FMS Financial Managers Society
Perspectives
A publication of the Financial Managers Society

Getting better: FOMC leaves rates unchanged amid improving economic picture

By Robert B. Segal, CFA, Atlantic Capital Strategies, Inc.

Once again, the Federal Open Market Committee (FOMC) decided to maintain the target range for federal funds at 0.25% to 0.50% following a meeting in Washington. The Committee upgraded its assessment of the economy, stating that near-term risks to the outlook have diminished while labor utilization has shown "some increase," though inflation remains too low.

In a sign of improving confidence about the strength of the recovery, the Fed said the labor market has "strengthened" since its June gathering. The weak employment report in May (38,000 new jobs) was a significant cause of concern for the Committee. The solid rebound in the June figure (287,000 new jobs) seems to have given the group encouragement that the May report was an aberration. Officials described spending as "growing strongly" amid robust retail sales figures, and said economic activity was expanding at "a moderate rate," a mild upgrade from its assessment in June.

According to analysts, the Fed left open the possibility of an interest rate increase later this year, possibly as early as September, as the FOMC statement was more hawkish than expected. The Committee is keeping a close eye on inflation and inflation expectations. In the most recent report on prices at the consumer level, the Bureau of Labor Statistics said core inflation is rising at a 2.3% annual pace. This compares with 1.6% as recently as early last year.

Fed officials project the median federal-funds rate target at the end of 2017 will be 1.625%, down from an earlier forecast of 1.875%. They predict the rate at 2.375% at the end of 2018, lower than the 3% they called for in March.

At this time, markets place the chance of a rate increase by year-end at 45%, down from 65% after the Fed's April 27 meeting: this compares with only 10%, however, at the end of June. The yield on the benchmark 10-year Treasury note traded recently at 1.50%, compared with 1.85% at the end of May. Further in on the curve, the five-year note currently yields 1.10%.

In this environment, it's helpful to revisit the institution's investment process. Some investment officers use a "shotgun" approach for selecting securities. Based on the recommendation of a few brokers, the investment officer will often buy the "cheapest" bonds available, regardless of the composition of the existing portfolio. This method can lead to a portfolio with sub-optimal allocation; less diversification means more risk on the balance sheet.

A more effective approach is to develop an investment plan that takes into account the institution's balance sheet and business plans. The plan should integrate with the asset-liability position, with the goal of increasing income and reducing interest rate risk over time. When putting together the strategy, the institution should set targets for the following areas:

- Sector allocation
- Portfolio duration
- Projected cash flow
- Price volatility

Each institution's balance sheet is comprised of a unique asset mix. Some are heavily weighted in long-term fixed-rate residential loans. In a falling rate environment, however, the loans could shorten dramatically, providing significant cash flow. On the other hand, commercial banks usually make a large number of floating-rate C&I

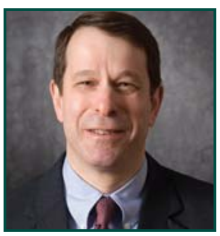
loans. These assets provide higher levels of income in a rising rate environment, but expose the institution to "income-at-risk" in a stable or declining rate scenario.

For the mortgage lender, unexpected changes in the market may cause significant volatility in cash flow. When rates rise, the loans extend, providing minimal funds to redeploy at higher yields. Falling rates lead to faster prepayments, and those funds must be put back to work at lower levels. Here, an allocation to short- and intermediate-term bullet securities, such as agencies and corporate bonds, may be appropriate, since the cash flows are known in advance. As the bonds season and roll down the curve, the price volatility declines, offsetting the potential economic valuation impact of 30-year mortgage loans.

Municipal bonds may be appropriate for the commercial lender. Long-term municipals provide high levels of current income, boosting earnings should the environment remain unchanged. They provide call protection for periods of up to ten years, enabling the institution to hold on to the yield for some time. The risk weighting (20% for general obligation bonds) serves as a buffer against the 100% risk weight of commercial loans.

One of the most important roles for the investment officer is to manage the institution's asset allocation strategy. A number of academic studies have shown that sector allocation is a big determinant of outperformance. With an effective investment plan, the institution should be able to improve income over the long run while minimizing unwanted surprises.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.



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