THE NEW RATE REGIME: INCOME WITHOUT THE VOLATILITY

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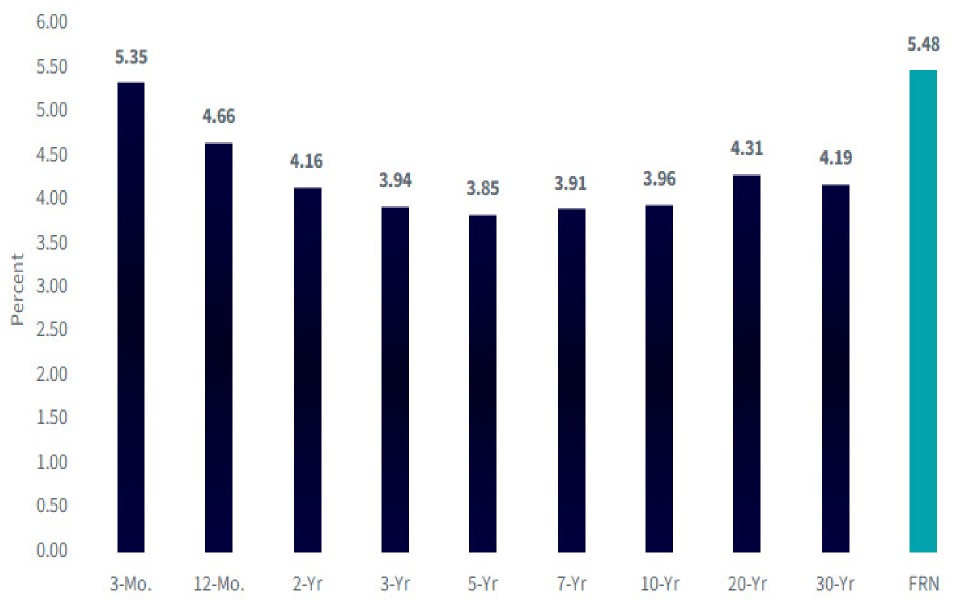
The money and bond markets appear to be doubling down on their optimistic expectations for Fed rate cuts this year despite the release of key economic data (jobs and CPI reports) that would normally be viewed as somewhat challenging to this narrative. That brings us back to a theme I've discussed quite a bit over the last few months: fixed income investors will more than likely continue to face elevated volatility, especially in the U.S. Treasury (UST) arena, without the income typically associated with it.

During the first half of January, UST yields, such as for the 2- and 10-Year notes, have witnessed increases of roughly 15–20 basis points (bps), only to come crashing back down again. In fact, in the case of the UST 2-Year note, its yield on Friday dropped to its lowest reading since May of last year.

U.S. Treasury Yields



Source: Bloomberg, as of 1/12/24.

Since I last blogged about this topic about two months ago, there has been a noteworthy development I wanted to bring readers up to date with: UST yields have fallen even further. To provide some perspective, in mid to late November, the UST 2-Year yield was just under 4.90%, or more than 70 bps above its current level, as of this writing. The widely followed UST 5- and 10-Year yields have declined roughly 50–60 bps during this same timeframe. In fact, the entire 3–10-Year sector of the Treasury yield curve last week was at yield levels below the 4% threshold. As recently as late October, these maturities were trading right around the 5% vicinity.

The main catalyst for these downward movements is continued optimism the Fed will cut rates aggressively this year. Implied probabilities for Fed Funds Futures are pricing in six to seven rate cuts for 2024, worth a total of at least 160 bps. This scenario would put the Fed Funds target range between 3.50% and 3.75%. Arguably, one can make the case that the UST market has already priced in a lot of good news, and as we've seen many times in the past (2023 included), the track record for the implied probability measure is not very good. In other words, there is definitely room for disappointment on this front.

So, what is one way investors can position themselves in this rate setting?

Playing Defense (Income without the Volatility): [WisdomTree Floating Rate Treasury Fund (USFR)]

- USFR is tied to the UST 3-month t-bill auction yield, which is directly tied to the actual Fed Funds Rate, not an expectation, such as what is being discounted by the fixed coupon sector.
- Why is that important? Because the Fed hasn't cut rates. The 3-month t-bill yield is essentially unchanged vs. the declines in the 2-, 5- and 10-Year yields I mentioned earlier.
- We believe Fed rate cuts are coming, but what if the market is wrong in its aggressive pricing on this front? Volatility.
- And don't forget the yield curve is still inverted, hence UST floating rate notes (FRNs) are the highest-yield Treasury security by a wide margin in many cases (see above).
- Even if the Fed cuts rates by 100 bps in 2024, UST FRN yields would more than likely still be well above the current fixed coupon Treasury yields.

Conclusion

This is the first in a series of blog posts on The New Rate Regime…so stay tuned!

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For the top 10 holdings of USFR please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/usfr

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DEFINITIONS

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

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

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Basis point : 1/100th of 1 percent.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

5-Year Treasury : a debt obligation of the U.S. government with an original maturity of five years.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

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.

Coupon : The annual interest rate stated on a bond when it's issued. The coupon is typically paid semiannually. This is also referred to as the "coupon rate" or "coupon percent rate.&rdquo.