



Dale Sheller
Managing Director/Director of
Financial Strategies Group

What if the Rate Cuts Don't Come in 2026?

Net interest margins are the lifeblood of community financial institutions' earnings. Typically, as margins go up, overall earnings go up and vice versa. Since the pandemic, margins have seen their fair share of volatility, driven first by all-time historic lows in interest rates in 2020 and 2021, followed in 2022 and 2023 by a total of 500+ basis points of Fed tightening. More recently, the Fed has cut rates for a total of 175 basis points. The first 100 basis points came in the latter part of 2024 and the other 75 basis points came in the latter part of 2025. The recent Fed cuts allowed institutions to reduce their cost of funds while asset yields pushed higher as many loans and bonds repriced up to more current market rates. These two dynamics of higher asset yields and lower cost of funds pushed net interest margins higher throughout 2025. However, that margin tailwind has already begun to fade. According to the FDIC's *Quarterly Banking Profile* for the first quarter of 2026, the industry's net interest margin slipped 8 basis points to 3.31%, while net interest income declined \$1.6 billion, or 0.8%, from the prior quarter. The FDIC attributed the margin compression to earning-asset yields falling faster than funding costs.

Last fall, when community financial institutions built their 2026 budgets, almost everyone wrote down the same assumption: the Fed would cut rates in 2026. When I polled audiences late last year, 58% expected 50 basis points of cuts in 2026, another 11% expected 75, and only 4% thought the Fed was finished. Additionally, 68% expected their net interest margin to expand this year. Much of that assumption was driven by their overall expectation for more Fed rate cuts in 2026.

Halfway through 2026, that assumption seems to be breaking. The potential for rate cuts has now been replaced by rate hikes. The Iran war pushed oil prices higher; oil ran from approximately \$57 a barrel at the start of the year to a peak near \$113. That increase ran straight through to gasoline and other energy prices.

This has reaccelerated the key measures of inflation, with the Fed's June projections lifting year-end PCE to 3.6% and Core PCE to 3.3%, both well above the 2.7% they penciled in just three months earlier.

Some institutions may have revised their budgets, while others may have chosen to keep what they have. Let's assess three key 2026 budget assumptions.

Assumption #1: Asset yields keep climbing. Many institutions have some percentage of their loan books set to reprice higher in the near term; however, the percentage of loans that have not been repriced from 2020 and 2021 gets smaller each day. Many banks now have less than 20% of their loan books left to reprice.

Assumption #2: Cost of funds falls. This is where your budget may begin to break— or may already be broken. Most institutions assumed more Fed rate cuts in 2026 would continue to allow funding costs to drift down. Instead, deposits remain competitive, wholesale funding is still expensive, and it's looking less likely we get relief from the Fed. Cost of deposits has been sticky, and if the Fed's next move is a hike, funding costs should rise.

Assumption #3: Margin expands. Take away the cost of funds relief and this assumption quietly collapses. If cost of funds doesn't fall, net interest margin expansion must be driven from somewhere else.

That somewhere else is the asset side. And here is the tricky part: the asset yield you put into the budget now must be earned, not assumed. The question every ALCO should be asking is simple: where does the next dollar of yield come from?

For most balance sheets, that question is getting harder to answer on the loan side. Loan demand has softened for some

(Continued)

institutions, competition for good credits remains fierce, and reaching for yield at this stage of the cycle means taking on both duration and credit risk—at exactly the moment when you need to be cautious.

The bond portfolio can help pick up the slack, and the yield curve is the reason. After years of an inverted or flat curve that paid you nothing to extend, the curve has steepened. For the first time in a long while, you get paid to move out of cash and into intermediate bonds. The curve has done the hard work, and there is yield to capture without reaching for unnecessary risk. But remember, the right bond for your portfolio isn't the highest-yielding one; it's the one whose structure, cash flow, and risk profile fit your balance sheet. Know what you own and why you own it.

So, what if the rate cuts don't come in 2026? The institutions that thrive won't be the ones who guessed the Fed correctly; they'll be the ones who built a balance sheet that performs whether cuts arrive or not. Margins are still the lifeblood of your earnings, and in a year without help from the Fed, defending that margin becomes an asset-side decision. The cost of funds equation is largely out of your hands; the yield, structure, and quality of your investment portfolio are not. Build a balance sheet that wins if the Fed stays put, and treat any eventual cuts as upside—not as the plan.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact **Dale Sheller at The Baker Group: 800.937.2257.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Dale Sheller
Managing Director/Director of Financial Strategies Group
The Baker Group LP

INTENDED FOR USE BY INSTITUTIONAL INVESTORS ONLY. Any data provided herein is for informational purposes only and is intended solely for the private use of the reader. Although information contained herein is believed to be from reliable sources, The Baker Group LP does not guarantee its completeness or accuracy. Opinions constitute our judgment and are subject to change without notice. The instruments and strategies discussed here may fluctuate in price or value and may not be suitable for all investors; any doubt should be discussed with a Baker representative. Past performance is not indicative of future results. Changes in rates may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instruments.