DREW SIMMONS
Oklahoma Regional Manager
785.478.1116
drew.simmons@fhlbtopeka.com

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Smart Moves for Every Scenario

Whether you are asset-or liability-sensitive, find straightforward strategies for any rate environment

If there's a word that stands out from Chairman Powell's comments leading up to the Federal Reserve's next rate decision, it's "expeditiously."

That pretty much sums up the Fed's tone, and there's no question what the Fed is trying to telegraph when it comes to taming inflation — "We're behind the eight ball."

The Federal Reserve has embarked on their most aggressive tightening cycle in more than 20 years. The question is how much and how long? The labor market is strong with the unemployment rate at 3.6%, just 0.1% above the pre-pandemic low. Also, the stubbornly low labor force participation rate has seen a significant surge over the past five months, increasing 0.7% to 62.4%.

The elephant in the room is inflation. What was thought to be transitory behavior in the price of goods and services has quickly turned into a new normal for the economy, something that hasn't been seen since the Paul Volcker days of the 1980s.

The future for our economic outlook resides firmly on how quickly the Federal Reserve is willing to increase rates to combat inflation. The last time the Fed increased rates by 50 basis points was in 1999 during the dot-com bubble.

There's a reasonable chance for two 50-basis-point increases in May and June followed by consecutive hikes at each meeting this year. It remains to be seen how quickly rate hikes coupled with the Fed reducing their balance sheet will tame inflation. Yet, with inversion in the 10yr and 2yr points on the US Treasury curve, financial institutions are anxiously watching the Fed in preparation for the next economic cycle.

The question financial institutions need to ask right now is how their balance sheet and liquidity will respond to the volatile scenarios that could play out over the next 18 to 24 months. If history is any indication, the inversion of the treasury curve will result in some form of a recession.

A soft landing seems unlikely given how late the Fed is in their response. The dreaded stagflation scenario also cannot be ignored. Conversely, it's very difficult to say when and how severe

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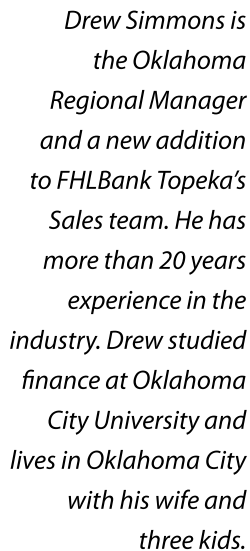

Drew Simmons is the Oklahoma Regional Manager and a new addition to FHLBank Topeka's Sales team. He has more than 20 years experience in the industry. Drew studied finance at Oklahoma City University and lives in Oklahoma City with his wife and three kids.

the next economic downturn will be given the strength in the domestic labor market.

This begs the question, what's next? Given all the variables and uncertainty, it can be easy to fall victim to paralysis by analysis. Instead, let's keep it simple and break it down to the following three outcomes:

1. Rising Rates
The Fed rights the ship, and inflation is tamed. The economy doesn't skip a beat, and we're off to the races. Supply chain disruptions dissipate, and wage inflation continues to attract more folks back into the labor force. Interest rates remain high, but the long end of the curve responds to keep margins attractive. This would be a big win for most financial institutions.

2. Flat Rates
The Fed increases rates, but the curve remains flat, and the Fed has to slow its pace of tightening. The supply chain disruptions continue, and there are more of the same problems that were emblematic of the COVID-19 pandemic.

3. Falling Rates
The Fed makes a policy error and is not able to employ its policy tools in time to avoid a recession. The Fed would have no choice but to return to zero interest rate policy implementation and liquidity remains in the market.

We addressed these same scenarios in our February outlook. There's nothing earth-shattering in these scenarios, but it's a pragmatic approach to begin the process of strategy generation.

