The ADVISOR

Focus on Community Banking Issues

Third Quarter 2021

ECONOMIC ENVIRONMENT

Is the Economy Improving Too Quickly?

In very short order, it feels like the U.S. economy morphed from pandemic-induced shutdown to raging growth that is straining our ability to meet consumer demand. After being forcibly shut-in for over a year, people want to make up for lost time, with strong demand for travel, cars, and housing, as well as everyday items such as new clothes or going out for dinner. The job market has been strong, but not strong enough to soak up all the openings. Currently, there are roughly 9.5 million unemployed people in the U.S. with 9.2 million available jobs, and if those could be matched, then problem effectively solved. However, job seekers are refusing to accept jobs and wages they likely would have snapped up pre-pandemic. This is most pronounced at the lower end of the wage scale, resulting in restaurants being unable to fill positions, to the point of only being able to offer drive-through services at many locations. To this point, you may have noticed the story about a Burger King in Nebraska where all the employees walked out, but not before updating the marquee sign to read "We all quit… Sorry for the inconvenience." Employees have never had this type of leverage and power.

Inflation

The impact of the rapid economic acceleration can be seen in a number of specific areas (cars, housing, etc.), as well as in the overall inflation metrics utilized by investors and the Fed to gauge pricing pressure. Headline CPI (Consumer Price Index) has trended higher each month in 2021, from 1.4% in January to 1.7% in February, 2.6% in March, 4.2% in April, 5% in May and finally 5.4% in June. It should be noted, however, that what the Fed calls 'base effects' really do matter, as these year-over-year increases compare to when the economy was shut down during the height of the pandemic.

EPG RATE FORECAST

July 2021

MARKET RATE	Actual (%) 6/30/2021	Projected (%) 6/30/2022	Yr1 Δ	Projected (%) 6/30/2023	Yr2 Δ
FedFunds	0.25	0.25	0.00	0.75	0.50
Prime	3.25	3.25	0.00	3.75	0.50
3mthTsy	0.05	0.18	0.13	0.50	0.32
6mthTsy	0.06	0.23	0.17	0.60	0.37
1yrTsy	0.07	0.43	0.36	0.75	0.32
2yrTsy	0.25	0.63	0.38	1.00	0.37
3yrTsy	0.46	0.85	0.39	1.25	0.40
5yrTsy	0.87	1.35	0.48	1.80	0.45
10yrTsy	1.45	2.13	0.68	2.75	0.62
30yrTsy	2.06	2.75	0.69	3.25	0.50

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

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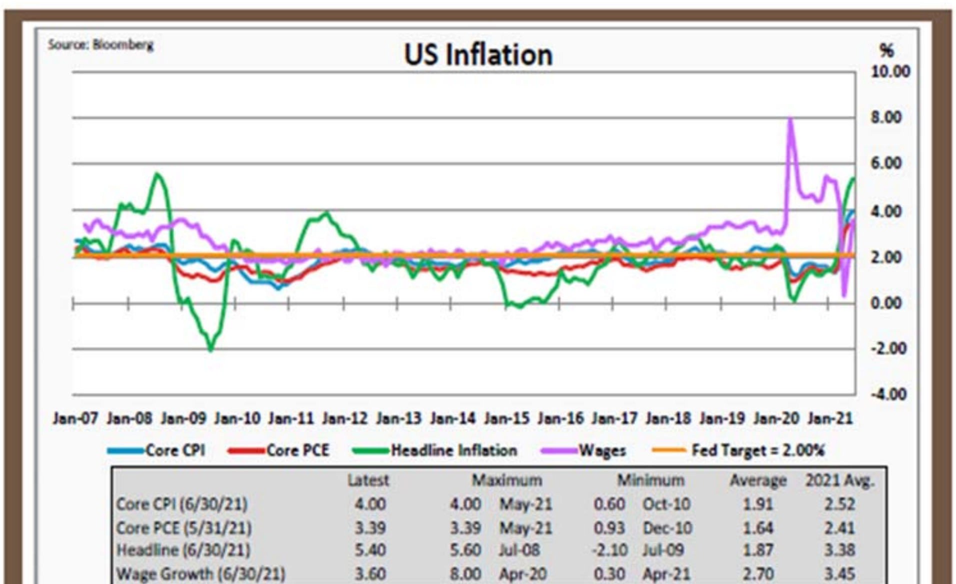
ECONOMIC ENVIRONMENT

