SouthState
CORRESPONDENT DIVISION

MARKET INSIGHTS & COMMENTARY

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Bond Portfolio Trends: Fourth Quarter 2021

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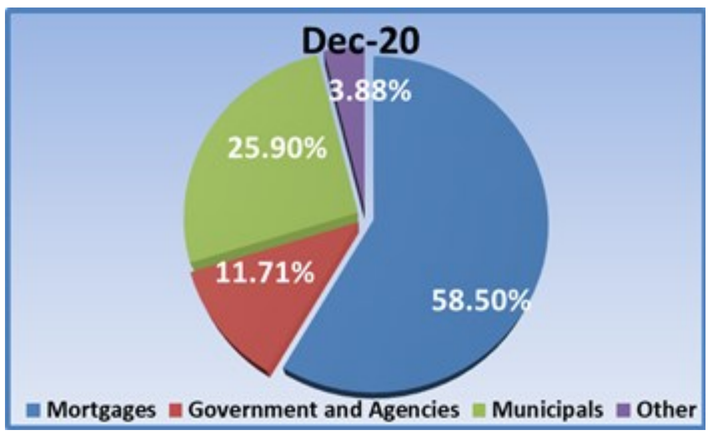
Beginning in May 2012, we started tracking portfolio trends of our bond accounting customers here at the Correspondent Division of SouthState Bank. At present, we account for over 130 client portfolios with a combined book value of $19.0 billion, or $143 million on average per portfolio. Twelve months earlier, the average portfolio size was $99 million which represents a 44% year-over-year increase and 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 plateau, if not shrink, in the months ahead as loan demand improves and excess liquidity starts to moderate.

After a first quarter of higher long-term Treasury yields, and a second quarter of lower yields, the third and fourth quarters were ones of testing ranges with a low yield of 1.17% in the 10yr (Aug. 3rd) and a high of 1.70% (Oct 21). December, however, did provide some contrast. The first half of the month saw yields dip to a low of 1.34%, but after the mid-month FOMC meeting and new hawkish tone from the Fed, yields rose slowly to finish the year at 1.51%. So far in 2022, yields have continued higher as the curve continues to test the cycle highs set in March 2021.

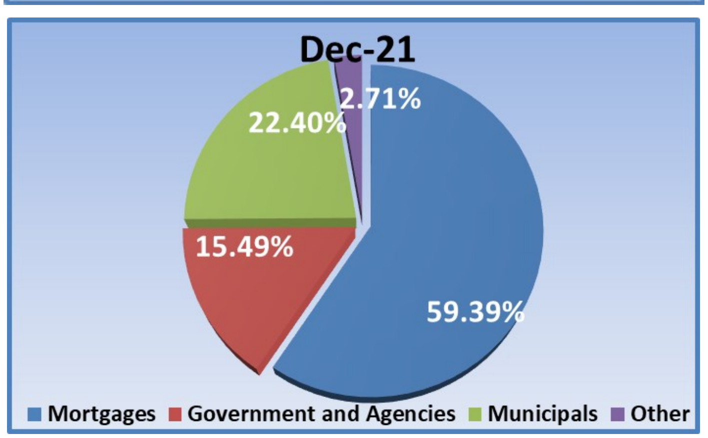
The December FOMC meeting confirmed the Fed would move quicker and more forcefully to combat inflation than was previously the expectation. They projected three rate hikes in 2022, and now some Fed officials are indicating that a fourth hike may be necessary. Also, the minutes revealed the Fed would move more quickly to taper and then reduce its balance sheet, perhaps beginning after only two rate hikes. This would be considerably faster than the last round of balance sheet shrinking in the 2015-2017 tightening period. Several Fed officials are now saying that a rate hike at the March meeting is possible with a second in June, then balance sheet run-off soon thereafter. Thus, the intermediate part of the curve, where the duration of most of our client's portfolios reside, saw yields increase considerably while the uptick in longer-term bond yields was more limited, with flattening in the yield curve the result.

During the quarter, two-year yields rose 46bps ending the year at 0.73%. Meanwhile, 10-year yields rose just 5 bps during the quarter to 1.51%. That price action flattened the 2yr-10yr Treasury spread from 121bps as the quarter began to 77bps at quarter-end. As mentioned above, that flattening action came as the Fed revealed it will move aggressively to combat inflation leading to higher short-term yields. Longer-term yields were more docile in December believing the Fed would manage to quell the inflationary forces but also slow the economy some as well. 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 58.5% of portfolios, municipal allocations stood at 25.9%, Agency/Treasury investments were at 11.7% and the "Other" category (CDs, corporates and other floaters) was 3.9%.