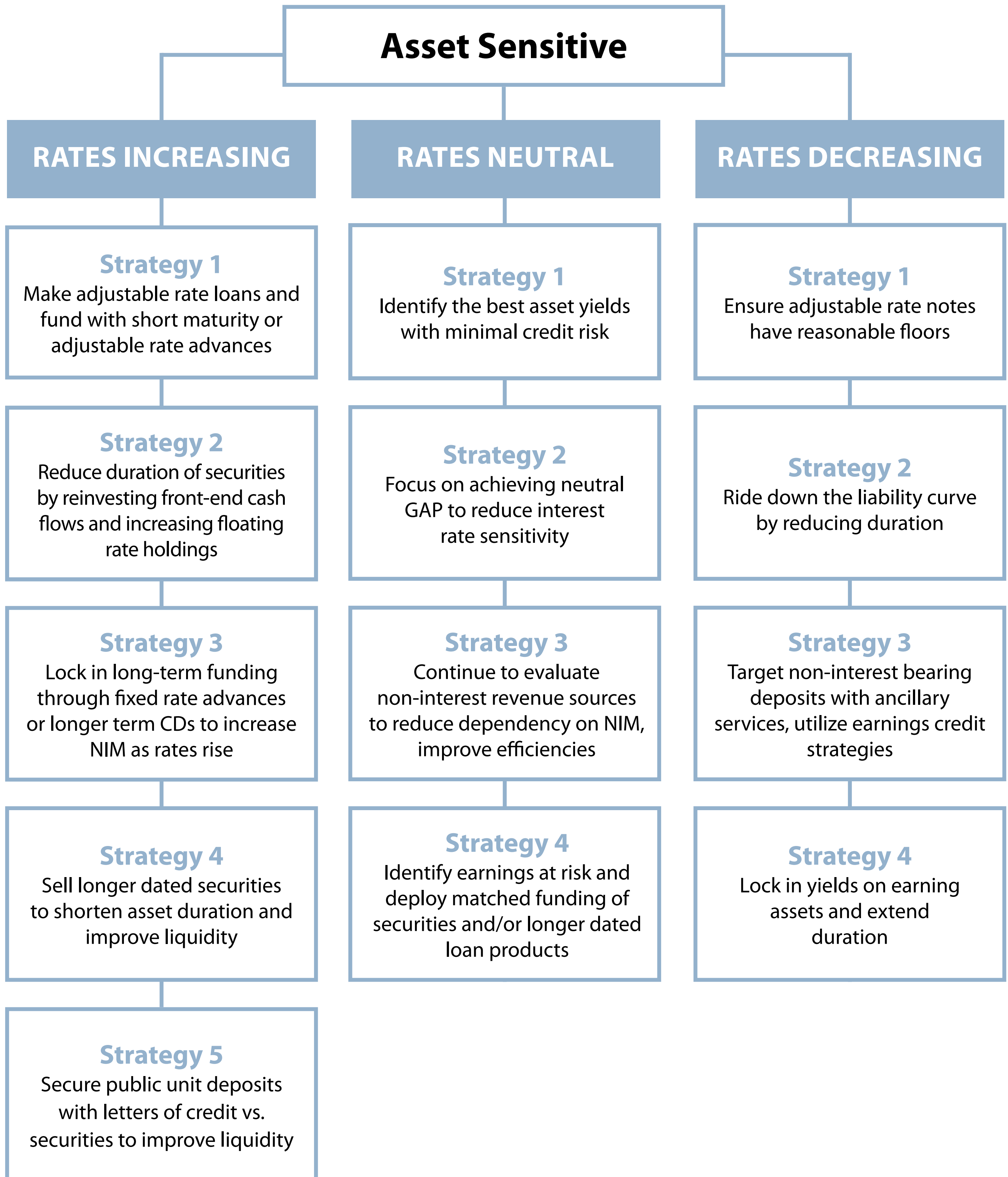
The next step is to apply these scenarios to the unique nature of your balance sheet. Whether your financial institution is asset- or liability-sensitive is a good starting point, and we can apply strategies that make the most sense.

