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Mean Reversion: Bond Yield Relationships Are Looking Familiar, Finally

I would like to make clear in the title of this column that we're not talking about anything rude or unfriendly. In fact, you are about to learn just the opposite. It has been many a year since the U.S. bond market's yield curve has been normally sloped. By "normal," we mean that the differential in short and long yields (i.e., "2s to 10s") is around 100 basis points (1%), which has been the average this century.

However, a normal yield slope is like a heartbeat: it's rare that we're at the average. In fact, the last time the 10-year Treasury yield was 1% higher than the 2-year yield was November 2021. The painful 28-month window where the curve was upside down finally ended in September 2024, and we thought we were going to make a run at an even steeper curve this year. At the moment, we're stuck in the plus-40 bps range. There is in fact a possibility that the Federal Open Market Committee (FOMC) hikes rates later in 2026, which could wipe out any slope altogether.

Numbers Have Improved

So, we have some steepness, which fundamentally should help community banks' net interest margins (NIMs). Using the 600+ banks that utilize The Baker Group for their interest rate risk modeling as a proxy, the industry is effectively insulated against rate shocks. The inverted yield curves of the recent past are evidence that positive slopes simply create pricing power across balance sheets. According to the FDIC, community bank NIMs improved by nearly 50 pbs between March 2024 and March 2026 as the upside-down curve era receded into the merciful past.

Another piece of this dynamic is that for the first time in four years, yields on Treasury securities across the maturity spectrum are higher than overnight rates. That too should create room for margin expansion. It's intuitive that a 2-year Treasury note should yield more than Fed Funds, but that wasn't the case between 2023 and 2025. Portfolio managers now have economic incentive

to extend out on the curve and spread products—securities other than Treasuries—provide a further yield boost.

Planets Aren't Aligned, Yet

But let's not get ahead of ourselves. Yes, the curve has some modest slope and yes, one can buy a 2-year Treasury at a higher yield than sitting in Fed Funds. But we still aren't at optimal levels for either. The 2-to-10 slope looks like it may be mired at its current levels until the bond market gets some clarity from the FOMC about its next steps. Also, under new Chairman Kevin Warsh, "clarity" may be hard to come by since he's suggested that forward guidance may become a precious commodity.

Add to that the fact that yield spreads on the products that community banks purchase are not at record levels either. It remains a challenge for C Corps to buy bank-suitable tax-free munis with any spread at all out to the 15-year maturities. (S Corps are another story for another column.) Mortgage-backed securities (MBS) spreads have trended lower since 2023 on most products, which is interesting in that rates have likewise trended lower in that time frame, when usually yield spreads widen. Both munis and MBS have benefited from a general lack of supply, particularly new issue mortgages.

Looking Up

What hasn't yet been discussed is that nominal rates are still nearly at an 18-year high. And the theme of "reversion" mentioned above is good news for bond investors. Positive slope, spread between overnights and everything else, and inflation trends that are gaining steam all contribute to the available yield levels.

Two more notes about the current financial environment: 1.) A friendly reminder that an upwardly shaped curve helps the math work on a bond swap, in which certain securities are simultaneously purchased and sold, and 2.) Bank profitability

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has been solid so far in 2026. As the second half of the year ensues, a “loss-earn back” trade to convert some lower-yielding circa-2021 purchases into much higher yielding 2026 levels can make sense for a lot of community banks. Your brokers can model all configurations of these trades to quantify the costs/benefits for management team discussion.

Much could happen between now and year-end to weaken the current backdrop, which appears to offer investors reasonable value. One example is persistent inflation. Chairman Warsh’s first meeting included ample acknowledgment that price stability is a higher priority than full employment. Any move closer to rate hikes could cause the yield curve to flatten from here.

Nonetheless, the reversion to the longer-term averages in term relationships in the fixed income market have produced current opportunities not seen in years. Nothing mean about that.

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