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

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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.

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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.