In certain areas, price increases have been significant, as well as headline-grabbing based on the outsized moves in a short amount of time. Lumber, for example, reached an all-time high on May 7th as the price shot up dramatically starting in January, driven by tight supply and strong homebuilder demand, combined with a dose of speculative trading. However, as these issues eased, the price plunged just as sharply as it rose, falling 40% in June, leaving the price down 18% overall in 2021. For people looking for evidence of the Fed's 'transitory' inflation, this fits the bill perfectly, and can likely be used as an example of how prices may moderate in other hot sectors, such as cars. Prices for used cars, specifically, have increased steadily this year, with gains of 10% in April, 7.3% in May and 10.5% in June (information from Slate.com), driven by the much-publicized shortage of microchips hampering new vehicle manufacturing. As a result of not being able to build new cars, demand has shot up for used ones as people look to replace vehicles after putting off purchases over the last year. Will the shortage of component parts last forever? Assuming not, then production will ramp up eventually, allowing people to buy new cars, reducing the pricing pressure on used cars. So, like lumber, but for different reasons, the recent rapid increase in prices will likely correct at some point and return to some sense of normalcy, allowing this blip in prices to be deemed 'transitory'.

Prices for other high demand items, such as air travel and hotel rooms, have increased quite a bit as well, but are not as concerning as the percentage increases would lead one to believe. The increase in airfares (10% in April, then 7% in May) was driven largely by a lack of pilots, causing airlines to cancel routes exactly when people want to start traveling again. Over time, airlines should hire additional pilots to meet increased demand, causing prices to moderate. Although these may seem like large increases, airfares remain below 2019 levels, and a lack of business and international travel (so far) should keep prices in check for the near future.

Interest Rate Forecast

Implicit within our interest rate forecast is the assumption that the Fed is correct about inflation, that it will indeed be transitory. However, transitory does not mean nonexistent, so even though the 10-year Treasury has rallied significantly lately, pushing the yield down to 1.30%, we believe the yield is likely to rise through the remainder of 2021 ending the year closer to 1.75%. Further down the road, the 10-year yield is projected to rise to roughly 2.50% by the end of 2022, then to 2.75% by mid-2023. The Fed is likely on hold through 2022, raising the Funds rate 25 basis points in the first quarter of 2023, then moderately boosting rates by 25 basis points per quarter for about the next two years. This is a bit quicker than the Fed's most recent dot plot expectations of two hikes by the end of 2023, as we feel the



Headline inflation at more than 12 year high

Fed will be forced to tighten faster than they expect due to a combination of continued economic growth, declining unemployment with corresponding wage growth and moderate overall pricing pressure. Rates at the shorter end of the curve will be held in check by the Funds rate but could begin to move in mid-2022 in anticipation of Fed tightening.

The big question at this point is the following: **Why is the 10-year yield so low, given the current inflation numbers and expected strong economic growth as we exit the pandemic?** The answer is a combination of factors, including:

- *Transitory inflation:* So far, the market is buying what the Fed is selling regarding inflation. However, if that changes, rates could move very quickly.
- *Fed asset purchases:* As long as the Fed keeps buying, yields at the longer-end of the curve will continue to be pressured lower. When the Fed tapers, likely in early 2022, this pressure will start to decline.
- *Delta variant:* The constant threat of a resurgence of COVID through a potentially more potent variant is enough to apply significant pressure to longer rates.
- *Industry liquidity:* With continued excess liquidity in the banking system, the hunt for yield forces longer-term rates lower.

What Could Change the Outlook?

The obvious answer to this question is entrenched inflation. In this case, we could see a rapid increase in longer-term interest rates, potentially resulting in a combination of any of these items:

- *An accelerated rise in the Fed Funds rate as the Fed plays catch-up and is forced to act more aggressively than they have in recent tightening cycles.*
- *A rapid rise in mortgage rates, resulting in a corresponding decline in housing values.*
- *A sharp sell-off in equities as investors jump to much higher yielding Treasuries.*
- *Higher prices on many good and services, triggering a decline in consumer spending, which accounts for about 2/3 of economic activity.*

However, the Fed has essentially bet the economy and its reputation on its position, so they will likely do whatever is necessary to avoid entrenched inflation.

