

# Planning For 2026: The Economy, Federal Reserve Policy & The Outlook For Community Bank Balance Sheets

2026 NDBA Bank Management Conference  
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**BakerGroup**

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**Audience Q&A**

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**How was you characterize the economy today?**

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**How would you characterize your current personal financial situation?**

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**When do you think the Fed will next cut interest rates?**

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**Where do you think the terminal rate for Fed Funds will be this cycle?**

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# Market Conditions & Fed Expectations

## An Economy of Contradictions

- GDP grew 4.4% in Q3, while job growth collapsed to weakest in 5 years
- 22 states in recession, while some states like Texas and Florida still expanding
- Healthcare & technology expanding, housing & manufacturing contracting
- Rich doing great on asset inflation, middle class struggling on necessity inflation

## Employment

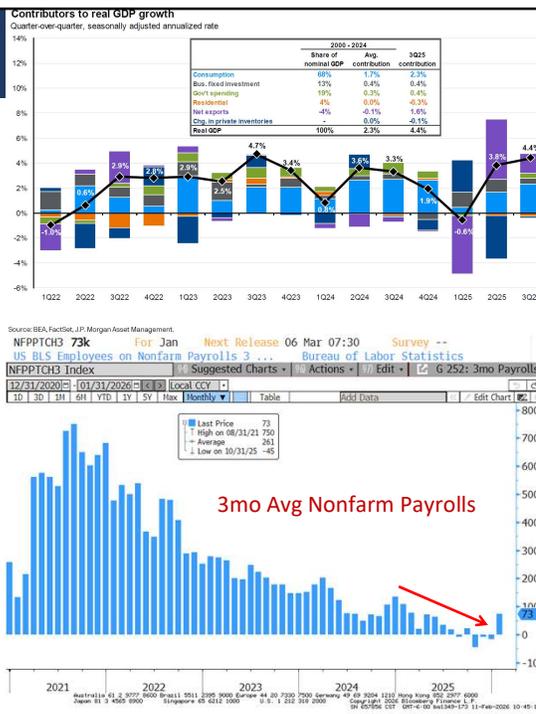
- There has been a marked slowdown in both the supply of and demand for labor
- 2025 job gains revised down by 1mm, average just 15k/mo
- +130k non-farm payroll jobs in Jan, 3mo Avg = 73k
- Unemployment Rate fell to 4.3% in Jan
- Average Hourly Earnings 3.7% YOY vs 3.0% pre-pandemic
- Labor Force Participation = 62.5% vs 63.4% pre-pandemic

## Inflation

- Headline CPI = 2.4%, Core CPI = 2.5%
- NY Fed 1-Year Inflation Expectation: 3.1%
- 10yr Breakeven Inflation = 2.33%

## Federal Reserve Monetary Policy

- **The Fed is divided between those that see employment as the greatest risk and those that see inflation as the greatest risk so the Fed will most likely pause rate cuts and assess the incoming data.**
- The Fed cut rates 25bp Dec 10 to 3.5-3.75%
- Dec Dot Plot shows 25bp rate cut in 2026
- Market is now pricing in 50bp of rate cuts in 2026 with first in June/July
- Fed has begun purchasing Treasuries again to maintain "ample" reserves

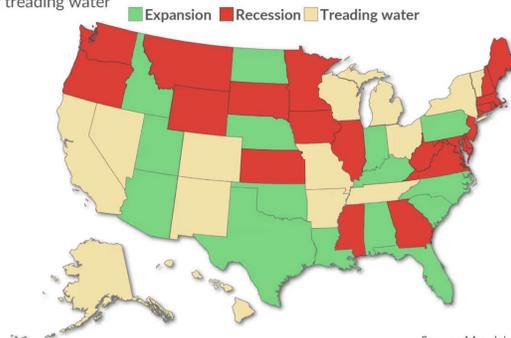


# Is The Economy Good? Depends On Who Your Are, What You Do & Where You Live

- The **US economy is not homogenous, it is bifurcated.**
- The **rich are doing well** because of asset inflation, while the **middle class is struggling** because of necessity inflation.
- According to Moody's, **1/3<sup>rd</sup> of states could be in recession**, while states like Texas and Florida are still expanding.
- Good producing sectors like **agriculture, manufacturing and construction are in recession**, while **healthcare and technology are still expanding.**
- **Is the economy good? The answer may lie in who you are, where you live and what you do.**

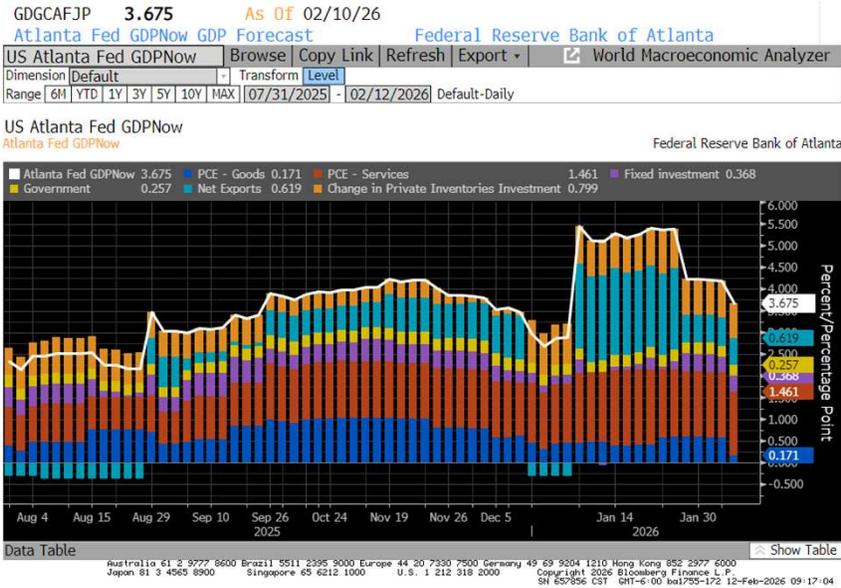
## These 22 states are now in recession

A state-by-state look at which local economies are growing, shrinking or treading water



Source: Moody's Analytics

# Q4 GDP Tracking at 3.6% on Better Net Exports, Spending & Inventories



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# October Trade Deficit Was Smallest Since 2009 On Falling Imports & Rising Exports

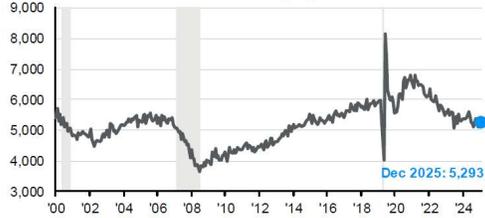


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# Shrinking Labor Force Faces A “Low Hire, Low Fire” Labor Market