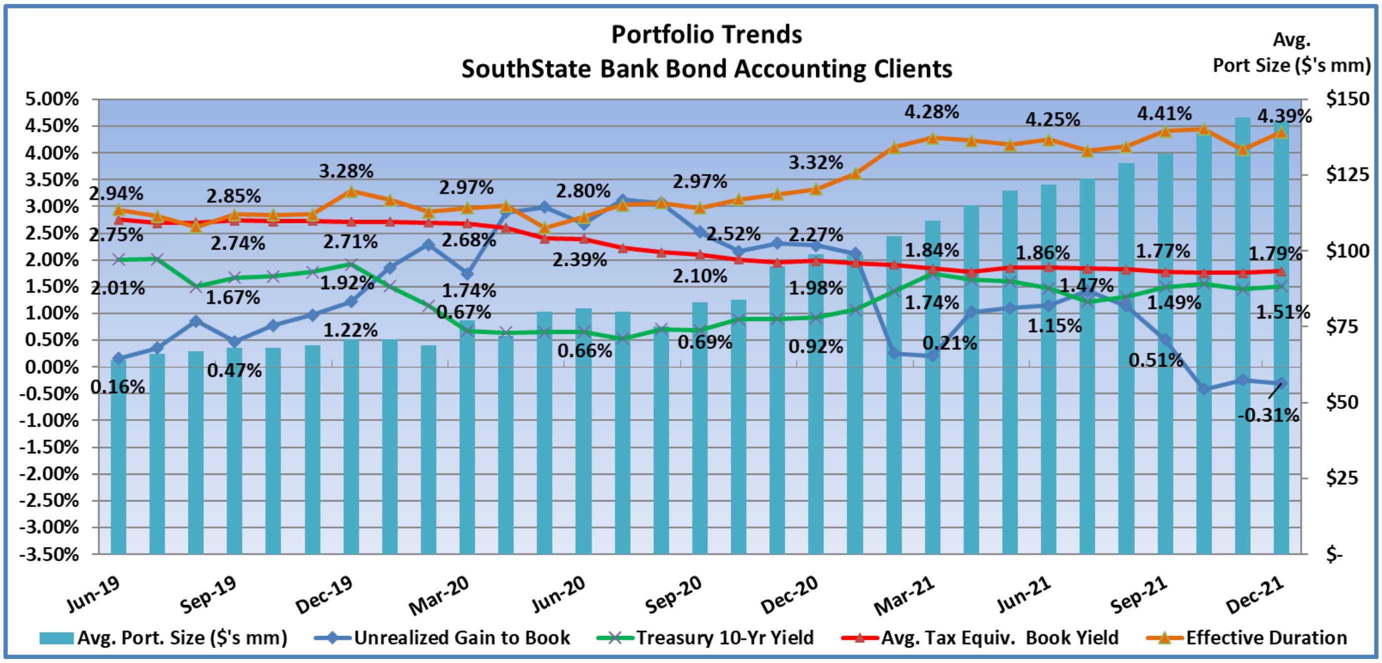
Fast forward one year to December 31, 2021. The MBS/CMO sector comprised 59.4% of portfolios, a 0.9% increase during the past year as portfolio managers continued to reinvest returning principal, and more, and moved more dollars into 30-year product to find acceptable yields. This has been a trend for 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 25.9% to 22.4% (18.4% tax-free, 4.0% 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 increased during the year from 11.7% to 15.5% at quarter-end. The "Other" category decreased slightly from 3.9% to 2.7% with corporate bonds constituting more than half the category at 2.0% while CDs totaled 0.7%, 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 plus years.



The extreme yield declines in the first few months of 2020 were reflected in declining portfolio yields for much of 2020 and throughout 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% and saw a modest uptick to 1.79% as 2021 drew to a close.

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 continued in the fourth quarter with the 10-year yield finishing 2021 at 1.51%.

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. In the fourth quarter, durations were nearly unchanged at 4.39 years as market yields remained range-bound and portfolio mix changed very little during that time.

While 10-year Treasury yields were mostly range-bound during the fourth 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 29bps, and that had a detrimental impact to prices in that part of the curve. Unrealized gains reflected that difficulty, starting the quarter at 0.51% of book value but slipping to -0.31% at year-end.

Finally, new investments in the fourth quarter of 2021 were once again dominated by the MBS/CMO sector with purchases equaling 45% of the $1.4 billion in total par (36% in MBS and 9% in CMOs). These amounts were very similar to third quarter purchases. The 45% MBS/CMO allocation compares to a legacy total of 59%. Of the MBS purchases, 47% were in 30yr pools, 22% in 20yr pools, and 15% in 15yr pools. The Treasury/agency sector followed with 36% of total purchases (25% Treasuries, 6% agency callable, 3% agency step-ups and 2% agency bullets). The current Treasury/agency purchases at 36% easily exceeded the legacy total of 15%. The municipal sector followed at 17% of total purchases (9% tax-free, 8% taxable). The muni purchases compare to 22% legacy muni allocations.

The average tax-equivalent book yield for fourth quarter purchases was 1.43%, with an average effective duration of 4.93 years and negative convexity of –0.89. Compare those figures to the legacy portfolio book yield of 1.79% and effective duration of 4.39 years. Thus, the search for yield via longer-duration securities continues. But new purchases still trail legacy yields by nearly 36bps 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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