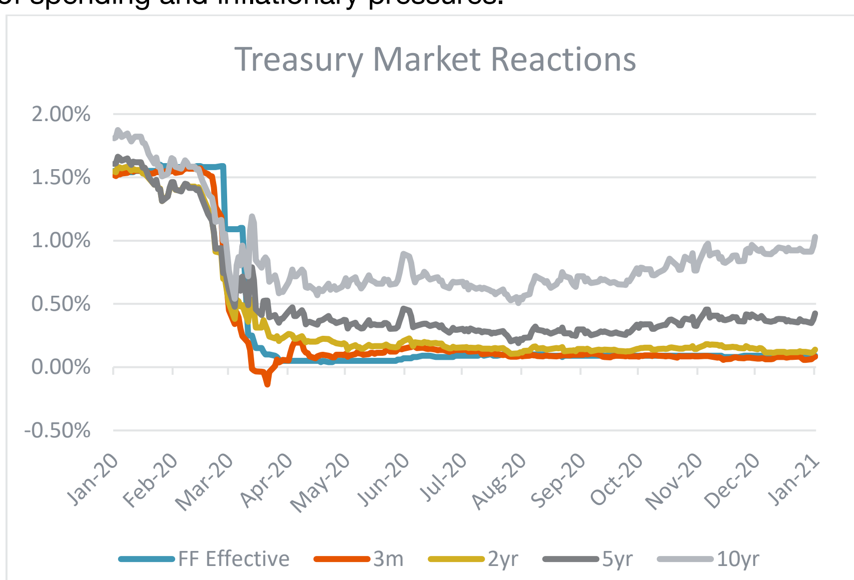
The other main source of credit risk in typical bank investment portfolios is the corporate sector. Corporate credit behaved somewhat similar to what we saw in the municipal market. The CDX 5yr High Yield Index widened over 600 bps at the start of the pandemic, but has tightened in toward similar levels where it began 2020. Investment grade credit followed a similar trajectory, though it tends to trade in a tighter range, so the basis point moves in investment grate credit were less dramatic. Subordinated debt issued by community banks followed a similar path, experiencing stress in the spring, but recovered back to pre-crisis levels as investors see few attractive yield alternatives and credit risk appears to have remained subdued, thus far.

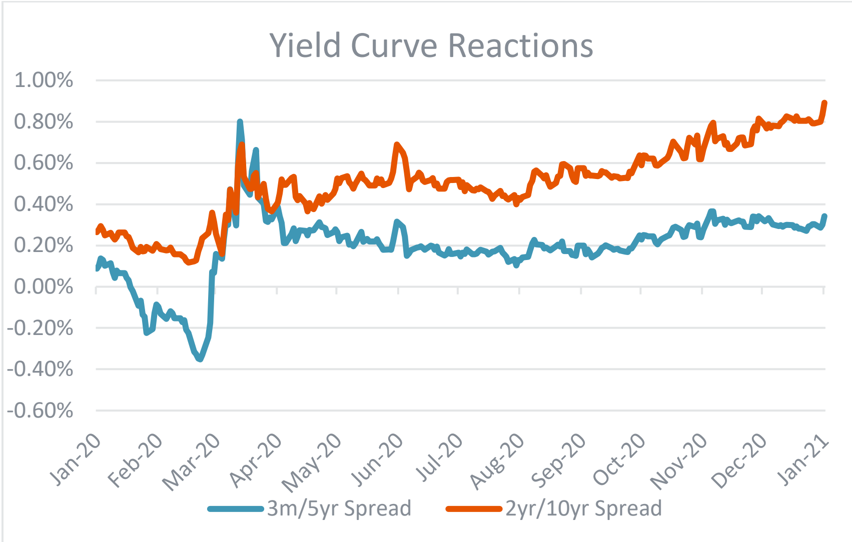


Source: Bloomberg L.P.

Treasuries

U.S. Treasury rates plummeted after the Federal Reserve implemented 150 bps of emergency rate cuts to the policy rate in response to concerns about the effect COVID-19 would have on the U.S. economy. Stimulus catalyzed the longer end of the curve higher heading into the end of 2020, as increased liquidity raised the market's expectations of spending and inflationary pressures.





Source: Bloomberg L.P.

All else equal, the short rate/5-year Treasury spread is most relevant for banks, while the spread between 2-year and 10-year Treasuries is most discussed. The latter measure hit not only its high since before the pandemic, but more than double the rate from the start of the year. The former is also at a significantly higher level than at the start of the year. Outside of the direct impact on earnings from the investment portfolio sectors mentioned above, these two yield curve metrics may have significant implications on the banking environment, even more than nominal rates being higher alone. Next week, we will explore some balance sheet strategies for dealing with all of the trends identified.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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