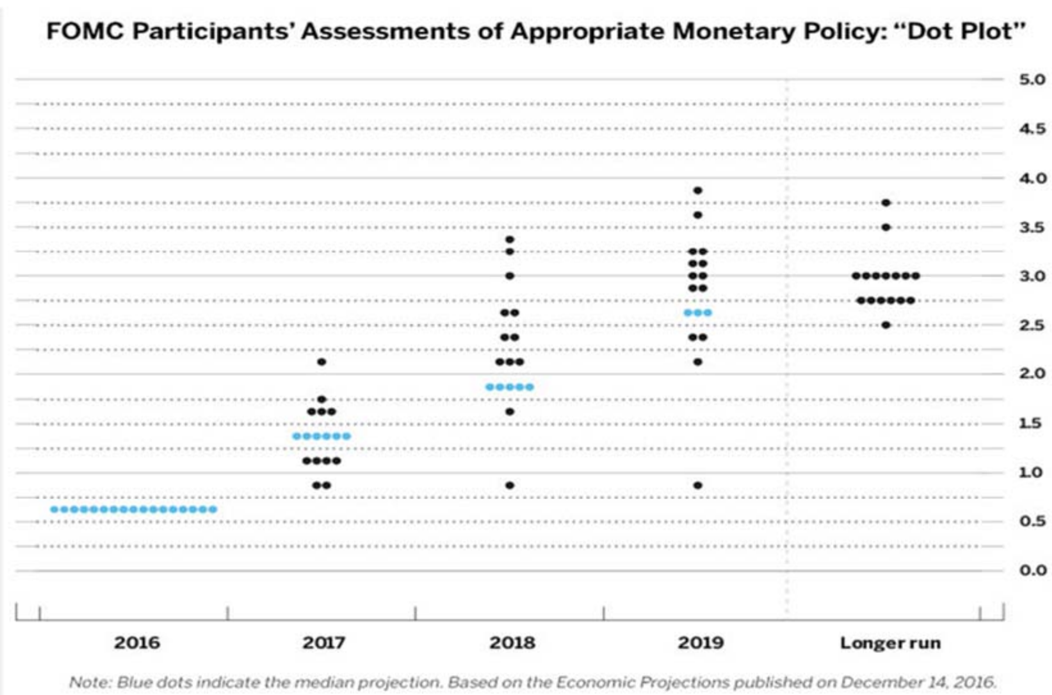
FHLBBoston

# Exposed to Rising Interest Rates? Now May Be Time to Extend Some of Your Funding.

Economic releases suggest that the US economy finished 2016 on a weak note. The fourth quarter 2016 GDP release showed an annual growth rate of 1.6 percent, the lowest level in five years. While this follows a pattern of uneven economic indicators, the FOMC sees an economy that will expand into 2017 and beyond.

For our members whose net interest income would be pressured by rising interest rates, this latest economic release could lead to some interesting discussions at ALCO meetings as they decide their course of action regarding wholesale funding choices for the year ahead.

The FOMC "Dot Plot" from December, shown below, indicates some stronger economic conditions going forward than in some of their recent releases. The median projection has the Fed Funds rate between 1.25 percent and 1.50 percent by the end of 2017, signifying three rate hikes over the next year, and between 1.75 percent and 2.00 percent by the end of 2018. By the end of 2019, the FOMC projects Fed Funds to be between 2.50 percent and 2.75 percent or 200 basis points over today's level.




Source: *Federal Reserve Monetary Policy – FOMC Calendars*

Longer term, the committee sees the Fed Funds rate at around 3.00 percent. An additional factor complicating upcoming funding decisions is the surprise outcome of the US presidential election. The new administration's plan to cut taxes and invest in the nation's infrastructure could prove beneficial to the economy in the short term.  Additionally, this expansionary fiscal policy could increase the federal deficit and lead to higher interest rates in the future.

Many liability sensitive members have been funding at the short end of the curve for a while now, given the feeling that the Fed would be on hold for an extended period. Now that they have tightened twice in the past 13 months, is it time to start moving at least some of your wholesale funding out the curve a bit? One strategy members often utilize is a barbell approach. Using this approach, members would extend a portion of the funding while keeping some exposure to the short end of the curve. If short rates rise more than the "Dots" forecast, at least you have reduced your exposure to the short end of the curve. If the economy stumbles and short rates rise less than anticipated, you continue to have some funding pricing off this part of the curve. Even a medium-term advance can benefit you if rates increase moderately. Let's assume the Fed Funds rate does increase 75 basis points over the next year and the yield curve, out to the two-year point, moves up by the same amount. If you take a three-year Symmetrical Prepayment Advance at 2.00 percent, for example, and choose to prepay after one year, you will have a gain of approximately one percent. Your total cost for the year will also be about one percent, or about the same cost as if you stayed in Fed Funds. If you go longer, the gain will increase and the total cost will decline, so you would have been better off than had you stayed short.

The next several years appear to be marked by uncertainty. By extending some of your funding now, you can stabilize some of your funding costs and manage some of the exposure to rising interest rates.

The Federal Home Loan Bank of Boston has a variety of solutions to help you hedge the risk of rising interest rates. Please contact the Financial Strategists at 1-617-292-9644, the Money Desk at 1-800-357-3452, or your Relationship Manager to discuss solutions that best meet your needs.