Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

March 19, 2021

Steeper Curve Strategies: Curve Extensions Back in Vogue

Please see this week's ***Rate Sheet*** *and* ***Yield Curve Opportunities****.*

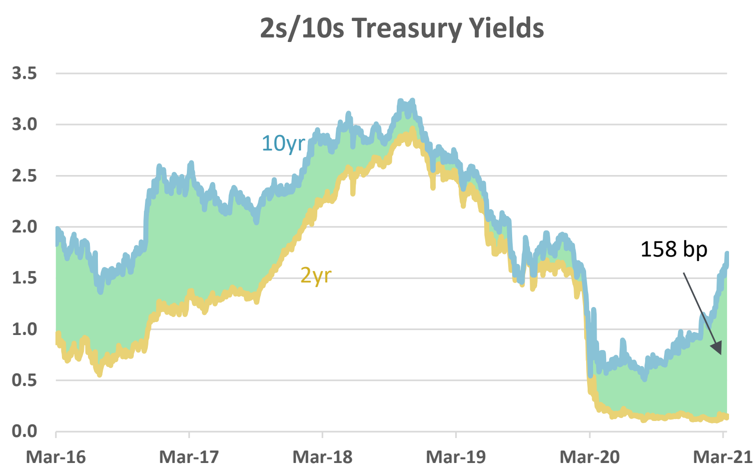
The fact that bank valuations are often at their highest when investment portfolio marks are at their lowest offers limited solace to managers watching their AFS gains erode by the day. This week we begin a multi-part series entitled "Steeper Curve Strategies" to take advantage of moves in the curve. We kick off by sharing some thoughts from Justin Hoogendorn, CFA's "Bond Market Focus", a weekly publication with investment ideas and current topics in the fixed income market. For access to that publication, and others from our team, please reach out. In the next few weeks we will continue the series with pieces on derivative tactics for enhancing earnings, and strategies to make your balance sheet work harder for you.

The surge in 10yr yields has drawn investor attention, as the 10yr has hit the highest level in more than a year. However, Fed-on-hold expectations have limited the movement in the short-end of the curve, raising the 2s/10s curve to the steepest levels in more than 5 years. This stark contrast between the short-end of the curve and the long-end allows for investors to limit the amount of duration extension by exiting shorter positions. We have seen some interesting trades in both corporates and taxable municipal bonds that have added 160-185 bps and have increased the likelihood of adding value with curve roll-down.

The Steepening of the Curve

This past fall with a flat yield curve, we wrote about the winter of low reinvestment opportunities. Coming into the spring with an opening economy and a hefty $1.9 tn stimulus package, yields have bounced higher. The 10yr has moved to 1.74, bouncing off of a low of .51% to the highest level in a more than a year. The 2s/10s curve, however, is even more compelling from a historical basis as it has reached the steepest level in over 5 years. At 158 bps, the 2s/10s is 1% steeper than the average of under 60 bps over the past 5 years (Figure 1).

Figure 1: The Treasury curve has reached the steepest level in more than 5 years for extension trades from 2yr to 10yr bonds @ 158 bps



Source: Bloomberg, Piper Sandler

This steepening should be a welcomed event for both financial institutions and other investors looking for reasonable yields in the fixed income market. This movement traditionally helps to improve bank Net Interest Margins, which will also be a very welcomed event. Additionally, money managers should benefit from the higher yields by earning more yield for clients. However, yields have stuck stubbornly low at the short-end of the market. In fact, expectations for a Fed-on-hold have only recently given way to a cheapening in 5yr and 7yr maturities with rising yields in this area over the past month.

Causes and Resulting Strategies

Low short yields press investors to take some duration risk to reap the rewards of higher yields. Fortunately, history is on your side for taking this risk. Over the past 30 years, investors adding duration on a back-up to the degree that we have recently experienced has paid off handsomely as long-term rates have tended to bounce lower in the long-run (Figure 2). Although inflation remains a concern, much of the movement of late has been a cheapening of real rates, not a large rise in inflation expectations.

