U.S. TREASURY CURVE CHANGES SINCE FED TIGHTENING & PROJECTIONS/FUTURE FED FUND RATE HIKES

Hello everyone. Welcome back to Seifried & Brew's weekly briefing. I am Jamie Sumner, chief analyst. For this week's briefing, we want to look at ***interest rates***. We want to look at the projection or forecast of interest rates throughout the next year. So, it's going to be kind of an interesting look here but before we go into the future let's look into the past a little bit.

Let's go back to the Treasury curve when the day before the Fed started their ***tightening strategy***. Here (Slide 2) we can see pretty steep yield curve and this is where we were the day before the Fed started tightening. As you know on 16th of December 2015 they started that tightening process; increased the range from 0 to 0.25, from 0.25 to 0.5, and then they waited a year and then they started once again with their rate increases. (Slide 3) But when we look at this and we flip over to (Slide 3) where we were at the first quarter of 2017, you can see the short end of the curve has been affected by that lift in ***Fed Funds***. However, the long end of the curve here for the Treasuries had some upward momentum, but not as much as the short end. So, we're still seeing that pressure holding down on that long end of the curve. Now as you know as the Fed moved in June, we picked up another 25 basis points (bps), so we flip forward to (Slide 4) the 10th of August here and we can see 1-month Treasury at that 1%. Now this is interesting, how the long end of curve moved between the end of March. In August, we actually saw a fall back or a pullback in those rates and now we're down to that 10-year at a 2.2% on August 10, 2017; we compare that to the 2.4% where we were on March 31st. In December if you recall that 10-year got up to its 2.60% level. So, we saw this shift, this non-parallel move in the yield curve, and in fact we saw the slope of the curve come in here. This is where we've been, we're coming up to this point. We were hoping that we would see this long end of the curve move up as well as benefit us on the asset side of the equation for those longer assets but that has yet to happen here. However, those banks that have those adjustable rates that are in that time to adjust, they're seeing that benefit in here. We flip this then into the future, (Slide 5) we look at the forward curve, the spot curve as of the 11th of August here. You can see this dashed blue line and then we look at 6-months out with the green dotted line and then that solid light blue line would be 1 year out, going out to August 11th of 2018. What you see is a continual shift in the short end of the curve and we see this moving up faster than the long end of the curve. So, we see this non-parallel shift continuing to occur inside the forward curve. So that means that continual tightening of that spread between the 10-year and a 2-year Treasury which then correlates to a narrowing of the net interest margin overall. That's what we have with that forward curve. So, this is the spot curve doing some bootstrapping, pulling out some of the rates into the forward curve. You can get this on your Bloomberg terminal at ***FWCV***.

Let's look at the economists now (Slide 6). So, we step away from the mathematical equations for the current curve and then projecting forward. Let's look at what the economists are saying. We have where we were at the end of second quarter and then the projections out to the end of 2018. You can see in here the spread of the 10-year to the 2-year continues to come down. The movements are a little different inside the different rates but the overall spread of that, or a slope of the yield curve, continues to come down. So that's continuing, that non-parallel movement inside of rates. Again, not a good story for the banks' ***net interest margins***. As we start to see this come back down we're going to potentially see that net interest margin come down. We reported last week where we saw an increase in a net interest margin quarter-over-quarter, however we *questioned if that was going to be sustained into the future?* And this would suggest, that that is not going to be sustained, that that might be an anomaly for right now, and we're going to start to see that managers' margin of pullback down.

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We move from the projections here of the overall rates in the market and we look at the implied probabilities of the ultra-short-term or the Fed Funds rate (Slide 7). As you know the Fed came out and they said that most likely in the near future, suggesting potentially that in September, they will begin that balance sheet unwind. And because of that and because of the economic numbers that have been coming out, we see this push off in the next rate hike for the Fed. In fact, when we look at the implied probabilities, we can see there is the greatest probability, even going out towards April or May of 2018 that the Fed will not move. This continues to get pushed out. Just a couple of weeks ago this would have been March, and now they got that 54.7% probability that the rate on the Fed Funds will still be 1.00 to 1.25 going out to May of 2018. So, this is something to keep an eye on. In fact, we drop even down 44% probability in June (greater than the 1.25 to 1.5 range) so we're continuing to see this push out of when the Fed is going to move next. This could be a benefit for banks because we see our deposit pricing not having that pressure to move up.

However, when we look at the CD prices (Slide 8), and if you recall last week when we went over the mix of cash type deposits to total deposits, we saw it peak out and then come down for the last quarter. So, we saw this leveling off, which is something that hasn't occurred over the past couple of years. So that could be the potential for depositors' appetite now moving toward CDs. So, you look at the ***CD market*** in here; average national CD rates, these rates taken from SNL. So, we look at the SNL rates for August 8th, 2017. You can see the 1-year rate at 54 bps and where we were at the end of the first quarter at 48 bps. So we are seeing that shift up a little bit but it is a pickup in those rates. However, when we look at the bankrate.com rates and where they're showing, the national average on that 1-year is at a 1.41%. Their best rate that they put out there is at a 1.60%. So, you see that upward momentum; these are the special rates, the promotions that are going on for that 1-year. So this is kind of what your depositors are seeing here in the market when they're looking. So, some interesting numbers here; you look at the 2-year rate at that 1.61%, the best rate at that 1.81%. Now if we start to see our depositors move from those cash tight deposits into the CDs that's just going to exacerbate that movement in your cost of funds. You're going to go from the rates of you know, 0.5 or even 0.1, up to these higher rate close to 1%, increasing that cost of funds, thereby reducing down that net interest margin. So that's where the CD rates are today in the market, the most current information that we have.

When we look out into the future, ultimately what we see, and everything is projecting to that narrowing of the yield curve, that could potentially be eroding our net interest margin. That coupled with the idea that the depositors' appetite may be moving to longer-term products or CDs, that, in effect, could increase our cost of funds, further eroding our net interest margin. All the while we are not getting any relief on the long end of the curve to support the higher yields out there for our assets. Unfortunately, I wish I could bring you better news but that's where we are today. It's something to keep abreast on, something to keep in mind, and we will continue to look at this situation as you move through the quarter and we visit our banks at the ALCO meetings that we attend. We thank you very much for joining us and we'll see you back here next week. Have a great week.

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