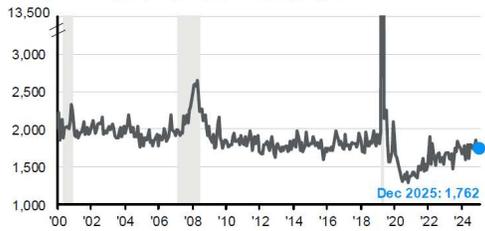
## JOLTS hires

Total nonfarm hires, thousands, seasonally adjusted



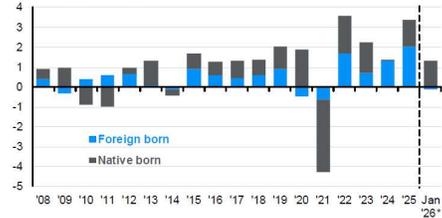
## JOLTS layoffs

Total nonfarm layoffs, thousands, seasonally adjusted



## Labor force growth, native and immigrant contribution

Year-over-year change as of January, aged 16+, millions



## Labor force participation

% of civilian noninstitutional population, seasonally adjusted (SA)

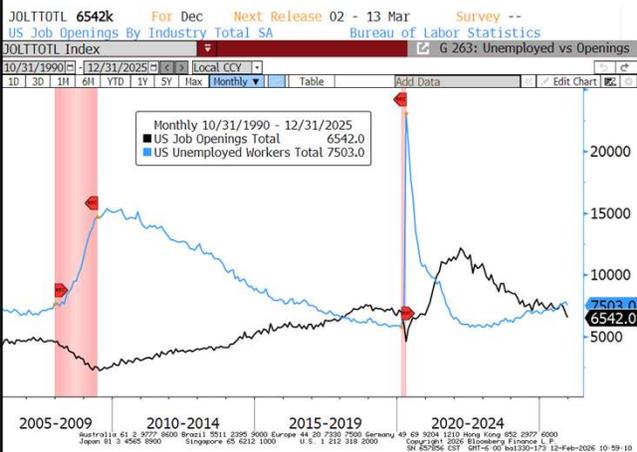


Source: FactSet, J.P. Morgan Asset Management; (Left) BLS; (Right) NFIB.

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# The Supply and Demand For Workers Is More Balanced, Reducing Wage Growth

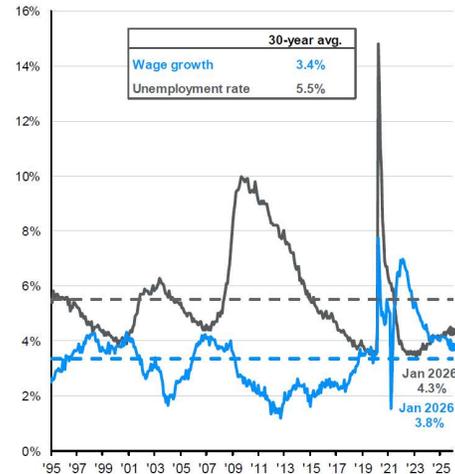
## Job Openings vs Unemployed Persons



The number of unemployed persons is higher than the number of job openings for the first time since 2017, excluding the pandemic.

## Civilian unemployment rate and annual wage growth

Private production and non-supervisory workers, seasonally adjusted, %

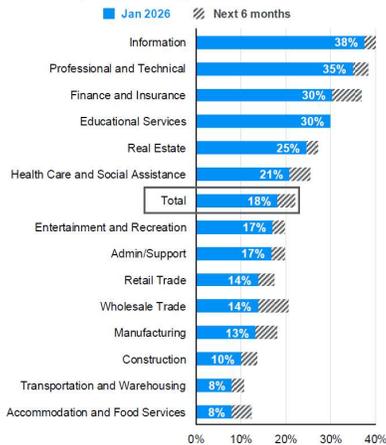


Rising unemployment and a plunge in job openings has cooled off wage growth, reducing inflationary pressures.

# Industries Adopting AI The Fastest Have Seen The Greatest Drop in Job Openings

## Businesses using AI in any business function

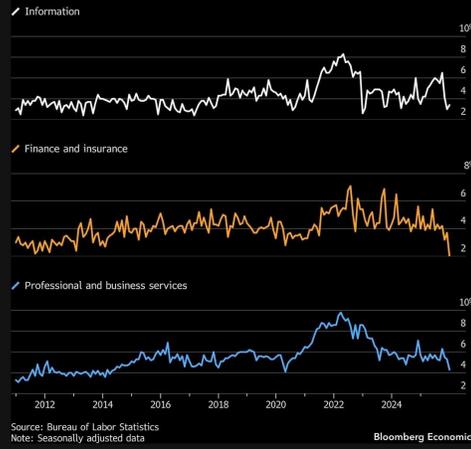
% of all firms reporting use of AI applications



Source: J.P. Morgan Asset Management; (Left) Census Business Trends and Outlook Survey; (Right) Bureau of Labor Statistics

## White Collar Job-Openings Rates Plunge

The number of unemployed overall now exceeds openings, as the ratios in some sectors that typically hire white-collar workers fall to historic lows



Source: Bureau of Labor Statistics  
Note: Seasonally adjusted data

Bloomberg Economics

# Number of Federal Employees Shrinking At Record Pace

## Number of Federal Employees

USEGFDSA 2686.0 As of 01/31/26 Thousand  
US Employees on Nonfarm Payrolls Federal... Bureau of Labor Statistics



## Federal Employees as a Percent of Total Nonfarm Payrolls

.FEDPCT U 1.6933 Description Fed Employees as % of Total  
As of 2/12/2026 Owner RYAN HAYHURST



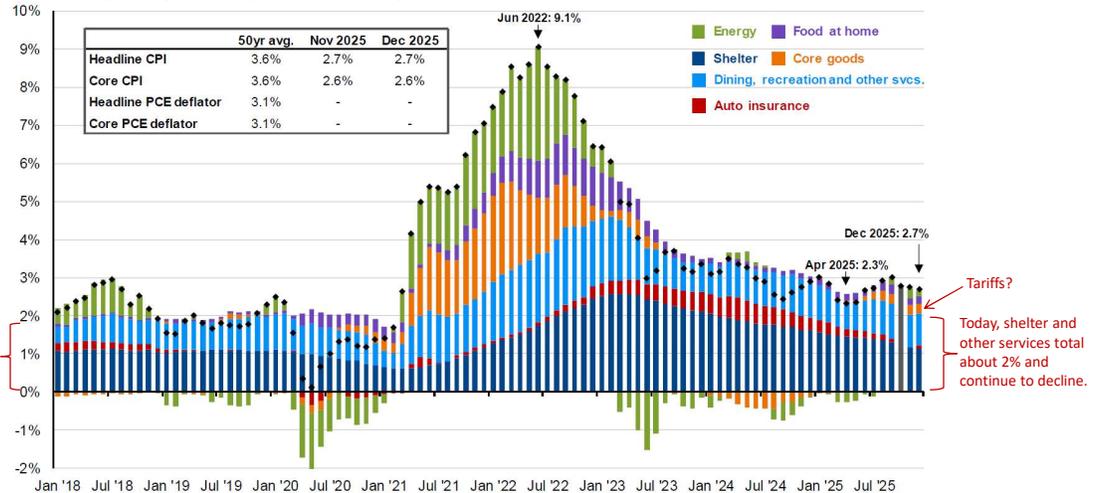
The number of Federal employees is down 327k (11%) to the lowest level since 1966.