We recommend that clients look at extension trades and have helped a number of clients extend in the corporate, taxable municipal, and mortgage sectors. At present, corporate spreads are marginally cheaper than taxable munis (Figure 3). Taxable munis spreads were cheaper than corporates for most of 2020. However, muni spreads tightened following the election.

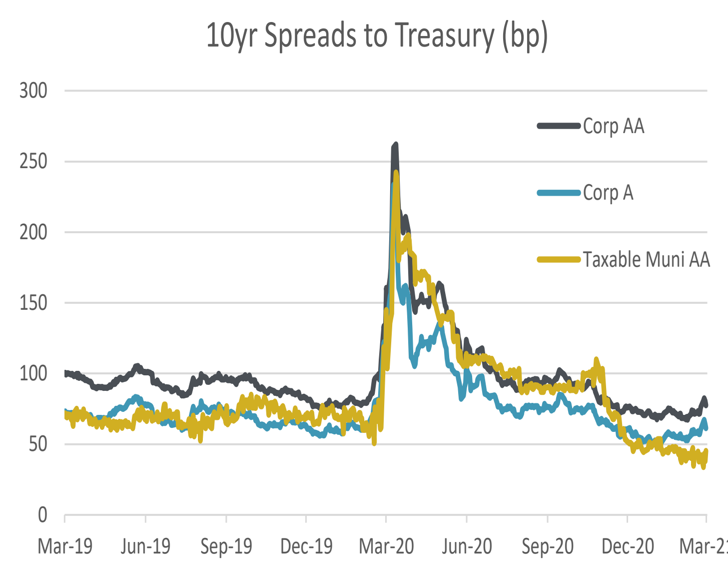
There are a couple of good reasons for the tightening. First, Democrats were viewed as the party to give greater support to state and local governments. This proved true in the stimulus package, as $360 bn will flow to state and local governments, along with $176 bn for education and $56 bn in support of transportation. Second, much of the supply in taxable munis has been due to advance refunding activities and there is hope of advance refunding returning to the exempt market after a bill was introduced and could be pressed forward in the upcoming infrastructure plan.

Investors have added 160-185 bps for moving from the 1-3yr area of the curve to the 7-10yr space in the corporate sector for similar credit quality. We have used this opportunity to position in credits that are poised to outperform in this current environment. Additionally, a number of analysts on the street have grown bullish on the corporate sector due to high growth expectations in 2021.

Figure 2: Buying the bounces in rates has paid dividends over the past 40 years. Will this time prove different?

Source: Bloomberg, Piper Sandler

Figure 3: AA taxable muni spreads were even or above A-rated corporates for most of 2020, before tightening in the 4th quarter



Source: Bloomberg, Piper Sandler

PayPal (PYPL) is an example of a growing corporate issuer that is newer to the large issuance market. It offers value versus established issuers, as it has consistently grown revenues and has been cash flow positive for several years. PYPL has come to the market with benchmark issues in 2019 and 2020. Additionally, the split rating of A3/BBB+ is likely conservative due to the limited history of this issuer. Our models argue that the performance has been good enough that this company could potentially be upgraded in the future, assuming they continue to throw off free cash flow. Extending this name from the 2yr area of the curve to the 8yr area of the curve adds 170+ basis points.

Similarly in the taxable municipal space, investors can find offerings at better than 2% in the 10yr area of the curve, which should equate to around 160-170 bps yield pickup for extending. Finally, curve roll has traditionally added value in fixed income portfolios, yet the flat curve over the past number of years has limited its role. From a performance perspective, curve roll-down should add value going forward as long as the Fed keeps rates low at the short-end of the market over the next several years.

Adapting it for the Balance Sheet

These sectors may make sense as options for financial institutions looking to deploy excess liquidity, while they wait for loan growth to pick up. They also make good reinvestments in transactions that require the institution to take a loss. Selling low performers, whether yield, credit, or prepay offenders, and reinvesting into higher-yielding longer bonds as described above is a proactive way that institutions are using this yield curve to emerge with a better structured investment portfolio. The good news is that such strategies are not limited to bond swaps. Over the next few weeks, we will explore receive-fixed swaps and pre-investing cash flows, among other strategies. If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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