FIRST BANKERS' BANC SECURITIES, INC.

UPDATE

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Balancing "What-If" and "What Is" for Community Bank Bond Portfolios

A great line of advice that you may have heard, one that is useful for thinking about portfolio strategies, is to make sure that you balance "what-if" and "what-is" considerations in the decision making process. After the election in November many of you saw the values of holdings in portfolios plummet. The overall set up from a macro perspective reminded me of the period from mid-2012 to mid-2013 with an election, international uncertainty, a more bifurcated FED debate and a precipitous spike in rates. Many of the same challenges that market participants were challenged with in early 2013 have been resurrected with the latest market movement. As always, the bank portfolios that can find the relative value across various sectors will be the beneficiaries of their ability to exploit a sloppy bond market.

Assessing "What Is" and Valuing "What Ifs"

The facts are the facts and they provide the backdrop for our operating environment. U.S. GDP growth has averaged 2.3% for the last 12 quarters. Inflation has averaged 1.0% for the last 12 quarters. The FED Funds target has increased up to 75 basis points but overall the posture of monetary policy is still largely accommodative. Weighty concerns persist in the international finance and geopolitical arenas that can have huge and direct impacts abroad but also domestically. A new administration promising to shake up the status quo in Washington D.C. is something most of us probably welcome but the mechanisms they use and the topics they shake are where the 'what-ifs' will be weighted. It is important to keep in mind that no matter who is in charge in the capital the pace of change will be challenged because of the amount of interests that rely on the status quo are immense. It is necessary to operate in the current reality without getting carried away assigning probabilities to potential future developments.

Operate in the "What Is" environment

Without completely ignoring the 'what-ifs' that exist, those tasked with managing investments in the bond portfolio must operate within the confines of 'what-is' because that is the current reality. Given the recent spike in rates, the bond portfolio has been brought back into focus, but the focus is skewed towards a greater risk factor to bank profitability. I like to view the spike in rates as an event that in the short term can be painful and disorderly but when viewed through a longer run lens as an event that actually restores order and creates opportunity for action. I think one of the sectors that can provide actionable ideas is the municipal sector.

As rates climbed following the election we saw a wave of selling in the municipal sector. A lot of it was driven by bond funds liquidating positions and the volume of selling and resulting chaos resulted in an oversold municipal market. This was further compounded by the uncertainties surrounding the taxation issues unique to municipal securities. In the end there were and are a lot of participants that "can't see the forest for the trees". When it comes to the 'what-if' part of this equation the fear is that municipal bonds values will be decimated if the tax code is changed to a regime of lower effective rates. While this would most likely be true, by the time any tax policy made its way through congress the market will have long ago adjusted for this contingency. The market can react much faster than legislation can be approved and I think the ability to weight the possibilities of tax regime change combined with movements in the municipal market will again present opportunities. Taxable equivalent yields will adjust in a matter of days and weeks not quarters and years. Some of this may already be being priced into the market as we saw drastic spread widening in municipal bonds when compared to other recent spikes in interest rates.

This type of spread widening provides opportunities to buyers of municipal bonds as the valuation of securities can take a back seat to the need to sell at levels that otherwise would be deemed as too cheap. As more bonds hit the street and broker balance sheets swell with inventory, the secondary market for municipal bonds works through a period of price discovery. This period of price discovery is where you can find value as an investor in municipal securities.

Be cognizant of the credit and terms of any municipal security – as well as the potential for 'what-ifs' affecting your valuation – but don't become paralyzed by the 'what-ifs' because that is not the current reality that we all have to operate in.