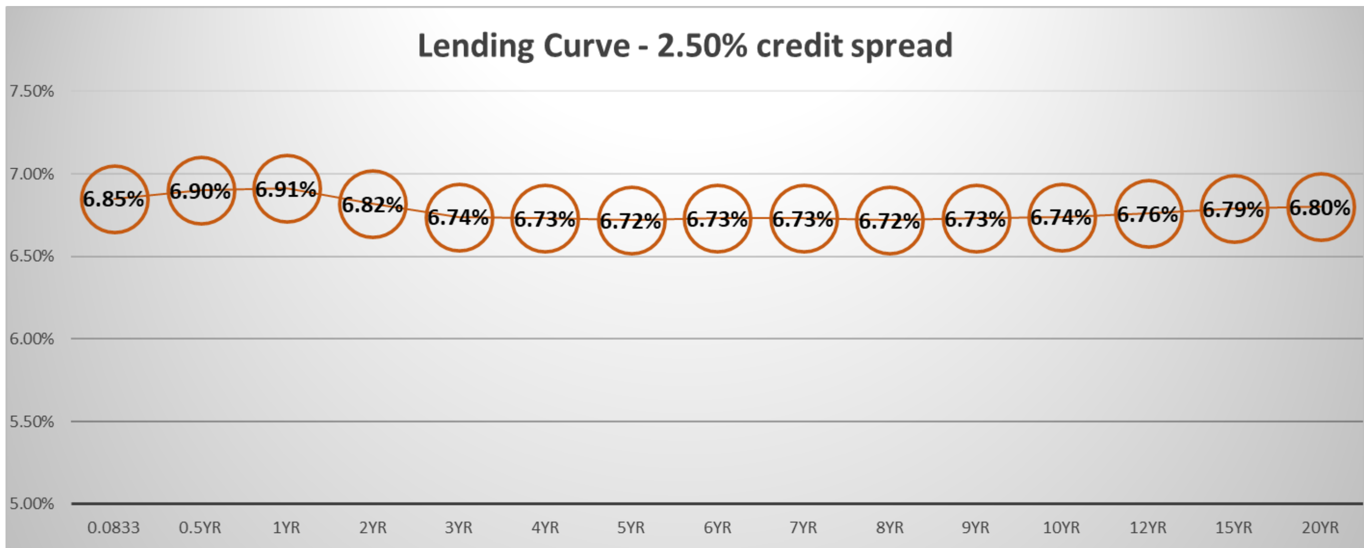
The Fed is on pause and the next move may not be a cut

At their January 29th meeting, the Federal Reserve left short-term interest rates unchanged, and signaled a pause to its current monetary policy actions. The Fed is always data dependent, and has now signaled that it will wait until the President's policies materialize and will see the impact on inflation and job creation. The current lending curve at 2.50% credit spread is shown below.



