Advance Strategies with an Inverted Yield Curve

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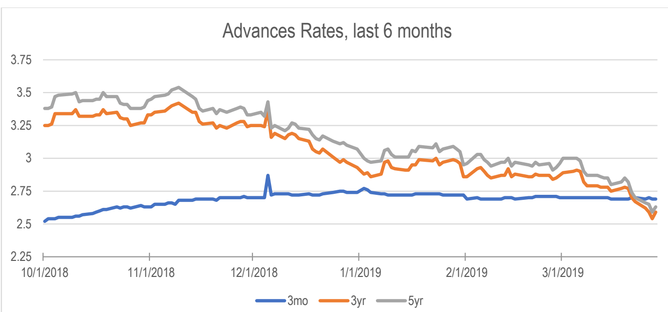
Bank treasurers are charged with balancing two key goals that frequently oppose one another: improving earnings (goal A) and reducing risk (goal B). Risk takes many forms on a balance sheet, but interest-rate risk and the length of the liabilities pose a persistent challenge. In a "normal" yield curve environment, reducing interest rate risk often comes at the expense of better earnings.

The current shape of the yield curve presents an interesting dynamic. Consider the chart below, showing FHLBank Boston's Classic Advance rates for three tenors (three-month, three-year, and five-year) over the last six months.



As uncertainty in the economy and the speculation over the Fed's next move grows, the yield curve has flattened considerably. Intermediate rates have dropped, while short-term rates have risen slightly. Back at the beginning of the fourth quarter in 2018, if one was inclined to mitigate interest rate risk and extend maturities on an advance from the three-month term to the three-year or five-year mark, it would have come at the cost of an additional 73 and 86 basis points, respectively: goal B accomplished, but at the expense of goal A.

But with the recent inversion of the yield curve, three-year and five-year rates have dropped below that of three-month rates (by 10 and six bps), creating the dynamic where it is more supportive of margin (goal A) to put on a longer liability profile (goal B).

There is no free lunch when it comes to managing interest rate exposure. A flattening and inverted curve suggests market sentiment is leaning bearish on the near-term prospects of the economy and that the Fed's focus may shift back to easing from the tightening path they have been on. Nevertheless, most balance sheet managers agree that being an interest-rate speculator or market timer is not in their job description. Being a spread and risk manager is a more accurate assessment. So, when market conditions are such that both spread and risk exposures can be positively impacted, it's often prudent to take advantage of such opportunities.

The Advance Rollout Analysis below looks at the benefits of building a blended advance strategy with terms between three months to three years, as opposed to a simple rolling of a three-month advance. The strategy also takes advantage of the long-term advance specials that FHLBank Boston's Money Desk occasionally offers, as well as benefits from the Advance Renewal Discount Program (ARDP), which can further lower the cost of borrowing. This example assumes splitting up one larger maturing short-term advance; depending on the specific schedule for the organization, more ARDP benefits may be attainable.

In the current structure, the interest cost savings amounts to 12 basis points (2.57 percent vs. 2.69 percent), and the average life of the advances extends by two years (from three to 27 months). The strategy accomplishes both goals by targeting the inverted parts of the yield curve, while still maintaining 20 percent of the exposure inside of one year, keeping some of the flexibility that shorter-term advances provide. Greater cost savings and/or greater rate risk mitigation may be achieved through shifting the allocations and can be tailored to meet specific liquidity and asset-liability needs and preferences.

A funding-strategy model can help you develop strategies to hedge interest-rate risk and maximize profitability. Our strategy team works with members to provide customized funding strategies based on your institution's overall sensitivity position, objectives, and other needs. Please contact me at 617-292-9644 or andrew.paolillo@fhlbboston.com or contact your relationship manager for details.

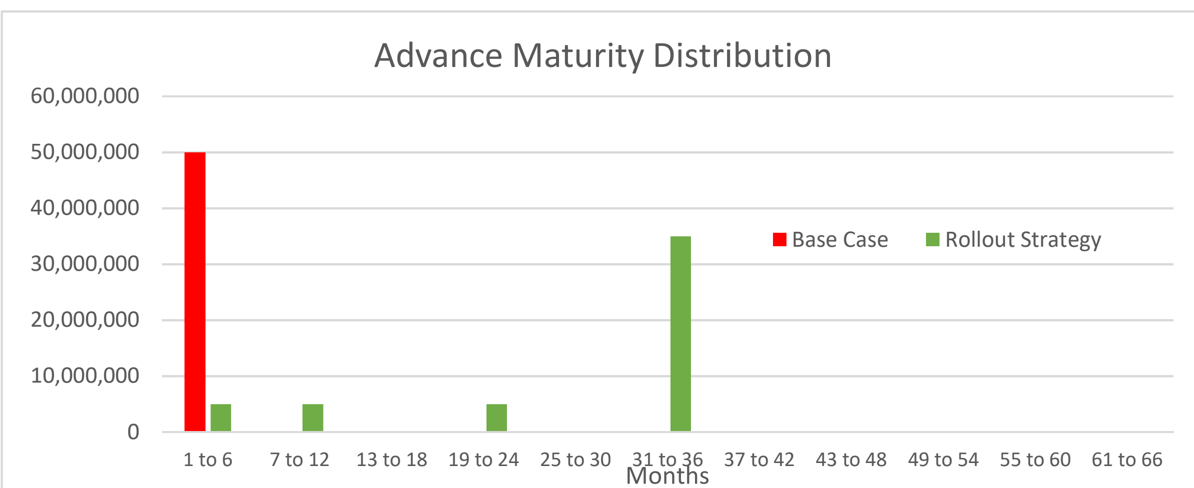
Advance Rollout Analysis

	Term	Rate
Base Case	3mo	2.69
Amount	50,000,000	

	Term (yrs)	Rate	Div Adj Rate	
Rollout Strategy	2.29	2.57	2.37	
	Term	Rate	Weight	ARDP
	0.25	2.69	10%	
	0.75	2.62	5%	
	1.00	2.64	5%	
	2.00	2.59	10%	
	2.75	2.54	50%	8
	3.00	2.55	20%	

	Term (months)	Annual Int. $	Annual Int. %
Base Case	3	1,345,000	2.69
Rollout Strategy	27	1,285,500	2.57
Difference	24	-59,500	-0.12

as of 3/29/2019		
Advance Rates		
1wk	2.69	
2wk	2.69	
3wk	2.68	
1mo	2.69	
2mo	2.69	
3mo	2.69	
4mo	2.7	
5mo	2.7	
6mo	2.7	
9mo	2.62	
1yr	2.64	
1.25yr	2.64	
1.50yr	2.64	
1.75yr	2.65	
2yr	2.59	**Special Rate***
2.25yr	2.64	
2.50yr	2.63	
2.75yr	2.62	
3yr	2.55	**Special Rate***
3.50yr	2.63	
4yr	2.65	
4.50yr	2.66	
5yr	2.59	**Special Rate***



* Special, discounted rates on advances with one-, two-, three-, and six-month terms are regularly available to members through the Money Desk.

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