Federal employees as a percentage of total nonfarm payrolls fell to 1.7%, the lowest level on record.

# Inflation Not At Target But Continues To Normalize

## Contributors to headline CPI inflation

Contribution to year-over-year % change in CPI, non-seasonally adjusted



Source: BLS, FactSet, J.P. Morgan Asset Management.

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# Inflation Expectations Have Fallen As "Tariff Inflation Armageddon" Never Happened

## 1-Year Inflation Expectations



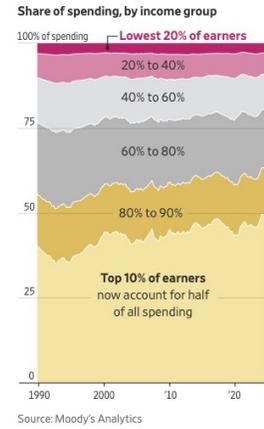
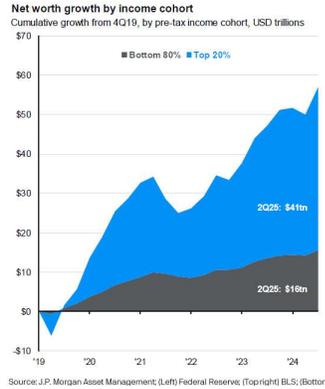
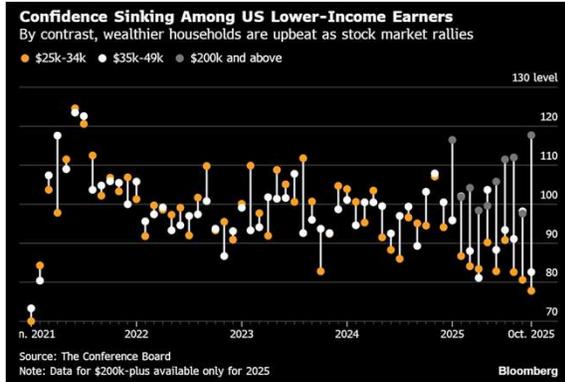
## Univ of Mich 1-Year Inflation Expectations by Political Party



NY Fed 1-Year Inflation Expectations are 3.1% and remain steady. Univ of Michigan 1-Year inflation expectations surged to 6.6% following the tariff announcement, but have since fallen to 3.5% as the expected tariff induced inflation surge never happened.

Most of the surge in Univ of Michigan inflation expectations were driven by democrats who expected nearly 10% inflation by now. On the other side, Republican have expected 0-1% inflation.

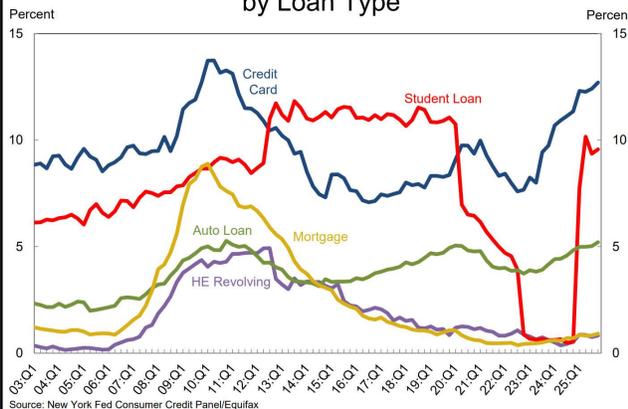
# The Rich Feel Better, The Poor Feel Worse and The Divide Grows



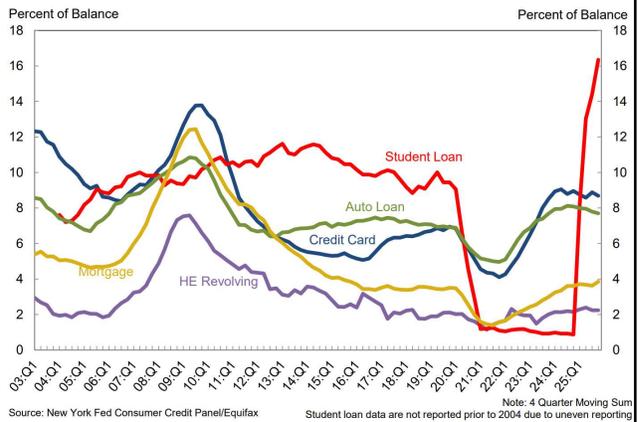
- Consumer spending and confidence is up amongst wealthier households, while low earners suffer
- Higher home prices and increased stock portfolio values likely fueling high income spending
- If either market falters these households could cut back spending dragging the economy down

# Consumers Are Falling Behind on Auto, Credit Card and Student Loans

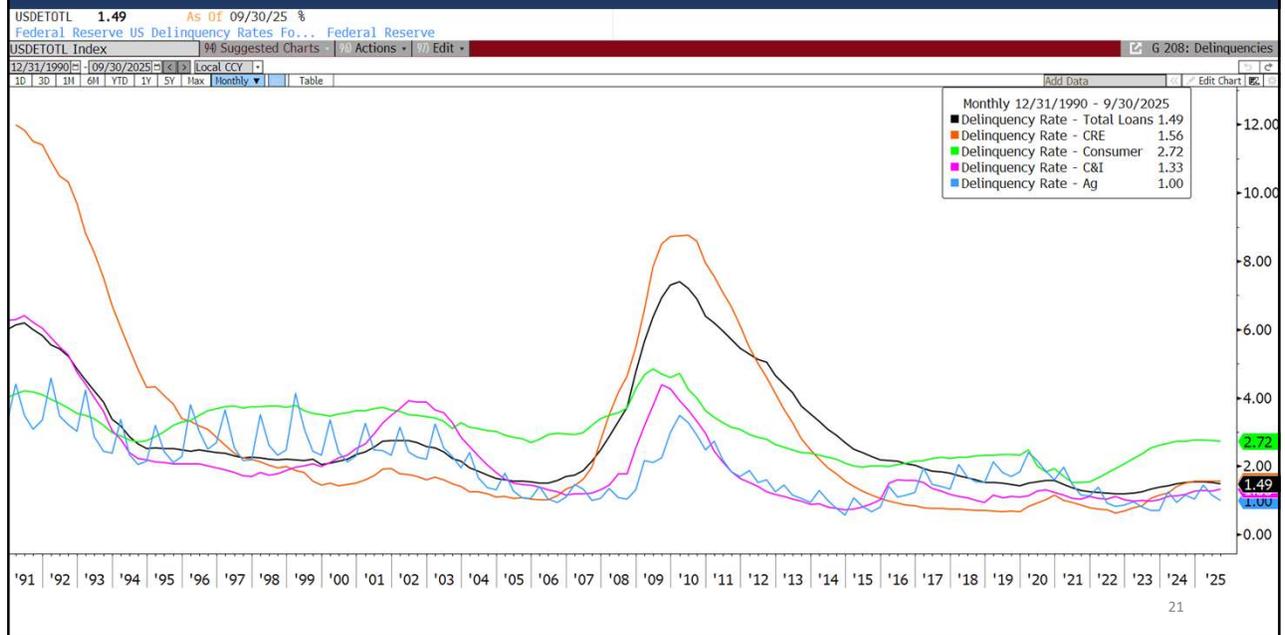
### Percent of Balance 90+ Days Delinquent by Loan Type



