SouthState
CORRESPONDENT DIVISION

MARKET INSIGHTS & COMMENTARY

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Bond Portfolio Trends: Second Quarter 2021

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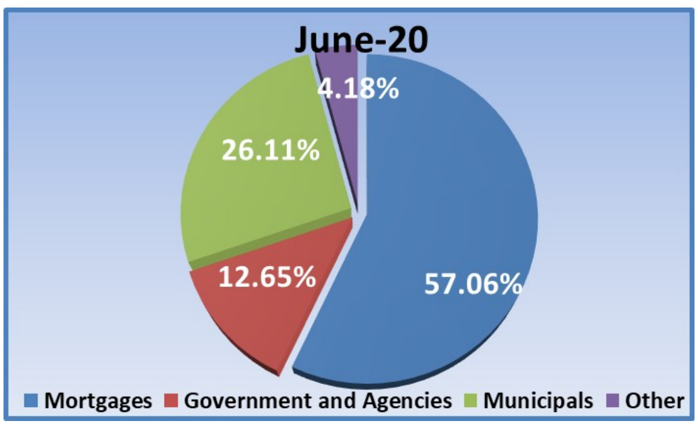
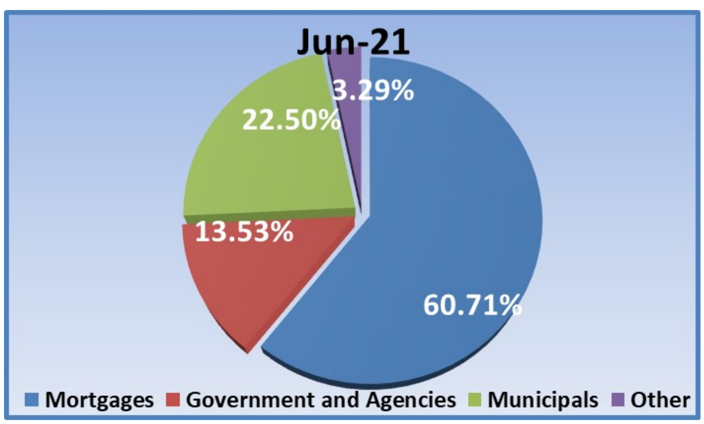
Beginning in May 2012 we started tracking portfolio trends of our bond accounting customers here at the Correspondent Division of SouthState Bank. At present, we account for over 130 client portfolios with a combined book value of $15.8 billion, or $122 million on average per portfolio. Twelve months earlier the average portfolio size was $89 million which represents a 37% year-over-year increase which speaks to softening loan demand during the year and the abundant liquidity that came aboard from the various stimulus programs. Portfolio size will likely continue to grow in the months ahead as loan demand remains unimpressive and liquidity remains strong. Eventually, the strengthening economy should lead to growing loan portfolios and plateauing investment balances but we are not there yet.

The first quarter trend of higher longer-term Treasury yields surprisingly reversed in the second quarter of 2021 as investors saw past near-term economic gains and focused on whether vaccination rates would achieve long-term expectations and hence the growth prospects in the services side of the economy. Investors too seemed to question that the Fed would remain on hold as inflation rose over 2%. In fact, the June dot plots showed a pulling forward of rate hikes into 2023 from 2024, seeming to confirm market expectations that the Fed would move quicker than reflected in earlier forecasts. Thus, inflation expectations were dialed back and that also contributed to rallies on the long end of the Treasury curve.

With the Fed at the zero-lower bound on fed funds for another year or two, the short-end remains relatively stuck in place. Meanwhile, as mentioned above, longer-end yields fell during the quarter. That led to a flattening of the Treasury curve in the second quarter after a nearly year-long steepening trend. Two-year yields rose 9bps during the quarter ending June at 0.25%. Meanwhile, 10-year yields fell 27 bps during the quarter to 1.47%. That price action flattened the 2yr-10yr Treasury spread from 158bps as the quarter began to 122bps at quarter-end. That flattening reversal experienced in the second quarter has held in early July as long-end yields continue to rally. Also reflecting a change in the quarter, the 5yr-10yr spread tightened from 80 bps as the quarter began to 58 bps reflecting selling in the middle part of the curve as investors reacted to the latest dot plots with two rate hikes in 2023. Thus, investors stood to get more yield from the intermediate part of the curve relative to other parts than was the case as the quarter began. Now let's turn our attention to the changes in portfolio allocation during the past year.