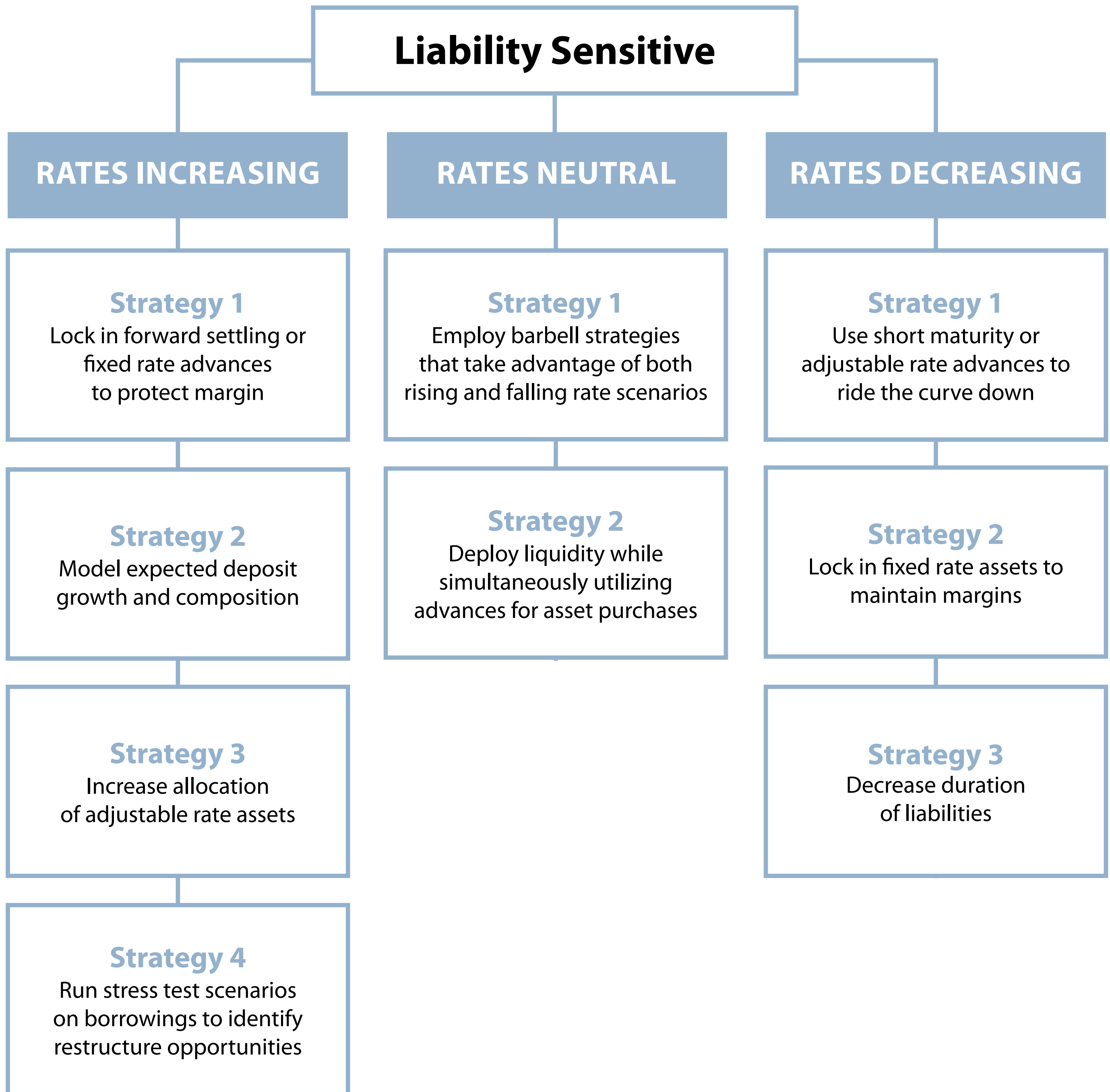
Most financial institutions are asset sensitive and perform best under a rising rate environment. As rates rise and the economy continues to improve, margins tend to increase and earnings rise as well. On the downside, liquidity and deposit pricing present challenges.

For those that find themselves in a liability-sensitive profile, a far different challenge is afront. The aggressive nature of the Fed's rate hikes presents an increase in your cost of funds and could compress margins.

These are all obvious problems, but shareholders and management must go through the tedious process of mapping these scenarios out so that the dry powder is at the ready for what the future holds.

The graphics that follow on pages 3 and 4 are examples of the types of strategies that could help in any of the interest rate scenarios. At FHLBank Topeka, we can help identify what strategies work best to prepare your institution for success.


Asset Sensitive
RATES INCREASING
Strategy 1
Make adjustable rate loans and fund with short maturity or adjustable rate advances
Strategy 2
Reduce duration of securities by reinvesting front-end cash flows and increasing floating rate holdings
Strategy 3
Lock in long-term funding through fixed rate advances or longer term CDs to increase NIM as rates rise
Strategy 4
Sell longer dated securities to shorten asset duration and improve liquidity
Strategy 5
Secure public unit deposits with letters of credit vs. securities to improve liquidity
RATES NEUTRAL
Strategy 1
Identify the best asset yields with minimal credit risk
Strategy 2
Focus on achieving neutral GAP to reduce interest rate sensitivity
Strategy 3
Continue to evaluate non-interest revenue sources to reduce dependency on NIM, improve efficiencies
Strategy 4
Identify earnings at risk and deploy matched funding of securities and/or longer dated loan products
RATES DECREASING
Strategy 1
Ensure adjustable rate notes have reasonable floors
Strategy 2
Ride down the liability curve by reducing duration
Strategy 3
Target non-interest bearing deposits with ancillary services, utilize earnings credit strategies
Strategy 4
Lock in yields on earning assets and extend duration



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