### Transition into Delinquency (30+) by Loan Type



# Bank Delinquency Rates Remain Historically Low Outside Consumer



# Housing: Weak Sales, Rising Supply & Near Record Prices (except New Home Prices)



# A Fed Divided: Which Part of Their “Dual Mandate” Is Greatest Risk?

## Unemployment Rate

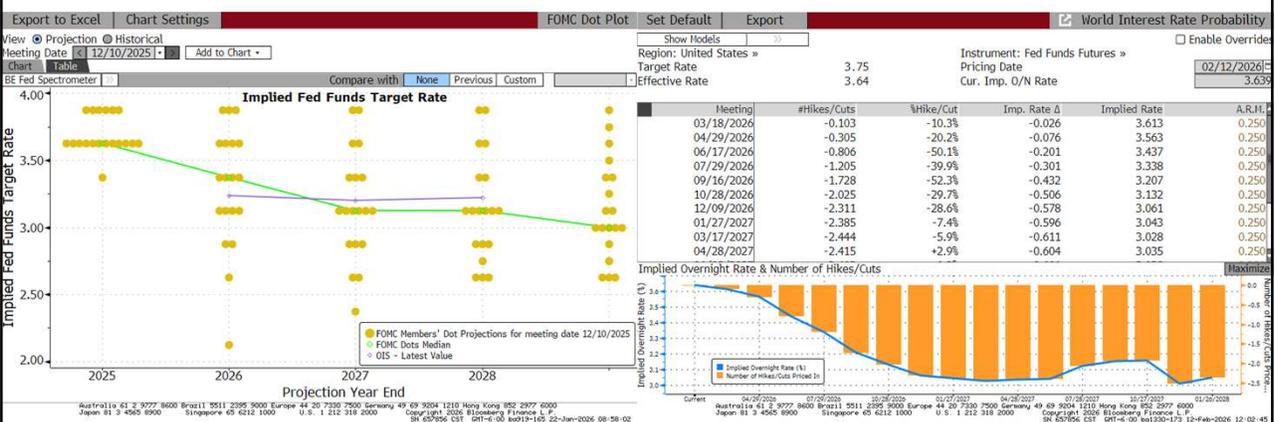


## Personal Consumption Expenditure (PCE) Price Index



Powell at the December FOMC press conference: “Interestingly, everyone around the table at the FOMC agrees that inflation is too high and we want it to come down, and agrees that the labor market has softened and that there is further risk. Everyone agrees on that. Where the difference is, is how do you weight those risks and what does your forecast look like...**We’re well positioned to wait and see**” where the economy evolves from here.

# December Dot Plot vs Current Fed Funds Futures Expected Path

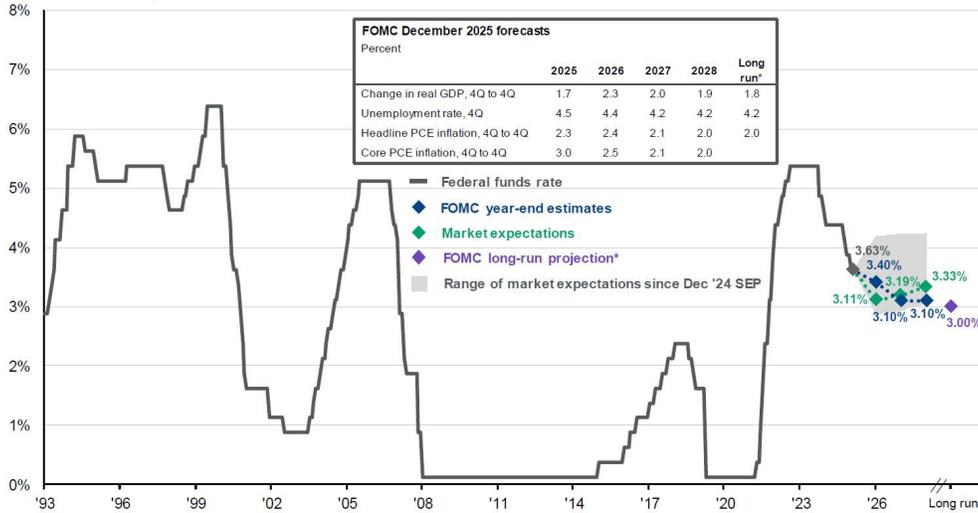


- Dot Plot suggests one rate cut in 2026 and one in 2027
- FOMC participants are the most divided they've ever been for 2026-2028
- How will the new Fed Chairman impact policy in 2026? He will be just 1 “dot” out of 19
- Fed Funds Futures show the next rate cut in June or July (first meeting without Powell?)
- Second rate cut priced in by October
- Terminal rate around 3%