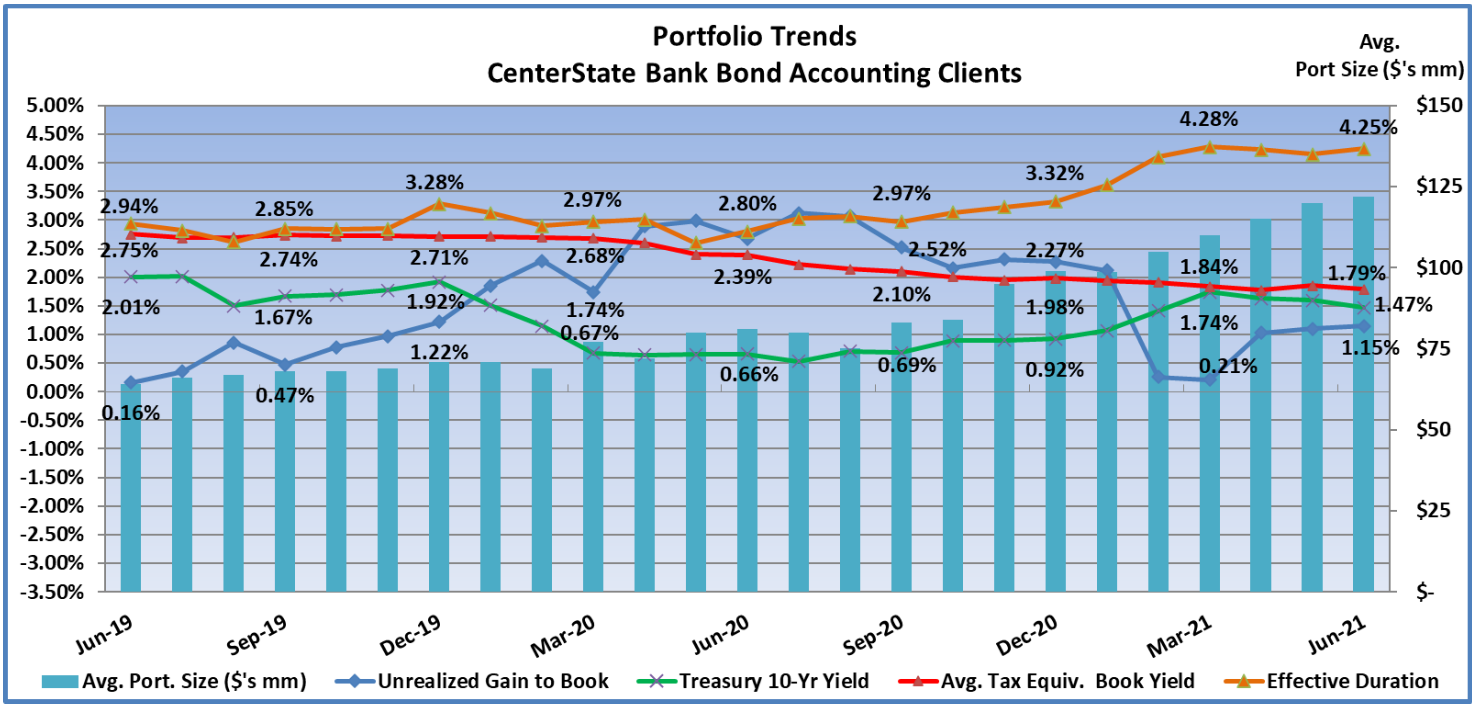


Let's begin by revisiting allocations a year ago, as shown in the pie chart to the immediate right. The MBS/CMO sector comprised 57.1% of portfolios, municipal allocations stood at 26.1%, Agency/Treasury investments were at 12.7% and the "Other" category (CDs, corporates and other floaters) was 4.2%.



