PORTFOLIO MANAGER's REPORT

Wednesday June 02, 2010 9:03 AM

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CURRENT OFFERING YIELDS - Wednesday: 06/02/2010 9:03 AM

	Trsy (Last Price)	Change (From Yest)	Agcy NC (Bullets)	Muni - TEY (A1; GO; BQ)	CMO (Avg Life)	MBS (Avg Life)
3 mo	0.145%	- -0.60 bp's	0.188%	0.450%		
6 mo	0.219%	+ 0.30 bp's	0.281%	0.511%		
12 mo	0.318%	+ 0.2 32'ds	0.528%	0.692%		
2 yr	0.774%	-0.5 32'ds	0.992%	1.162%	1.674%	1.724%
3 yr	1.208%		1.412%	1.768%	2.208%	2.308%
5 yr	2.075%	-1.5 32'ds	2.254%	2.980%	2.925%	3.225%
10 yr	3.272%	-1.5 32'ds	3.498%	4.995%	4.222%	4.272%
30 yr	4.169%	-3.5 32'ds	4.732%	6.920%		

TODAY'S ECONOMIC DATA

2-Jun	MBA Mortgage Applications Prior: 11.3% Actual: 0.9%	
2-Jun	Challenger Job Cuts YoY Prior: -71.1% Actual: -65.1%	
2-Jun	Pending Home Sales MoM Prior: 5.3% Actual: 6.0%	
DJIA	10,066.12	42.10
NASDAQ	2,229.92	7.59
S & P 500	1,075.74	5.03

Source: Bloomberg Fair Value Curve or Last Price (Treasury only); ALL yields and spreads are "representative", not actual. Spreads change as the market changes, actual offerings may be higher or lower than

TODAY'S NEWS

Treasuries Little Changed Before U.S. Government Report on Home Resales

June 2 (Bloomberg) -- Treasuries were little changed before an industry report that economists said will show pending U.S. home resales rose for a third month in April. The 10-year note erased losses as U.S. stock-index futures pared their gains. The Treasury will reduce the amount of notes and bonds it will sell next week by the largest amount since global credit markets collapsed, according to a Bloomberg News survey of primary dealers. Employment in the U.S. increased in May by the most since 1983, according to economists before the Labor Department's payrolls report later this week.

Think Ahead; Communicate With Your Board Regarding Today's Strategies

Many community bankers seem to think rates are going to trade sideways for a while followed by higher rates (they are probably correct, but beware when everyone thinks the same way). Like everyone else, though, they can't quite put their finger on when rates are going to take-off and how far they will go. In the meantime, selling excess overnight funds is so painful most bankers have driven off their rate shoppers but still end up with excess funds, as loan demand lags. So, difficult investment decisions are being made. There are two fundamental concepts inherent in today's uncertain market that should not be ignored.

First, make sure you are effectively communicating with your Board and entire management group regarding the pros and cons of your investment strategy.
Make sure you have a well thought out plan that conforms to your written investment policy and is easily reviewable by the Board. If rates rise during or after implementation of the strategy, will the Board understand what is happening to the portfolio and your balance sheet? Does the Board have the complete picture and do they understand the risk? Is the Board prepared to deal with decreasing market values and the possible liquidity issues associated with increased liability cost? Could management explain the current strategy and the market issues to regulators or the Board if asked? Does the investment portfolio have sufficient cash flow to allow cost averaging as rates increase? Are you prepared for the possible anemic bids if you want to sell some securities prior to maturity?

What if the economy fails to pick up steam and rates stay low or even decline? Have you measured the earnings impact if your asset mix shifts toward a larger investment portfolio and a smaller loan portfolio? How does the spread between your new investment, let's say 2%, and your cost of funds measure up? **This clearly illustrates the second key concept which is to reduce your cost of funds until you have squeezed the last bit of toothpaste out of the tube!** Simply stated, many banks are still paying too much for deposits. If your cost of funds are not well below 2% you are most likely paying too much (we know there are exceptions). To continue with our illustration regarding a shift in asset mix, for every $1,000,000 that moves from loans to investments the bank loses $30,000 of income assuming a 5% loan vs. 2% investment. More importantly, if your cost of funds is 2% the yield on your new investment compared to your cost of funds is 0%. This is heinous, but obviously much better than the -1.75% yield you would receive if selling overnight funds. Additionally, the lower cost of funds is helpful in allowing a more effective "lag" to your deposit strategy as rates increase.

Keep in mind we can make your job much simpler when it comes to sharing your investment plan and portfolio dynamics going forward. We offer PAR's (Portfolio Analytics Report) which is a complete set of investment reports that will help educate the board and regulators as you implement your current investment strategy. PAR's is not a bond accounting report but a comprehensive set of portfolio management reports that models duration, value, cash flow, yield, and many other important aspects of your portfolio. If you do not already have a system in place for these details, it is important to have this in place before your next exam. Call us for more details.