FLOAT LIKE A BUTTERFLY, DON'T GET STUNG BY A BEE

Kevin Flanagan — Head of Fixed Income Strategy
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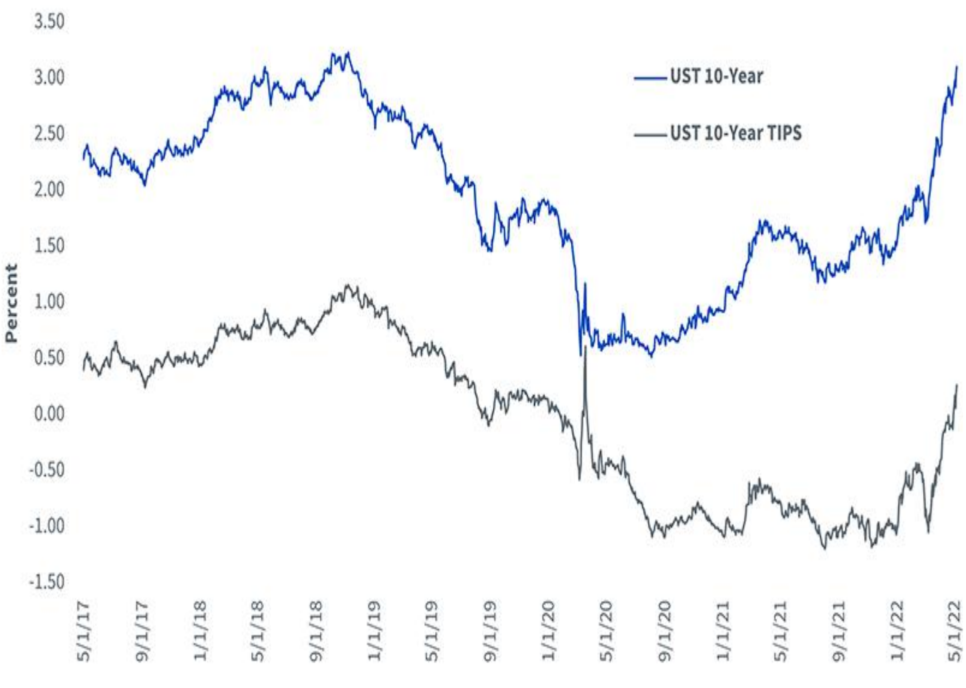
Following the knee-jerk reaction in the U.S. financial markets to the FOMC meeting last week, investors could be forgiven for thinking Powell & Co. had actually achieved their goal of not creating any issues to contend with. As we all know now, that "afterglow" didn't even last 24 hours. For the purpose of this blog post, I'm going to stick to the bond market. The jump in the U.S. Treasury (UST) 10-Year yield was a not-so-subtle reminder that even though rates, in general, had already risen thus far in 2022, there could be more to come.

As I outlined in some prior blog posts, "real yields" or yields in the TIPS market will be an important factor to watch when trying to determine where the UST 10-Year yield could be headed. As this graph clearly illustrates, the correlation between these two instruments is quite high, especially over the last five years. In fact, this latest move to the upside is occurring in lock-step fashion.

U.S. Treasury Yields



Source: St. Louis Fed, as of 5/6/22

Since early March, the 10-Year TIPS yield has exploded by +132 basis points (bps), and the absolute level is no longer negative, having crossed into positive territory to the tune of almost 25 bps as of this writing. For the "nominal" UST 10-Year note, the yield has skyrocketed an almost identical amount (+136 bps), piercing the 3% threshold as a result.

I believe this relationship will continue as the Fed is now embarking in a more noticeable fashion on tightening monetary policy. While the UST 10-Year note yield is coming increasingly closer to its November 2018 high watermark of roughly 3.25%, the 10-Year TIPS yield still has a long way to go to match the peak it achieved at that same point in time. To provide some perspective, the 10-Year TIPS yield printed a reading just over 1.15% three and a half years ago, or 90 bps above its current level. In other words, the UST 10-Year yield could have more "room to run" to the upside.

A Solution

Total NAV Return of USFR vs. Bloomberg Barclays TIPS Index During Recent Rising Rate Period & Year-to-Date			
Fund Name	Ticker	7/8/16 - 11/8/18	Year-to-Date
WisdomTree Floating Rate Treasury Fund	USFR	2.94%	0.33%
Bloomberg Barclays U.S. Treasury Inflation Notes TR Index	LBUTTRUU	-2.31%	-6.29%

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com. WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total Returns are calculated using the daily 4:00pm EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

For the most recent standardized performance click here.

As investors are finding out, TIPS are not necessarily an effective rate-hedge vehicle. Instead, a strategy centered on Treasury floating rate notes (FRNs) can offer fixed income portfolios a better solution for rising rates. The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means to tap into this strategy.

The table illustrates how 10-Year TIPS fared during the last rising rate period from July 2016 to November 2018, as well as the year-to-date experience, as compared to USFR. As one can clearly see, USFR has provided investors with a positive outcome while TIPS have produced visible negative returns. Both instances provide a glaring example of the differences between these two rate-hedging approaches.

It is important to keep in mind that TIPS are indexed to inflation while USFR is indexed (resets) to an interest rate instrument, the weekly UST three-month t-bill auction, which in turn is tied closely to the Federal Funds Rate. With the Fed in just the early stages of its rate hike policy, investors may wish to consider USFR as their preferred rate-hedge tool of choice.

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DEFINITIONS

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

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.

TIPS : Treasury Inflation Protected Securities.

Basis point : 1/100th of 1 percent.

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

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.

Inflation : Characterized by rising price levels.

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).

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.