There is a potential other scenario, where economic growth falters significantly due to the COVID resurgence, resulting in rates that decline and remain low for an extended period. Although we do not believe this is a likely scenario, it deserves consideration based on the continued vaccine hesitancy in certain parts of the country. In this case, we could be looking at the 'tale of two Americas' in which the vaccinated portions continue to enjoy the freedoms of an open economy while other areas grapple with increasing caseloads, a strained medical system and restrictions on daily activity. This bolsters the argument to boost vaccination acceptance through additional incentives as needed. ◆

FIXED INCOME STRATEGY

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Pressure on the Net Interest Margin Continues

As we enter the second half of the year, we find ourselves assessing the current state of the fixed income markets and what opportunities they provide the community based financial institution investor. These opportunities are being assessed based on a number of objectives and understandings, including the following:

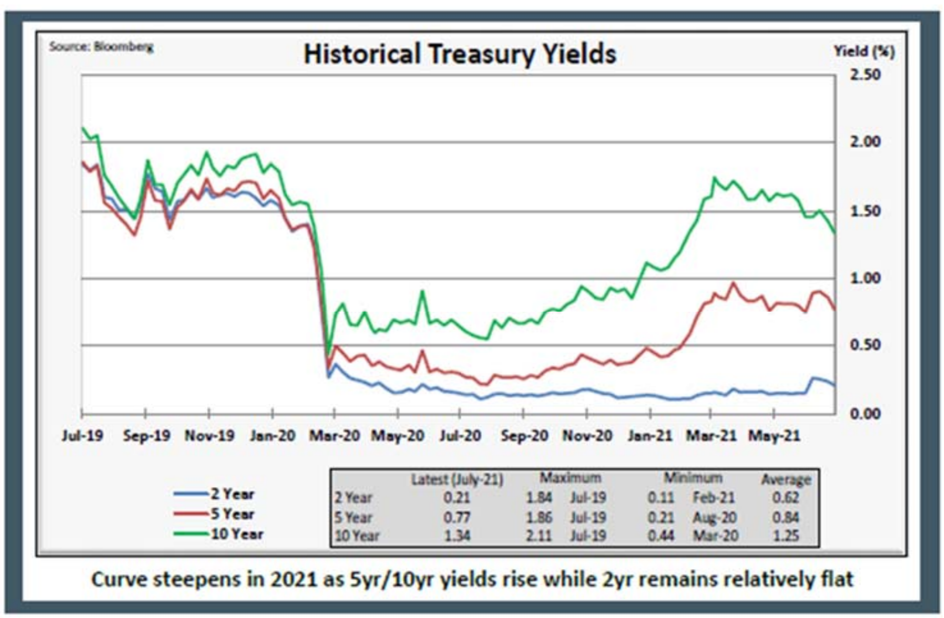
- *Securing a spread which is sufficient over the corresponding cost of funds over 3 years and beyond.*
- *A need to put cash to work to help minimize the erosion of the net interest margin as low yielding cash balances pull down profitability.*
- *An acknowledgement that an integrated approach to interest rate risk can use a variety of strategies to meet the challenge of rising rates, as opposed to simply staying in cash or investing "short".*

Concerns of Deposit Behaviors Tomorrow Continue to Drive Fixed Income Strategies Today

Almost all market participants expect interest rates to rise in the coming several years, with the yield curve steepening as longer rates move upward to reflect a growing and robust economic recovery with corresponding inflationary pressures, while the short end of the curve remains at relatively low levels, heavily influenced by the Fed. However, if the consensus view is for rising rates, why are investors not "staying on the sidelines" and what is supporting the strong and unprecedented flows into fixed income investments?

For community based financial institutions, the current state of the liability side of the balance sheet, along with expectations 1-3 years out is creating pressure to invest. Elevated cash balances persist, fueled by stimulus dollars deposited into non maturity accounts by both retail and business customers. While lending activity is expected to utilize a portion of these deposit balances, cashflow from the existing asset base combined with a possible wholesale funding strategy (as part of managing interest rate risk), is expected to keep this utilization level from materially shrinking cash balances to comfortable levels.

More specifically, fixed income investment strategy is being developed based on assumptions as to the behavior of these non-maturity depositors and how they intend to utilize the billions of dollars currently held in their deposit accounts. These deposits and the reasons such deposit levels exist



Curve steepens in 2021 as 5yr/10yr yields rise while 2yr remains relatively flat are new and unprecedented and as a result, it is difficult, if not impossible, to create assumptions that provide a degree of certainty as to how deposits will behave as rates rise and the competitive environment shifts.

