

# How to Ride out an Inverted Yield Curve

BY DENNIS FALK



It's been nearly four months since the famed yield curve, which plots bond yields from shortest maturity to longest, inverted for the first time in nearly a dozen years. The yield curve is considered a barometer of economic sentiment, and this turnaround has been seen to signal a potential massive slowdown for the US economy. In essence, an inverted yield curve means that bond holders are willing to settle for lower long-term yields because they think an economic recession is in the near future.

For banks, especially community institutions whose bread and butter is lending, this inverted yield curve typically means there is much less gain to be made on loans. Smaller lenders are also at a disadvantage in this environment, because they do not run large trading desks or money-management units, which for larger bank competitors can help significantly to offset the overall reduction in interest rates when the yield curve inverts.

Indeed, even as of a year ago, when

the inverted yield curve was just a glint in economic pundits' eyes, the KBW Bank Index had already fallen 1.5 percent for the year, which in turn also took its toll on the value of bank stocks. While many economists and government regulators have downplayed recession concerns and economic worries, community institutions are likely to feel more of the brunt of this inverted yield curve. The Dallas Federal Reserve Bank, among other economic prognosticators, have heralded



While many economists and government regulators have downplayed recession concerns and economic worries, community institutions are likely to feel more of the brunt of this inverted yield curve. The Dallas Federal Reserve Bank, among other economic prognosticators, have heralded the fact that while yield-curve inversion typically lasts a year or less, the flattening is likely to affect these institutions and reduce their profitability much more than larger financial institutions.

the fact that while yield-curve inversion typically lasts a year or less, the flattening is likely to affect these institutions and reduce their profitability much more than larger financial institutions. With this in mind, here are a few steps that may help, based on our work with our hedging clients:

#### **Focus on fee generation to manage short-term earnings.**

Banks make money by borrowing short-term funds and lending them out for longer-terms. But the inverted yield curve makes that much more difficult. Hence, you may need to consider where and how you can effectively generate fees, to balance out declining loan income. Hedging is one way to do this. Your institution gains even as the yield curve is inverted.

#### **Reset existing loans.**

In an inverted yield curve, borrowers are often tempted to shop their loans to other financial institutions with lower rates. You can proactively staunch potential loan prepayments by offering to refinance your most desirable or valued customers to keep them onboard.

#### **Consider loan variant options.**

While the inverted yield curve does signify a few clear indications, there are several unknowns. If lenders see this rate environment as a sign of coming recession, then they should stick with their knitting and keep booking fixed rate loans. Lenders who consider the inversion an economic blip (and not indicative of any long-term downturn) might want to offer more hedged floating rate loans. Lenders cash in on the higher floating rate received while borrowers pay a lower long-term fixed rate.

If you need additional information on inverted yield curve strategies or help managing the yield curve with PCBB's Borrower's Loan Protection product, please contact Dennis Falk. [IMYI](mailto:dfalk@pcbb.com)

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