# Fed Funds Rate Expectations & December FOMC Forecasts

## Federal funds rate expectations

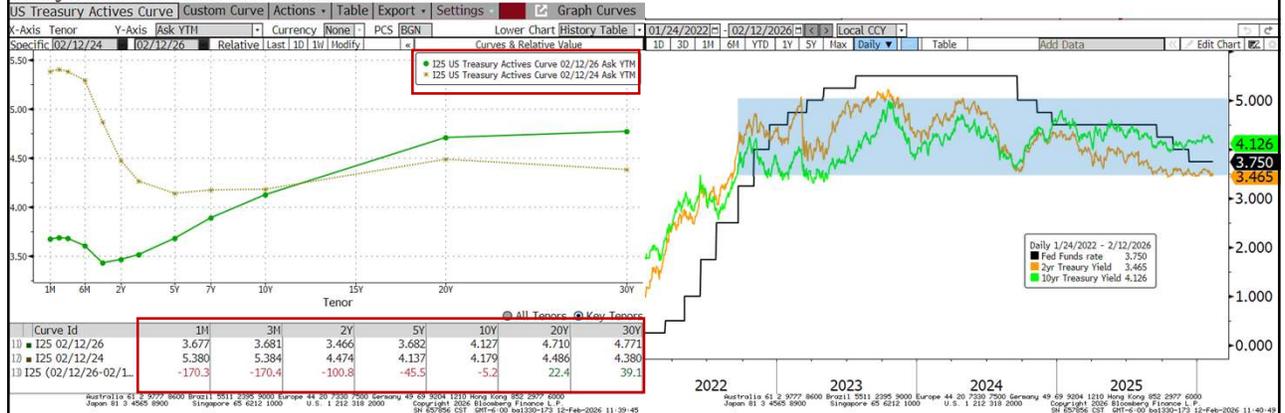
FOMC and market expectations for the federal funds rate



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

# Bonds Yields Have Fallen To Lower End of 3-Year Trading Range As Curve Has Steepened

Running as C15. Run GC for more features.



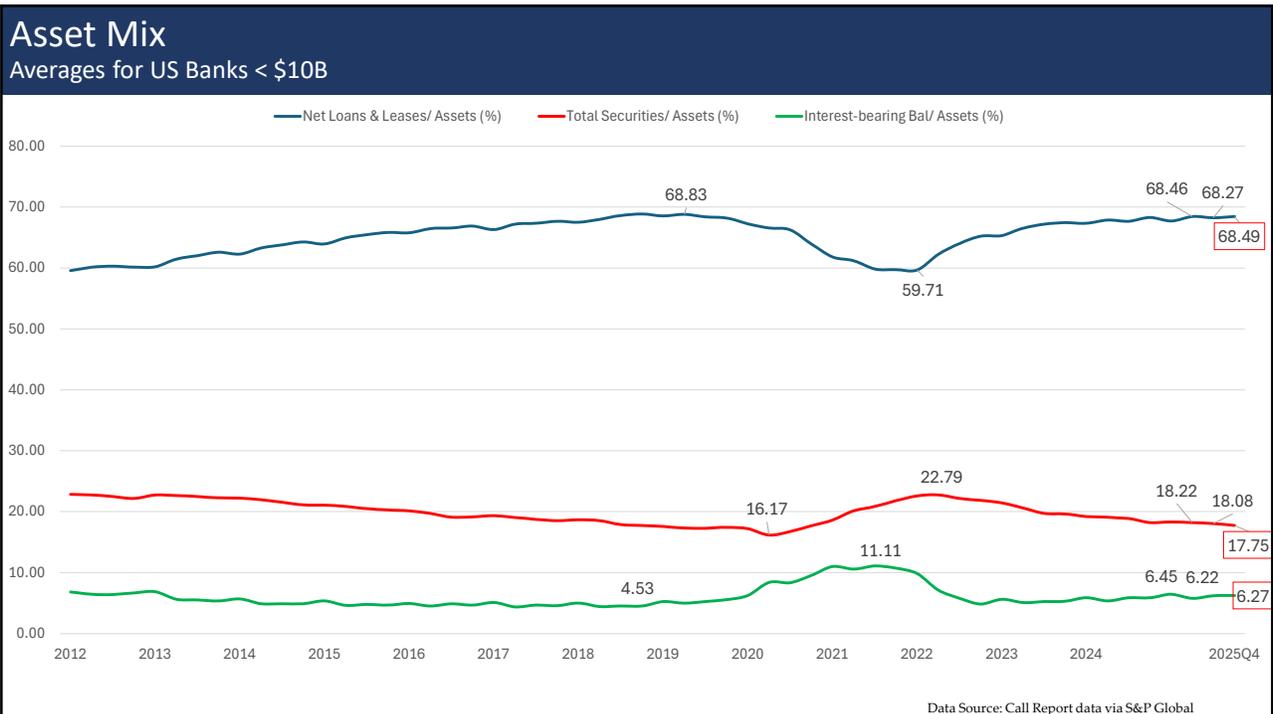
## 25 Year Lookback: Yields Still Near 18-Year Highs...For Now



## Economic Overview & Fed Policy Outlook Summary

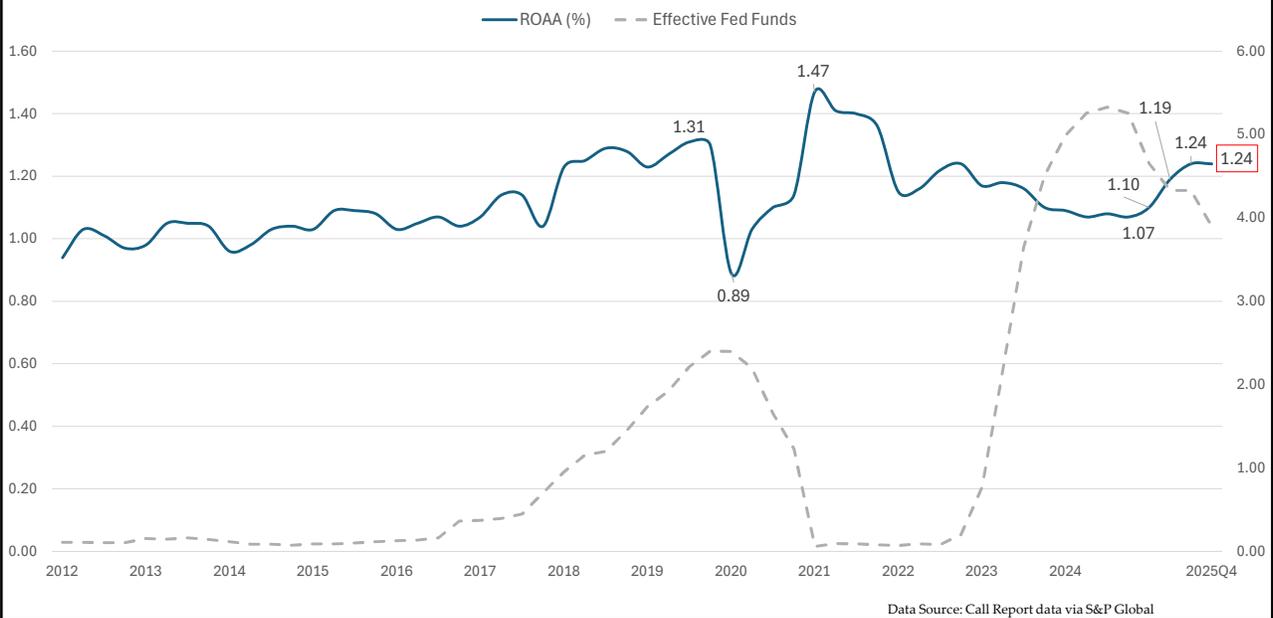
- An Economy of Contradictions: Strong GDP growth with the weakest job growth in 5 years; the rich doing great and the middle class struggling; some states and industries booming, others in recession.
- How well you are doing really depends on who you are, what you do and where you live
- A “Low Hire, Low Fire” labor market and shrinking labor force present challenges for the Fed
- AI adoption is already impacting white collar jobs and that impact is only expected to accelerate, but the increase in productivity should help lower inflation
- Inflation continues to normalize, while the risk of a tariff-induced spike has passed, helping reduce inflation expectations
- Consumer delinquencies continue to rise, particularly in autos, credit cards and student loans, while bank loan delinquencies remain low outside of consumer
- The Fed is divided between those that see employment as the greatest risk and those that see inflation as the greatest risk – the incoming data will determine who is right
- The Fed has signaled they are on hold for now but remain in easing mode, while markets expect 50-75bp of rate cuts this year starting in June/July
- Bond yields have fallen to the lower end of the 3-year trading range and threaten to break lower with further rate cuts, but remain near 18-year highs

