McQueen
Financial Advisors

# WHY FALLING RATES MAY HIT HARDER THAN YOU THINK

# Falling Rates

**What You Need to Know**

Most financial institutions have structured their investment portfolios with a heavy concentration in short-term assets including CDs, callable agencies, and overnight funds. These portfolio choices were a rational response to returning liquidity in a higher-rate environment. Now, the environment is shifting. Inflation is cooling, economic momentum is softening, and the next move by the Federal Open Market Committee is projected to be an interest rate cut.

When rates fall, short-term investment portfolios are the first to suffer. Reinvestment of maturing and called securities happens quickly and at lower yields. The lower yields quickly reduce income.

Lower income is projected and is measurable using ALM Income shock tests.

**How We Got Here**

Institutions have shortened duration for several reasons:

- To maintain liquidity during uncertain times.
- The yield curve was inverted resulting in higher yields for short-term securities.
- Market commentary leaned toward "higher for longer"
- Brokers selling callable bonds that are not best for most portfolios.

Interest rate cycles always turn, and short-duration portfolios offer little protection when that happens. Institutions that continue holding excess short-term assets are setting themselves up for margin compression and lower earnings.

**Why This Matters Now**

The market is pricing in a rate cut as early as next quarter. If you wait until the Federal Reserve makes its move, reinvestment yields will already be lower. Forward-thinking institutions are extending portfolio durations now with non-callable securities. There is a limited window to protect your yield. We believe this is one of the most actionable opportunities in the current rate cycle, and one of the most overlooked risks on balance sheets today.

**The Risk Today**

A portfolio with an average duration under 2 years may see 40–70% of its assets mature within 12 months. If rates drop 100 basis points, reinvestment income can decline sharply. In many cases, there will be little ability to offset this drop, because deposit costs are reasonably low and there is little room for additional deposit rate reductions. The resulting impact on net interest margin (NIM) can be quick, and in some cases, severe. For institutions with high asset sensitivity, the income decline is immediate. For those that fund with term deposits or borrowings, the damage may be compounded because funding costs will remain high while investment yields decline.

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**What to Look For**

Consider a portfolio review if any of the following are true:

· Portfolio duration is less than 2 years
· Over 40% of investments will mature in the next 12 months
· Investment mix is heavily weighted in callable bonds
· A substantial amount of investments are in overnight accounts
· ALM modeling shows risk to income in the falling rate scenarios

These indicators suggest reinvestment risk is already embedded and should be addressed soon.

**What to Do Now**

Today is the day to take prudent actions to prepare for the potential reduction in yields. It is important to understand that this is not a recommendation to compromise your liquidity position. Rather, it is a reminder to thoughtfully rebalance your investment portfolio while the opportunity to lock in yields still exists.

To do this, consider:

· Extending Duration
· Ladder investments out to the 2–5 year range
· Diversify purchases in term and type
· Do not buy callable or step up US Agencies

Consider:

· Bullet US Agencies
· High-grade municipal bonds
· Carefully selected short term mortgage-backed securities (MBS)

The right mix supports yield stability without sacrificing liquidity.

**Review Falling Rate Scenarios in ALM**

Conduct a detailed review of your -100 and -200 basis points income simulations, paying close attention to both net interest income and overall net income results. These scenarios, once considered unlikely, have now become increasingly plausible. A thorough analysis may reveal significant earnings pressure and exposures that could emerge quickly if rates begin to fall. This insight is essential for informed decision-making and timely portfolio adjustments.

**Align Liquidity with Portfolio Strategy**

You do not have to give up safety to gain yield. Maintain an adequate overnight position for operations but let your core investments work in your favor. A 2–5 year ladder provides stability, liquidity, and income.

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**What We Recommend**

Review your portfolio by weighted average maturity, callable exposure, and reinvestment risk.

- Carefully review ALM model results.
- Run additional ALM growth or what-if simulations to assess the impact of portfolio choices.
- Carefully review your callable securities and the risk that they all get called quickly.
- Identify how much of your portfolio could be laddered to 2–5 years without sacrificing liquidity needs.
- Discuss and document with ALCO and your board how today's short-term portfolio could become tomorrow's earnings problem.

**Final Word**

Over the past couple of years, short-term investments offered reasonable yields. Now, the environment is changing and market indicators suggest that the next move by the Federal Open Market Committee will be a rate cut. Investment income and margins are at risk. Without action soon, many institutions will find themselves reinvesting at 2% when they could have locked in 4% or more.

**Let's Talk**

We have helped hundreds of institutions analyze, rebalance, and reposition their investment portfolios. We work with you to ensure that you have the best strategic duration and products to fit your unique risk profile.

Contact us to schedule a portfolio review or a 30-minute strategy session with one of our specialists.