Implications for banks and borrowers

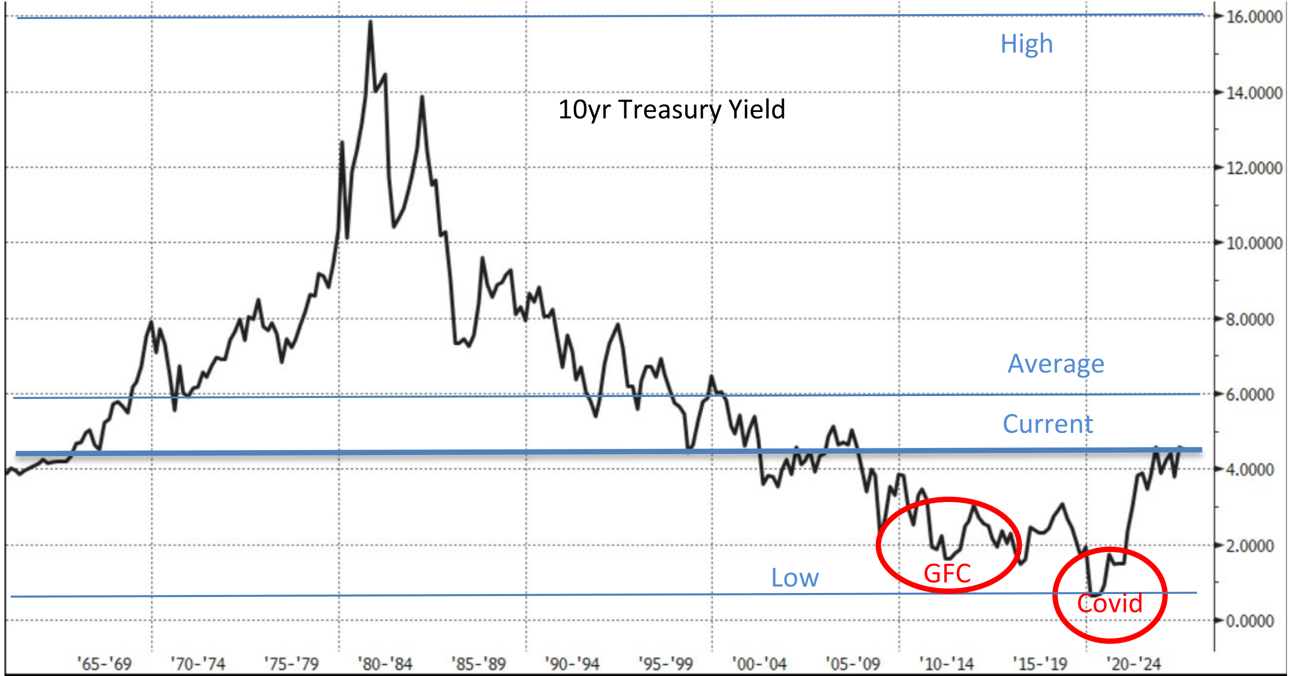
Lenders and borrowers may need to recognize a few essential implications from the Fed pause and gauge ALM and borrower demand accordingly.

1. There is no benefit to adding loan duration to the balance sheet because there is no carry trade for longer-term, fixed-rate loans. The graph above shows that banks receive no additional yield for fixed-rate loans in the 3 to 20-year range term.

2. The same motivation will drive borrower behavior. Because borrowers will see no material pricing difference for fixed rate loans over 3-years, many will attempt to extend loan duration to protect their cash flow and minimize refinancing risk.

3. Banks should be ready for either a cut or hike from the Fed in the next year – depending on the future of executive and fiscal policies.

Borrowers should be careful not to fall for recency bias. While recent interest rates have been low, those levels were largely driven by rare events (the pandemic and GFC). By historical comparison, interest rates are currently favorable for borrowers as shown in the graph below.



Pro-business policies are generally inflationary, and the main reason for borrowers not to expect lower interest rates is the near future. But the Trump 2.0 administration has additional stated policies which may be highly inflationary over the next few years as shown in the graph below.

ARC Loan Pricing and Credit Trends

Community banks should focus on correctly pricing their largest and highest credit quality relationships. These relationships generate the highest return for community banks, especially if these clients can generate additional hedge fee income for the bank. Community banks, on average, are generating between 1.0% and 2.0% of the loan amount in upfront hedge fee income. The below graphs show ARC loan pricing and credit trends.

Loan Pricing Trends

5.00%
4.50%
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%

3Q 2021 4Q 2021 1Q 2022 2Q 2022 3Q 2022 4Q 2022 1Q 2023 2Q 2023 3Q 2023 4Q 2023 1Q 2024 2Q 2024 3Q 2024 4Q 2024

Avg Credit Spread High Low

Credit Trends

DSCR: 2.50 2.00 1.50 1.00 0.50 -

LTV: 70.0% 68.0% 66.0% 64.0% 62.0% 60.0% 58.0%

3Q 2021 4Q 2021 1Q 2022 2Q 2022 3Q 2022 4Q 2022 1Q 2023 2Q 2023 3Q 2023 4Q 2023 1Q 2024 2Q 2024 3Q 2024 4Q 2024

DSCR LTV

Action Item

Contact the ARC Team to obtain a borrower presentation or Loan Command output specific to your client.