Excessive cash balances are expected to continue through this year and into next and therefore contribute to continued earnings pressure. This is a shift from a view held at the beginning of the year where many understandably believed robust and unprecedented loan activity would help "right size" inflated cash levels as refi activity slowed as rates rose and housing and business activity rebounded. While activity was strong, so was the inflow of deposits as continued stimulus programs and savings behavior more than replaced any dollars used to fund loan demand. This can certainly be seen in the historically low loan to asset ratios that so many institutions are experiencing. This is the backdrop that most community based financial institutions experienced, which caused historically high fixed income investing activity, even at a time when interest rates were low and spreads tight. "Putting cash to work" in order to generate income and offset the sizable negative margin pressure became the primary directive for fixed income investing.

Is Now the Time to Pause Additional Bond Investing?

With rates still near historic lows, the economy improving and stimulus inflows effectively over, is now the time to pause investing and wait for deposits to shrink, loan demand to pick up, and rates to rise? When looking at fixed income strategy, the drivers of contributing to institution profitability today while anticipating possible changing balance sheet and environmental factors tomorrow are at the core. Understanding that once all lending opportunities are fully exhausted, the lack of earnings on excess cash is too great a drag on profitability to not "put the cash to work" with bonds. Pausing investment in the anticipation of higher rates and wider spreads over the long term is "placing a bet" on a number of assumptions coming to fruition that few, if any can foresee in this environment. These bets could include an expectation of materially higher rates occurring sooner rather than later, deposit outflows driven by increased consumer spending or a material increase in net loan demand. While some or all of these alternatives may occur, foregoing accretive earnings while waiting for the "right time" can be an expensive strategy and counter to the performance goals of the institution. Rarely do all elements of any outlook come to pass as expected.

Continue Investing with a Wide Range of View

Rather, continuing a strategy of consistent bond investing to build a portfolio that anticipates a variety of future "what if" scenarios is the recommended course of action for today. These scenarios relate to how influences on the portfolio could change. Dynamics such as the most likely movement of rates over the coming years, the future spread relationships between the portfolio and corresponding cost of funding, and projected future cashflow behavior are important components of any analysis of risk and return. Investing in fixed income alternatives that address these "what if" environments is critical, and achieved through continual analysis of the component securities as well as the overall portfolio. ◆

EQUITY STRATEGY

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Prepare for Landing

There is no doubt that the economy is running hot, with first quarter GDP growing at an annual rate of 6.4%, and according to the Atlanta Fed's latest forecast, GDP growth for the second quarter is estimated to be 7.5%. Corporate earnings have followed suit, with companies in the S&P 500 reporting Q1 earnings growth of 52.5%. According to Factset, the second quarter is expected to be even higher with estimated earnings growth of 64%, which should set a peak before settling down.

The current economic recovery is like no other. Pent-up demand, high levels of consumer savings and a hot housing market have helped fuel a faster recovery than in previous recessions. We have experienced massive injections of stimulus, which has successfully bridged the economy through the pandemic. But as the saying goes "what goes up must come down" and this is no exception. As we pass the peak in fiscal spending, monetary accommodation and private spending, we expect the economy to transition to a lower but more self-sustaining expansion. Incoming data may be choppy and markets are likely to experience bumps along the way, but nothing to panic about. We are still in the early stages of an economic expansion and opportunities still exist. A high personal savings rate, a low interest rate environment, an accommodating Fed and the potential for additional stimulus should help usher in a soft landing. As such, we recommend investors fade near-term noise and focus on what the economy will look like as growth peaks.

Over the Horizon

It is very hard to predict precisely how the recovery will unfold, but certain key indicators can provide a good directional sense of where the economy may be heading. With consumer spending representing a large part of GDP, we believe consumer behavior will be a key component to economic growth. Second, business spending is another important component in driving economic growth, something that was missing during the last economic expansion. Third, corporate earnings have been exceptionally strong but can it continue? Last, inflation has become a heated topic and can have a meaningful impact on profitability.

Consumer Spending to Moderate

The personal savings rate declined to 12.4% in May from 14.8% the month before but remains higher than in February of 2020, when it was 8.3%. While fiscal stimulus will end in early September, the elevated savings rate suggests that consumers have more room to spend. Recent data shows consumer spending is down but this is due to a spending shift from durable goods to services as the economy reopens. High household net worth, soaring home prices and record stock prices should support consumption, though it will moderate from current levels.