# Community Bank Balance Sheet Trends



## Return on Average Assets (%)

Averages for US Banks < \$10B



**What do you expect will happen to your margin in 2026?**

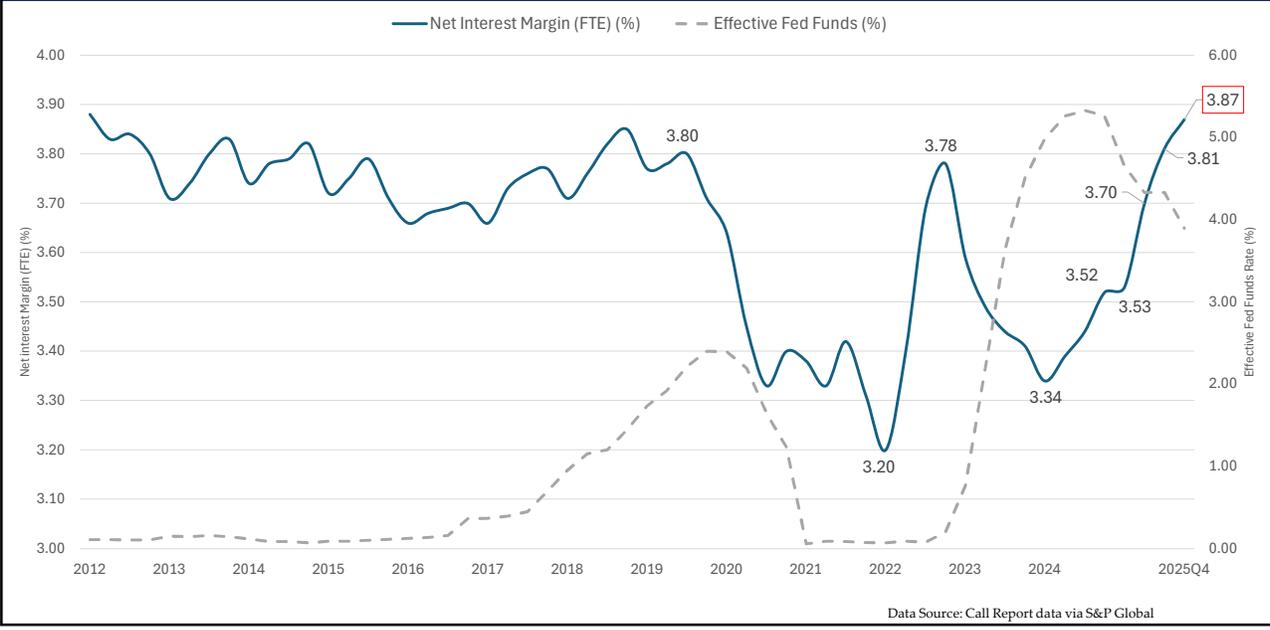
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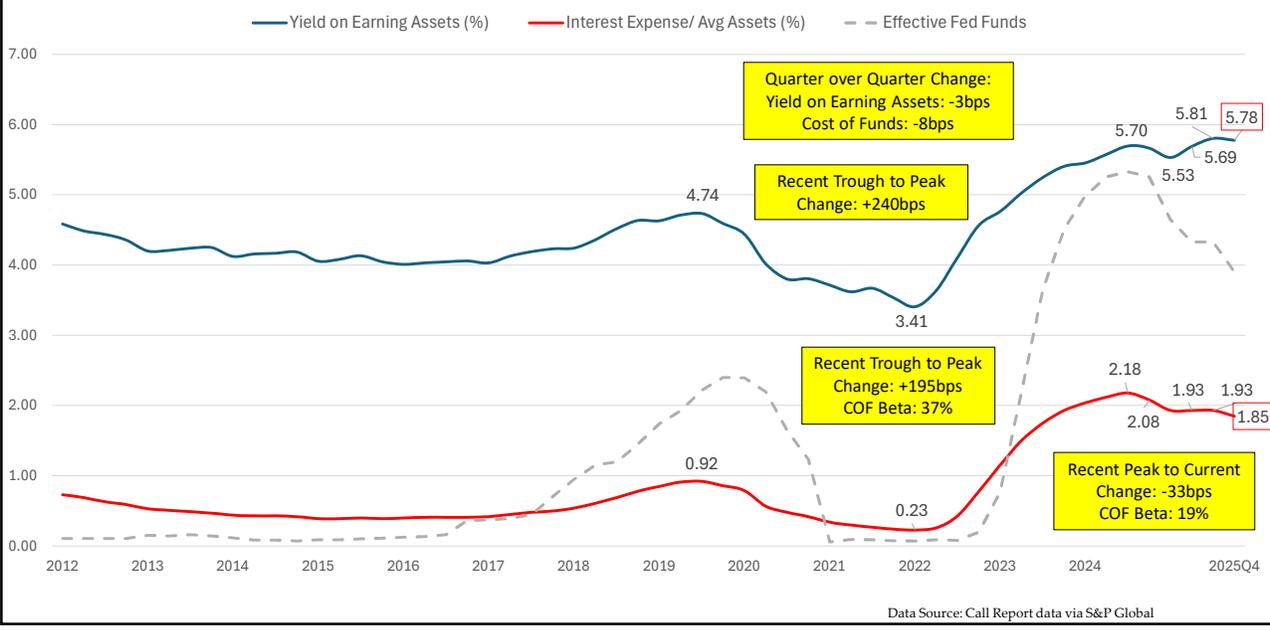
# Net Interest Margins