Fast forward one year to June 30, 2021. The MBS/CMO sector comprised 60.7% of portfolios, a3.7% increase during the past year as portfolio managers continued to reinvest returning principal, and more, and moved more dollars to 30-year product to find acceptable yields. This has been a trend for a year now of increasing MBS allocations along with investing in longer duration pools in order to find decent yields. Municipal allocations decreased slightly from 26.1% to 22.5% (18.0% tax-free, 4.5% taxable). Prices in the muni sector have continued to increase in the past year and that has perhaps slowed growth in the sector despite still offering some of the best tax equivalent yields for traditional bank investments. Agency/Treasury investments rose a bit during the year increasing from 12.7% to 13.5% at quarter-end. The "Other" category decreased slightly from 4.2% to 3.3% with corporate bonds constituting more than half the category at 2.5% while CDs totaled 0.8%, a decline from 1.3% in the prior quarter due to better yields elsewhere.

Now let's look at portfolio performance trends. The graph below tracks average portfolio tax equivalent book yield, duration, unrealized gain/(loss) as a percent of book value, as well as 10-year Treasury yields and average portfolio size over the last two years.



The extreme yield declines in the first few months of 2020 and resulting rangebound market into August were reflected in declining portfolio yields for much of 2020 and so far in 2021. 2020 began with portfolio yields averaging 2.71%, but by the end of the year yields had fallen to 1.98%, a full 73bps decline. During the first quarter of 2021 yields fell another 14bps to 1.84%. The second quarter saw further yield declines but the pace slowed to a 5 bps dip to 1.79%. As shown, longer-term Treasury yields (green line) began the year at 0.92% and spent the first quarter increasing to 1.74% by March 31. In the second quarter, however, yields fell to 1.47%. Unfortunately, the peaking in yields in the first quarter and subsequent decline in the second will likely prevent any near-term improvement in overall portfolio yields.

As Treasury yields moved decidedly higher in the fourth quarter of 2020 durations started to lengthen as higher long-term rates led to some slowing in prepayment and call expectations. Longer duration portfolio purchases also contributed and that combination sent the average duration to 3.32 years from 2.97 years as the fourth quarter began. That, however, was merely a prelude to the first quarter of 2021 as continued long-end rate increases and longer duration purchases moved durations out to 4.28 years at quarter-end. The second quarter, however, with its decline in longer-term Treasury yields and slightly less duration purchases saw portfolio duration decline slightly from 4.28yrs to 4.25yrs.

One positive development of declining second quarter yields was the improvement in unrealized gains. With rates falling throughout the second quarter, unrealized gains rose from 0.21% of book value as the quarter started to 1.15% as the second quarter ended. So far, in the early days of the third quarter, market yields continue to fall and if that continues unrealized portfolio gains will continue to improve.

Finally, new investments in the second quarter of 2021 were dominated by the MBS/CMO sector with purchases equaling 48% of the $1.5 billion in total par (41% in MBS and 7% in CMOs). The 48% MBS/CMO allocation compares to a legacy total of 61%. Of the purchases, 39% were in 20yr pools, 30% in 15yr pools and 30yr pools at 29%. The Treasury/agency sector followed with 33% of total purchases (24% Treasuries, 7% agency callable, 2% agency bullet and 0.5% agency step-up). The current purchases at 33% easily exceeded the legacy total of 14%. The municipal sector followed at 13% of total purchases (10% tax-free, 3% taxable). The muni purchases compare to 22% legacy muni allocations. The average tax equivalent book yield for the second quarter purchases was 1.36% with an average effective duration of 4.50 years. The average purchase yield fell from 1.39% in the first quarter but the duration of those purchases declined slightly from 5.38 years in the first quarter. Compare those purchases to the legacy portfolio book yield of 1.79% and effective duration of 4.25 years. The previous trend towards longer duration MBS investments slowed in the quarter with more 20yr MBS vs. 30yr and an increase in Treasury/agency investments vs. MBS. We will update this data again in October to track how allocations and performance characteristics are trending in the second half of 2021.

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