A decline in personal incomes in April after a strong March primarily reflected a decrease in government social benefits. Growth in wages will be an important driver for consumer spending. The good news is salaries, particularly for lower-wage workers, have been on the rise as employers seek to fill jobs in a tight labor market.

Business Spending

CEO confidence is at its highest level in 45 years, according to the Conference Board. The index experienced a sharp increase in the first quarter and further improved in the second quarter. The measure stands at 82, the highest level ever recorded since the measure began in 1976. Part of the survey gauges expectations on capital spending, hiring and wages, which are pointing to very positive trends. Many businesses are addressing the rising demand by implementing expansion plans and increased automation. A high level of cash on corporate balance sheets and improving cash flows over the past several years has put corporations in a solid position.

EQUITY STRATEGY

Earnings Peak

Second quarter earnings will likely mark the peak in earnings growth at 64%. Currently, third quarter earnings growth is estimated to be 24%, with Q4 declining to 18%. Since the start of 2021, consensus earnings estimates have been revised higher, and was true for the first quarter as well as the second quarter. Despite the upward revisions for the first quarter, the beat rate for the S&P 500 companies was over 80% and marked the highest percentage reporting a positive EPS surprise since Factset began tracking this metric in 2008. However, as the reopening is fully realized and GDP growth moderates, the magnitude of earnings beat will subside.

Is Inflation a Problem?

Although inflation has risen significantly this year, much of the increase is due to a jump in used car, airfare and hotel prices. Airlines and hotel prices collapsed at the start of the pandemic so it is not surprising to see higher prices given that the reopening has resulted in a surge of travelers. Airline prices in June were 24% higher than a year ago and hotel prices were up 19% on a year-over-year basis. So far, most of the rise in inflation is tied to the reopening, which may be why the Fed is not concerned.

Supply chain issues are also adding to the inflation picture. Much of the global production was shut down or pared back at the start of the pandemic. Now as the economies around the world reopen, companies are scrambling to meet demand. Once supply catches up to demand, prices should moderate. But this could take much longer than expected.

Wages, another key component of inflation, have been a concern. Labor shortages are being impacted mostly in the leisure and hospitality industries, and employers are boosting wages and incentives to attract workers. Wages for leisure and hospitality workers are up 7% in June since the beginning of the year. Many believe the labor shortage will ease in the months ahead. The combination of higher wages, school reopening and unemployment benefits ending in the fall is expected to bring more people back to work.

If the labor shortage persists, companies will look to accelerate spending on automation. The unemployment rate fell to 3.5% in 2019 and many companies were having a difficult time finding skilled laborers. Spending on automation was already picking up before the pandemic, as businesses increased the use of AI and robotics and applied new technologies to cut costs. For now, businesses are raising prices and consumers are willing to pay up after spending a year cooped up at home. This translates to a healthy outlook for businesses and strong earnings should continue. The prospect of a soft landing seems probable but with some bumps along the way. Investors should maintain a long-term view on what future opportunities bring as we come down from peak levels. ◆

S&P 500 Index trades at record highs

ALM STRATEGY

ALM STRATEGY

Establishing a Decision Framework for Potential Term Funding Extension

As we enter the second half of 2021, most community banks still have elevated if not historically high levels of liquidity. Deposit inflows averaging about a 20% annualized pace coupled w/asset payoffs make liquidity absorption difficult. Market discussion has shifted from Covid precautions to inflation and the timing of potential higher rates. In the interim, many banks continue to add longer term assets at historically low rates without the benefit of the natural hedge provided by term funding. As we have discussed previously, funding portfolios continue to shift to increased non-maturity deposit concentrations and away from longer term CDs and wholesale. This increases the uncertainty of potential deposit outflow, increased costs, and margin pressure in the future. **The conundrum: Should we take advantage of historically cheap term funding? If so, when and how?**

Should We Incur Term Funding?

To answer these three questions, it may be best to establish a framework for making the decision based on additional questions.