Averages for US Banks < \$10B



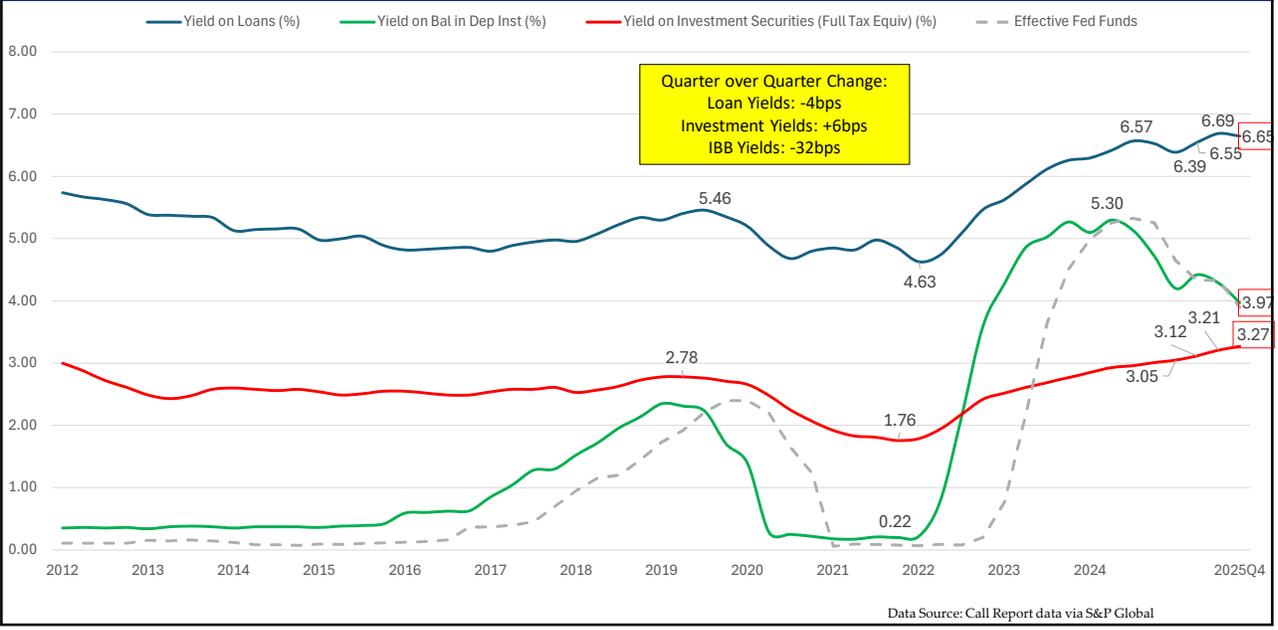
# Yield on Earning Assets vs. Cost of Funds

Averages for US Banks < \$10B



# Earning Asset Yield Trends

Averages for US Banks < \$10B



**What percentage of your COVID era loans (issued 2020-21) are still scheduled to mature/reprice?**

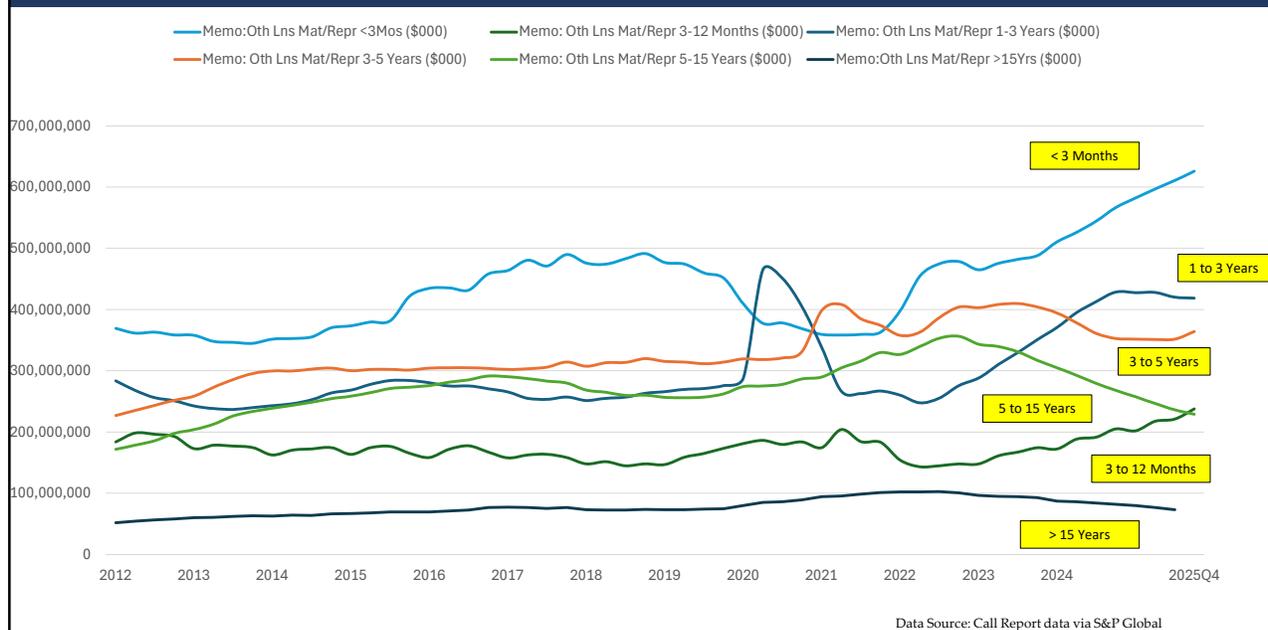
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## Loan Repricing Trends

