

UPSIDE DOWN...THE YIELD CURVE INVERTS

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Last week, the big news was that the [U.S. Treasury \(UST\)](#) 3-month/10-year [yield curve](#) became inverted for the first time since 2007. It is certainly a noteworthy development in bond-land. As of this writing, the closely watched UST 2-year/10-year [spread](#) is still on the positive side at 15 [basis points](#).

Here are some quick insights:

- The effect of last week's [Federal Reserve \(Fed\)](#) meeting is still resonating, with any economic data being viewed through that prism accordingly.
- The catalyst for this latest inversion may have been the continued soft performances of the eurozone Purchasing Managers' Indexes (PMIs), specifically those of the manufacturing sector and Germany.
 - The manufacturing PMIs for Germany, France and the eurozone are now all in [recession](#) territory, with Germany's at its lowest level since 2012.
 - The 10-year German bund yield dropped into negative territory as a result of the PMIs.
 - This is important for the U.S. rate outlook because the Fed mentions global growth as one of its primary concerns.
- U.S. economic data has been more mixed but does suggest a slowing in Q1 growth.
 - The U.S. PMI came in below consensus for March, but still safely above the "50" threshold of contraction versus expansion.
 - Existing home sales increased by 11.8% in February.
 - The data on housing, an interest-rate sensitive sector of the economy, is important because if the rise in U.S. rates is going to start having negative repercussions, this is a logical place for it to start.
- At its meeting last week, the Fed lowered its 2019 gross domestic product (GDP) forecast by only 0.2 pp and kept core [PCE](#) unchanged. Three months ago, a somewhat similar scenario resulted in two [rate hike](#) projections, but now the result is none. Following the December [FOMC](#) meeting, the Fed may be operating with an overabundance of caution.
- The most important outcome of last week's Fed meeting may be that there was no mention of, or forecast for, *rate cuts*. In contrast, [fed funds futures](#) have now priced in one rate cut for this year.
- The UST 10-year yield broke through the five-year [Fibonacci](#) 61.8% retracement of 2.5178. The next level is 50% retracement at 2.2887.
 - I'm not necessarily projecting this is where we go, but if upcoming U.S. economic data comes in soft, the glide path is there.

- What about U.S. economy surprises to the upside? The UST market is not priced for this scenario at all. In fact, the UST 10-year relative strength index is back in “overbought” territory. It’s had a good track record.

Conclusion

How might an investor position their fixed income portfolio in the current environment? I think one should use the inverted yield curve to their advantage. With the [WisdomTree Floating Rate Treasury Fund \(USFR\)](#), investors can capture an average [yield to maturity](#) of 2.55%, as of this writing, with a duration of 0.02 years. Compare this to a UST 10-year note yield of 2.44%. The Treasury floating rate note strategy offers an innovative, strategic solution for the short-government allocation for fixed income.

Unless otherwise stated, all data is Bloomberg, 3/25/19.

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DEFINITIONS

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.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Basis point : 1/100th of 1 percent.

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

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

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.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

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

Fibonacci retracement : A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.

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