FED POLICY, FLOATING RATE TREASURIES AND A 35/65 PORTFOLIO

Jeremy Schwartz — Global Chief Investment Officer
11/13/2018

On last week's "Behind the Markets" podcast, we spoke about fixed income strategy and outlook following the Federal Reserve (Fed) meeting with Kevin Flanagan, Senior Fixed Income Strategist at WisdomTree, as well as market dynamics and portfolio strategy with Jared Dillian, author of the Daily Dirtnap.

Flanagan pointed out the Fed policy statement last week ignored any discussion of the slowing housing data that resulted from the rise in mortgage rates (conventional 30-year rates are now 5%). Flanagan interpreted the Fed statement as sending a signal that another interest rate hike is coming in December and that we can potentially expect two to three more hikes next year.

Based on the Fed "dots," Flanagan sees room for four more rate hikes, so in that context we also discussed Flanagan's high-conviction fixed income strategy ideas.

Flanagan believes floating rate Treasuries—which are instruments whose rates reset every week with the three-month T-bill auction—offer compelling value. In a typical audience, approximately two-thirds of the people Flanagan speaks with still do not even know this asset class and bond exist because the Fed just started issuing these securities in 2014.

- If you believe the Fed is raising rates three, four or even five times between now and the end of 2020, Flanagan suggests floating rate Treasuries are where you want to be positioned. Currently, rates are 2.35% on securities with a one-week duration and the highest-quality Treasury paper. Flanagan sees these rates going up to 3.25% sometime in 2019—which is approximately where the 10-year bond is today.
- We discussed how floating rate Treasuries were the first issuance from the government since Treasury Inflation-Protected Securities (TIPS), and TIPS tend to be longer, thus resulting in negative performance in 2018 with their duration and real rates rising. Floating rate Treasuries are another instrument that can protect inflation—without duration risk.

Will Value Come Back?

Dillian echoed comments we've heard recently on our podcast about seeing a sustained shift from a momentum- and growth-led market to a value regime of outperformance over the next five years. Dillian thinks momentum might be dead as a factor—and his gut feeling is that there has been a change in the trend. He sees fundamental issues coming to some of big tech companies, potentially with government pressure and regulation coming to big tech.

High Real Interest Rates Attracting Capital to U.S.: Dillian sees the U.S. as being a destination for foreign capital given how high our real interest rates are compared with those in the rest of the world, trumping the valuation case to go international. He is still looking for opportunities there but sees risk of political negativity instead of positive catalysts.

Next Financial Crisis Coming from Corporate Credit? Dillian does not think residential real estate would be the next source of a global financial crisis—but, rather, the increase in U.S. corporate credit. Dillian sees $13.5 trillion in corporate debt outstanding, and the median rated bond corporate used to be an A and now it is BBB-. Dillian sees the median bond being junk-rated pretty soon. This ties back to some of Flanagan's advice on the show to get more discerning with fundamental credit strategies instead of just buying market cap-weighted credit beta.

A 35/65 Portfolio: Dillian described a portfolio that he thinks should be the standard for more personal portfolios that flips the standard "60/40" equity/bond mix on its head to be the 35/65 portfolio. He sees this as being the ideal portfolio—regardless of age because it delivers a more optimal Sharpe ratio or risk-adjusted return. He sees this as something portfolio investors can stick with behaviorally—it manages their ability to compound their wealth as long as possible. If people believe this isn't going to allow them to retire in time with lower expected returns, Dillian suggests to prepare the old-fashioned way: by saving more. He sees people being overly allocated to stocks and under-allocated to real assets like commodities, and, in that case, allocations like a 30/60/10 equity/bond/commodity would have merit.

This was a great conversation on macro dynamics with Dillian and Flanagan. To hear more, please listen to the full podcast in the link below.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Blue dots : the midpoint target range/level of the FOMC participants' projections for the future Federal Funds Rate.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Three-month U.S. Treasury bill : a debt obligation of the U.S. government with an original maturity of 3 months.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Inflation : Characterized by rising price levels.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Corporate Credit : compensation associated with the risk of lending to a corporation.

Median : The median is the value within a dataset at which 50% of all observations occur above and 50% occur below.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

Risk-adjusted returns : Returns measured in relation to their own variability. High returns with a high level of risk indicate a lower probability that actual returns were close to average returns. High returns with a low level of risk would be more desirable, as they indicate a higher probability that actual returns were close to average returns.

Commodity : A raw material or primary agricultural product that can be bought and sold.