Totals for US Banks < \$10B



## Use A Written Investment Strategy To Hedge Your IRR

### Q1 2026 Investment Strategy

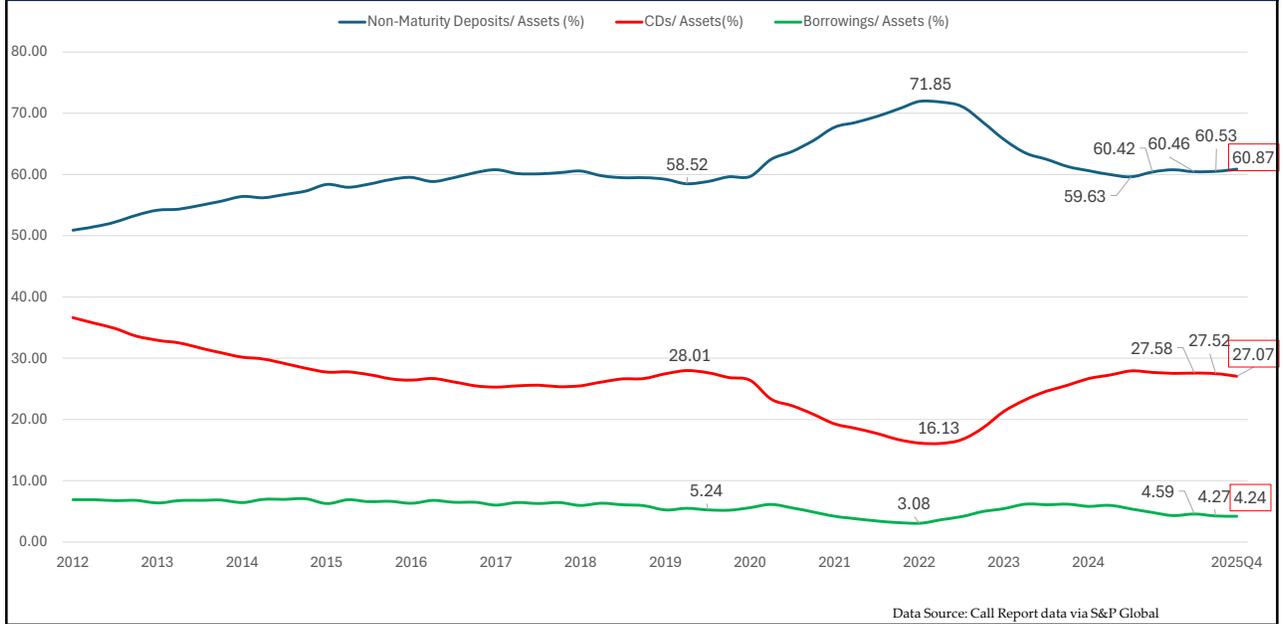
The labor market deteriorated sharply in 2025 and the Fed cut rates 75bp in Q4 2025 after a 9 month “pause”. The Fed wants to cut rates to 3% in the long term – the market thinks they will cut 50-75bp more this year. For the last 2+ years, our strategy has been focused on buying bonds near 18-year high yields and preparing for lower rates with longer durations and good call/prepay protection. **With the Fed still in easing mode**, our strategy remains largely unchanged, but **there is a growing sense of urgency to execute our strategy as the window of opportunity to buy higher yield bonds and make adjustments to the portfolio is closing.**

- Our strategy for Q1 2026 is threefold:
  - Prepare the portfolio for an extended period of lower rates
  - Find ways and make opportunities to buy bonds near 18- year highs before that is no longer possible.
  - Lock in those yields by ensuring the bonds we are buying will still be in the portfolio beyond the near-term.
- Focus on structures with longer durations that provide adequate call and prepayment protection.
- Continue shifting the strategy focus from “protecting value” to “protecting yield” in order to retain as much of the recent yield increase as possible if rates fall.
- Review your current sector allocation to determine if it is optimal given your goals, risk tolerances and rate outlook. **What worked in the past may not be best for the future.** Generally speaking, focus on reducing Treasuries and Callable Agencies in favor of prepay-protected MBS/CMO and longer-term Municipals.
- Consider a portfolio restructuring to “reset” the portfolio yield higher and increase portfolio income in 2026 and beyond. Remember: **bonds at unrealized losses mean you are already taking a loss of income every day versus current market rates even if you don’t sell.**

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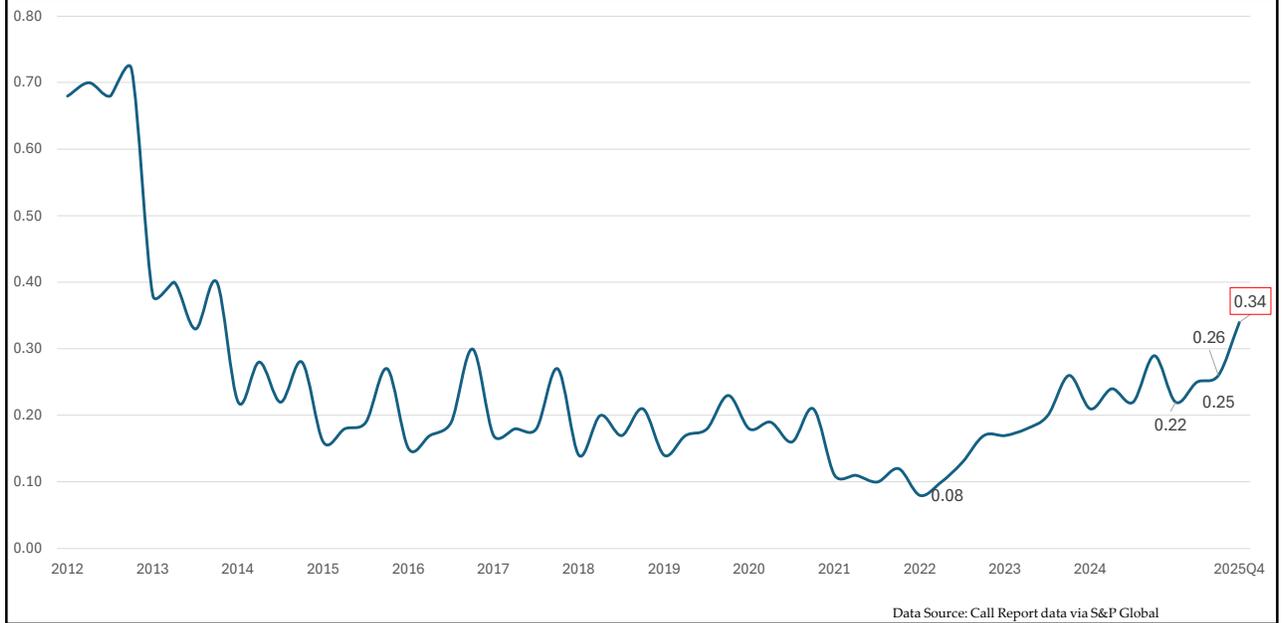
## Liability Mix

Averages for US Banks < \$10B



## Asset Quality – Net Chargeoffs / Avg. Loans

Averages for US Banks < \$10B



## Trends Summary

- Lower cost of funds in Q4 helped push margins to highest level since 2012 – how much more can we cut deposit rates?
- Bond yields still increasing while loan and cash yields fell – how many more COVID era loan resets are left?
- Loans are becoming more rate sensitive even as the Fed remains in easing mode and cash liquidity levels increase – are you prepared for lower rates?
- Assess your IRR and use your bond portfolio to lock-in today's higher yields and hedge the risk of lower rates with a written investment strategy focused on longer durations and prepay/call protection
- Capital levels remain very strong.
- Charge-offs hit the highest level in more than a decade and asset quality ratios are trending higher.

## Questions?

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