- *Can we afford more asset growth?*
- *Is our capital ratio strained?*
- *What is our current level of overnight liquidity?*
- *Do our cashflow forecasts predict increasing/decreasing liquidity?*
- *How stable are deposit inflows over the past year?*
- *Have we been adding low rate longer term assets to the balance sheet? Will this continue?*
- *Did we historically have a longer term, laddered funding portfolio?*
- *What is our post Covid earnings profile without the benefit of PPP fees and/or stock portfolio gains?*

The significant growth most have experienced over the past 18 months could make additional funding difficult unless liquidity subsides through deposit runoff. The CBLR minimum increases back to the 9% floor beginning in 2022 for those concerned about their current ratio. This does not need to be an obstacle if you are comfortable shifting back to the risk-based capital framework. Some banks may be trying to remain below the $500 million asset threshold which could limit additional funding as well. For those without size or capital restrictions, an obvious consideration is how much liquidity already exists. Consider liquidity expectations over the next 6-12 months given likely PPP loan forgiveness and/or deposit flows. Will child care tax credit funds which started in July further inflate deposit balances or will consumer spending finally result in outflows? Since it is extremely challenging to predict the latter, it may be more prudent to assess both your 2021 and 2022 earnings profile.

Banks with strong and/or inflated 2021 earnings due to reversed Provision expense, stock gains, and/or PPP fees may have more flexibility to take on additional funding despite elevated liquidity levels. If you are ahead of 2021 budget, it is far easier to incur negative spread funding in the short-term. It is not too early to plan ahead for 2022 and beyond, either. The stronger your current "core" earnings the greater ability to pay for some insurance now to help protect your NIM% in future years if rates are rising.

Another consideration for determining if you should take down longer term funding is how much future IRR exposure exists. This assessment needs to look beyond current measurement profiles skewed by elevated liquidity. How much exposure exists without the excess liquidity, after elevated Non-interest DDA balances potentially subside, and/or if assumed historical non-maturity "beta" sensitivity assumptions prove to understate risk in the next rising rate cycle? For those who previously had established laddered term funding portfolios, consider the IRR implications without this hedge should rates eventually rise.

Answering all of these questions provides objective data open to subjective interpretation depending on your institution's goals and overall risk/return comfort level. Balancing all of these factors will likely dictate whether it makes sense for you to take advantage of attractive available funding. For those that determine the opportunity makes sense, the next steps in the decision framework involve the implementation phase.

How Should We Take Advantage of Cheap Term Funding?

It is not recommended to attempt to extend term funding through retail customer CDs. The likely promotional offering rates required to entice customers to extend would be cost prohibitive relative to available funding in wholesale markets. It will be much cheaper and easier to access non-retail funding. This would also help control the timing, sizing, and maturity structure of the term funding taken. This will allow for optimal diversification of liability cashflows and hedging of IRR.

Recommended maturity ladders should extend as far as five year terms. Start with the longest term initially and back fill using shorter maturities if rates are rising and the ladder is being created over time. Ultimately a 2-5 year portfolio will provide IRR protections against rising rates and diversification of cashflow maturities. This may also cheapen the overall cost of the ladder. Alternatively, use of option funding could allow for longer overall terms (e.g. 5yr concentration) with the holder possessing the flexibility to put back the funding without penalty at your discretion. This is particularly attractive within the broker CD market where current options are virtually free. The cost of creating the ladder currently averages ~75bp if using the cheapest available sources. When implementing, all available sources should be reviewed to ensure cheapest execution. Community banks without a history using Broker funding should not be concerned about regulatory review, particularly when term funding is used as an IRR hedge. The objective of this strategy should be to accomplish an IRR hedge w/ flexibility at cost below 1.00%.

When Should We Implement a Term Funding Strategy?

This objective can be achieved currently. Whether or not to pull the trigger now gets back to the original list of questions discussed previously. For those who want to wait in the hope of deposit runoff alleviating some of the capital and/or earnings implications of additional funding now, keep in mind that rates may rise in the interim. Future deposit runoff may be due to higher consumer spending which increases economic growth and market rates. This may result in a missed opportunity to lock in cheap funding. This risk reinforces the attractiveness of current option funding. Taking down this type of funding would provide opportunity to pay back next year should deposit runoff not occur.

Ultimately, there is not a right or wrong answer as to whether to implement a term funding extension strategy, as it really becomes more a choice about potential earnings management over multiple years. Given the uncertainty about when or whether rates will increase, the choices made today may prove to be more or less successful in the long term; however, given this is likely an IRR management strategy, it should be viewed in that perspective. Would you have more remorse for taking down funding you do not really need if rates don't rise? Or, would you regret not taking advantage of historically cheap funding when you look back after rates rebound off of pandemic lows? The decision framework outlined above will be the focus of discussion during the second half of 2021 within client ALCO to ensure strategies are analyzed and customized based on individual risk/return profiles. ◆

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