SouthState
CORRESPONDENT DIVISION

MARKET INSIGHTS & COMMENTARY

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Bond Portfolio Trends: Third 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 $17.2 billion, or $132 million on average per portfolio. Twelve months earlier the average portfolio size was $83 million which represents a 59% year-over-year increase which speaks to the ongoing soft loan demand and the abundant liquidity that came aboard from the various pandemic stimulus programs. Portfolio size is very likely to continue growing in the months ahead as stronger loan demand remains elusive and liquidity remains strong. Perhaps 2022 will lead to growing loan portfolios and plateauing investment balances, but we are not there yet.

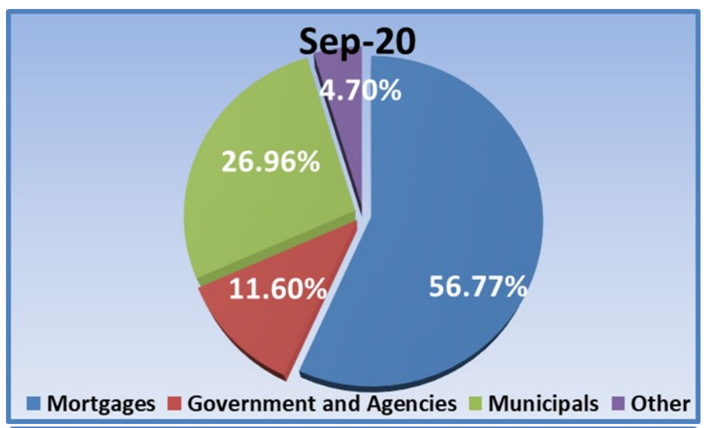
After a first quarter of higher long-term Treasury yields, and a second quarter of lower yields, the third quarter was one of testing ranges with a low yield of 1.20% in the 10yr and a high of 1.54%. The last week of September, however, did provide some fireworks. That's when the FOMC meeting on September 22 pulled forward a rate hike into 2022 and Chair Powell laid out a vision to be done with QE tapering by mid-2022.

That news led to selling in Treasuries, particularly the intermediate part of the yield curve, reflecting the more hawkish rate-hiking forecast of the FOMC. That had investors revisiting the question of exactly how long the Fed would sit idly by while inflation remained over 2%. The rate forecasts and Powell's post-meeting press conference seemed to confirm that the Fed would move quicker than reflected in earlier forecasts and meetings. Thus, the intermediate part of the curve, where the duration of most of our client's portfolios reside, saw bond prices retreat.

During the quarter, two-year yields rose 3bps ending September at 0.28%. Meanwhile, 10-year yields rose just 2 bps during the quarter to 1.49%. That price action flattened the 2yr-10yr Treasury spread from 122bps as the quarter began to 121bps at quarter-end. As mentioned above, that seemingly quiet yield curve between July and September actually hid quite a bit of range-testing during the quarter. Also, the 5yr-10yr spread flattened from 58 bps as the quarter began to 52 bps reflecting heavier selling in the middle part of the curve as investors reacted to the latest dot plots with a rate hike in 2022 and two more in 2023.

Now let's turn our attention to the changes in portfolio allocation during the past year.

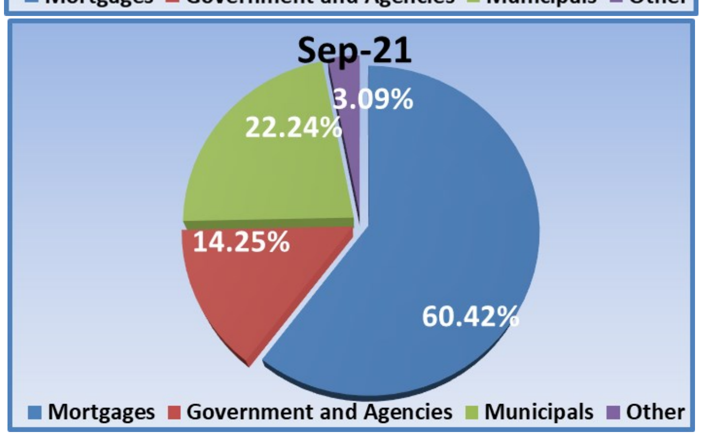
Let's begin by revisiting allocations a year ago, as shown in the pie chart to the immediate right. The MBS/CMO sector comprised 56.8% of portfolios, municipal allocations stood at 27.0%, Agency/Treasury investments were at 11.6% and the "Other" category (CDs, corporates and other floaters) was 4.7%.



