The Baker Group

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The Fed Finally Cut Rates – Now What?

After the most aggressive tightening cycle in forty years and the second longest period ever with rates at the peak of the cycle, the Federal Reserve finally relented and cut rates 50bp in September. And just like that, the banking industry has pivoted from focusing on the risk of rising rates to the risk of falling rates. For the last three years, banks have been managing the interest rate risk associated with rising rates. Deposit costs have surged, bond portfolios have depreciated by record amounts, and margins have been squeezed. Now that the Fed has cut rates for the first time since early 2020, what should community banks expect during this easing cycle and how can they better prepare for lower rates?

Fed Funds Rate & Prime

The Fed's September "Dot Pot" showed they expect to cut rates another 50bp in 2024, followed by 100bp in 2025 and a final 50bp in early 2026 to end with a fed funds rate of 2.75-3% and a prime rate of 6%. This means banks should prepare for short-term interest rates to fall about 200bp over the next eighteen months if the Fed's forecast is correct. However, the Fed's "Dot Plot" is based on their forecast for a "soft landing." What happens if a recession occurs in 2025? Then the Fed will almost certainly have to cut rates more than that and much more quickly, probably pushing the fed funds rate below 2% in 2025 if history is any guide.

Bond Yields

Bond yields normally lead the Fed lower and typically fall in anticipation of future rate cuts. Prior to the Fed's September rate cut, the 2yr Treasury yield had already fallen 160bp and the 10yr yield had fallen about 140bp. Some bankers may believe bond yields have already fallen enough and will not fall further. History suggests this may not be the case. During each of the last five easing cycles in 1984, 1989, 2000, 2007, and 2019, bond yields actually fell more after the first rate cut than before. If you average the moves during those five easing cycles, the 2yr yield fell an average of 141bp prior to the first rate cut but fell an additional 405bp after the first rate cut. The 10yr yield fell an average of 126bp before the first rate cut and then fell a further 308bp after. This suggests bond yields may have much further to fall during this easing cycle, and banks should prepare their investment portfolios and balance sheets for lower rates in the years ahead.

Bond Portfolio

Bank bond portfolios depreciated significantly as the Fed hiked rates aggressively in 2022-23 and remain at an unrealized loss despite the recent drop in rates. And banks have purchased far fewer bonds in the last twelve to eighteen months with yields near 5% than they did in 2020-21 when yields were near record low levels. In fact, some banks have not purchased a bond in the last two years. This means those banks will not have any unrealized gains in the portfolio that they could use to offset potential loan losses, which may occur if the economy enters recession in 2025 or beyond. Banks should be actively participating in this market by adding bonds to the portfolio while yields remain higher than in sixteen out of the last seventeen years.

All banks should maintain a written investment strategy to help manage risk and maximize performance. This strategy should be focused on preparing the portfolio for an extended period of falling rates punctuated with shorter periods of yield retracements. This means banks should be focused on buying longer durations (assuming their risk profile allows that) and bonds with good call protection and prepayment protection. The goal is to build a diversified portfolio with stable cash flow by adding higher yielding bonds that will maintain that yield even as rates fall. The last thing banks need during this easing cycle is a lot of callable bonds that will get called away or MBS/CMO that will experience significant levels of prepayment risk if rates

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fall. The focus should be on good structures with stable cash flows and avoid chasing yield in non-traditional, riskier securities.

Interest Rate Risk

Most community banks experience margin compression as rates fall and margins are already at the lowest level they have ever been entering an easing cycle. During the 2000 and 2007 easing cycles, community banks lost an average of 40bp of margin as rates fell and they lost 75bp in 2019-22 as the pandemic drove margins to a record low. Banks should be actively positioning their balance sheets to protect margin before rates move lower. This generally means becoming more liability sensitive with longer, more fixed rate assets and shorter liabilities. Banks should review their most recent interest rate risk reports to determine if the change in margin income and economic value of equity in a falling rate environment are acceptable. If not, the time to make adjustments to the balance sheet is now.

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