DAZED AND CONFUSED? WE'VE GOT YOU COVERED

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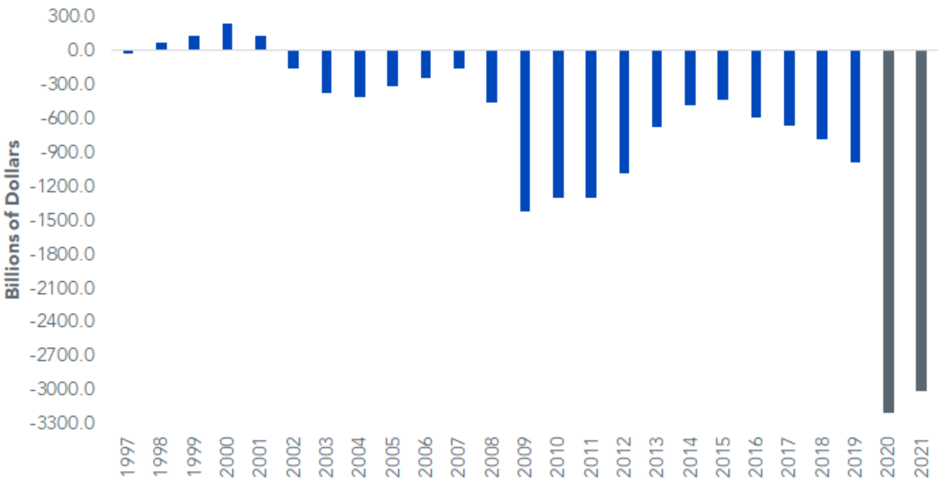
Over the last month, the combination of U.S. monetary and fiscal support has come at not only breakneck speed but, perhaps more importantly, at amounts that were almost unimaginable just a few months ago. It could leave an investor feeling dazed and confused.

While the Federal Reserve (Fed) has been grabbing the headlines on an almost daily basis, the news that seems to be flying under the radar is the U.S. government's recently passed CARES relief package. When I say "under the radar," I don't mean the rollout and potential additions to the package. No, I'm referring to something that appears to have garnered scant attention in the bond market — a skyrocketing federal budget deficit.

U.S. Budget Deficit/Surplus



Source: 1997–2019, U.S. Treasury Dept., as of 4/9/20. Note: 2020 & 2021 are estimates.

Let's take a look at the above graph for some perspective. Since reaching a recent "bottom" of $439 billion in 2015, the U.S. budget deficit has been on a steady upward trajectory, peaking at $984 billion for 2019. Prior to the aforementioned CARES package, it was estimated the nation's shortfall would pierce through the trillion-dollar threshold for 2020, revisiting the 2009–2012 experience. Now, given the $2.2 trillion cost of this latest relief package, not to mention the two others before it, it is reasonable to project an incredible deficit of potentially at least $3.0 trillion for this year and for 2021.

Obviously, the government has to fund this shortfall, so get ready for an explosion in upcoming Treasury supply, consisting of both bills and coupons. In fact, it has already begun. Since a good portion of the relief package is designed for as quick an impact as possible, the clear path for the Treasury is to ratchet up its t-bill issuance. To provide some perspective, the three-month t-bill that was auctioned this week totaled $57 billion, a $15 billion increase from the amount offered March 16. Given the desire of the nation's debt managers to keep the weighted-average maturity of Treasury (UST) debt relatively constant, combined with the Fed's quantitative easing (QE) U.S. Treasury purchases, t-bill issuance as a whole could represent two-thirds of the federal government's financing needs, or up to $2 trillion.

Interestingly, as the markets settled down over the last week or so, the supply/demand dynamic for the three-month t-bill has resulted in a visible increase in yield. After posting a low point of -0.14% a little more than two weeks ago, the yield was right around 0.25% as of this writing, a reversal of nearly 40 basis points (bps).

So, what are fixed income investors to do? We see the two weights of our barbell strategy as solutions to this deficit conundrum:

- The WisdomTree Floating Rate Treasury Fund (USFR) not only seeks to provide a hedge for potentially higher UST rates, it can also benefit from any possible upward yield effects, specifically in the three-month t-bill sector, from this explosion in new supply.
- Market cap-based fixed income indexes will over-weight entities with the most debt outstanding. Given the expected surge in UST supply, the benchmark Bloomberg Barclays U.S. Aggregate Index (Agg) will most likely see its weighting to Treasuries remain elevated as compared with other investment-grade asset classes, potentially sacrificing yield in this historically low-rate environment. The WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY) uses a rules-based approach to reallocate across subcomponents in the Agg, seeking to enhance yield while maintaining a similar risk profile.

Unless otherwise stated, all data sourced is Bloomberg as of April 9, 2020.

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

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

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.

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).

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Basis point : 1/100th of 1 percent.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.