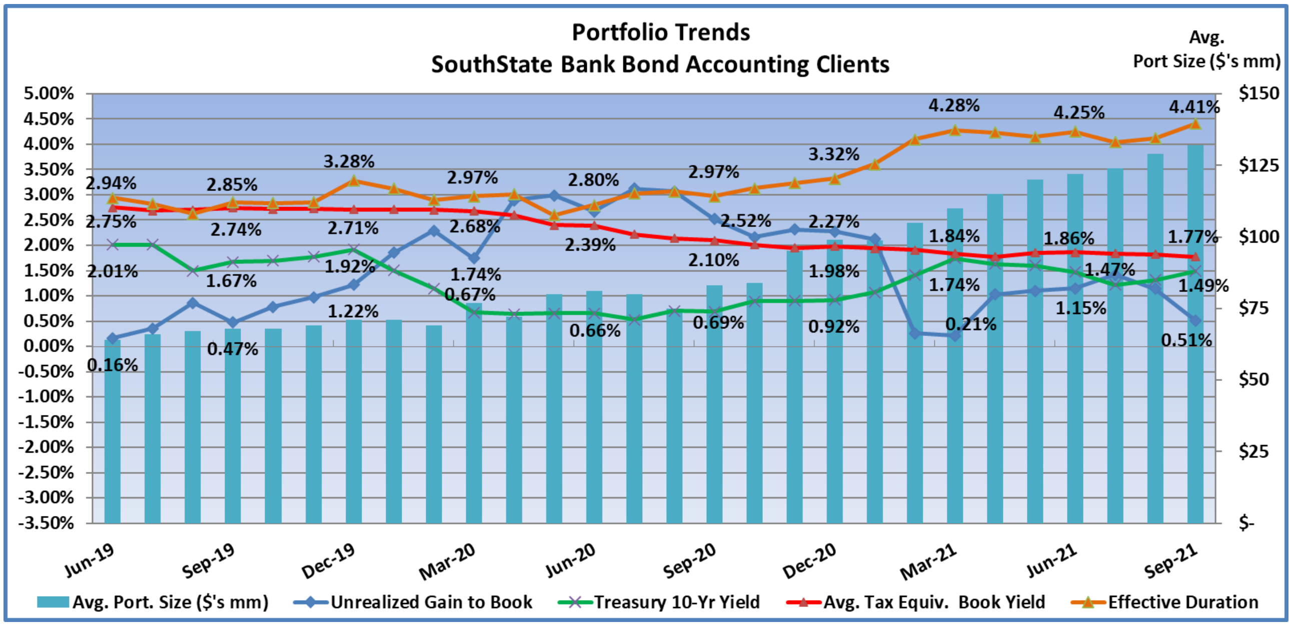
Fast forward one year to September 30, 2021. The MBS/CMO sector comprised 60.4% of portfolios, a 3.7% increase during the past year as portfolio managers continued to reinvest returning principal, and more, and moved more dollars into 30-year product to find acceptable yields. This has been a trend for over a year now of increasing MBS allocations, along with investing in longer duration pools in order to find decent yields.

Municipal allocations decreased from 27.0% to 22.2% (18.0% tax-free, 4.2% taxable). Prices in the muni sector have continued to remain rich 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 securities rose a bit during the year increasing from 11.6% to 14.3% at quarter-end. The "Other" category decreased slightly from 4.7% to 3.1% with corporate bonds constituting more than half the category at 2.3% while CDs totaled 0.8%, a similar level to the prior quarter due to better yields being found further out the curve.



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 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 yields stabilize at 1.86% but they slipped another 9 bps during the third quarter to 1.77%.

As shown, 10-year Treasury yields (green line) began the year at 0.92%, increasing to 1.74% by March 31, the year-to-date high. In the second quarter, yields fell to 1.47% but were range bound in the third quarter ending nearly unchanged at 1.49%. This range bound behavior will likely keep portfolio yields drifting a bit lower in the fourth quarter as reinvestment yields struggle to maintain existing book yields.

In the fourth quarter of 2020 Treasury yields moved higher and 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 higher as 2020 ended. 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 saw portfolio duration decline slightly from 4.28yrs to 4.25yrs. With range bound yields in the third quarter durations drifted higher to 4.41 years as reinvestments in longer duration bonds continued. This portfolio duration is the longest since July 2014.

While 10-year Treasury yields were mostly range bound during the third quarter it was accompanied by bouts of volatility and range-testing. Shorter maturities had a particularly tougher go of it with 5-year Treasury yields increasing 10bps and that had a detrimental impact to prices in that part of the curve. Unrealized gains reflected that difficulty starting the quarter at 1.15% of book value but slipping to 0.51% as September ended. That's the lowest unrealized gain since the first quarter ended with the 10-year Treasury hitting it's year-to-date high of 1.74%.

Finally, new investments in the third quarter of 2021 were once again dominated by the MBS/CMO sector with purchases equaling 43% of the $1.2 billion in total par (36% in MBS and 7% in CMOs). The 43% MBS/CMO allocation compares to a legacy total of 60%. Of the purchases, 39% were in 30yr pools, 28% in 20yr pools, and 23% in 15yr pools. The Treasury/agency sector followed with 28% of total purchases (17% Treasuries, 6% agency callable, 2% agency bullet and 3% agency step-up). The current purchases at 28% easily exceeded the legacy total of 14%. The municipal sector followed at 24% of total purchases (16% tax-free, 8% taxable). The muni purchases compare to 22% legacy muni allocations.

The average tax equivalent book yield for third quarter purchases was 1.38% with an average effective duration of 5.61 years and negative convexity of –1.16. Compare those purchases to the legacy portfolio book yield of 1.77% and effective duration of 4.41 years. Thus, the search for yield via longer-duration securities continues but they still trail legacy yields by nearly 40bps so margin contraction looks likely to continue.

We will update this data again in January to track how allocations and performance characteristics trended through the end of 2021.

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