FOMC WATCH: STAY ON THE HIKING TRAIL

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06/13/2018

No surprise here: The Federal Open Market Committee (FOMC) delivered its second rate hike of 2018. The quarter-point increase pushed the target range for the Federal Funds Rate up to 1.75% to 2.00%. Based upon the Federal Reserve's (Fed) outlook, it would appear as if further gradual rate hikes are still the more likely scenario going forward, but interestingly, there have been some shifts in attitude regarding just how many additional moves could be forthcoming.

Heading into the June FOMC meeting, market expectations were certainly priced for a rate increase, as the implied probability for Fed Funds Futures was essentially at 100%. However, the outlook for the remainder of 2018 has changed a bit in recent weeks. In mid-May, Fed Funds Futures were pointing toward the possibility of two additional increases for the remainder of this year but were dialed back to only one further hike as of this writing. A similar development occurred with respect to the 2019 outlook.

It is interesting to note that the recent peak in the Fed Funds Futures gauge occurred at the same time the U.S. Treasury (UST) 10-Year yield broke through to the upside, posting its highest reading since 2011. What happened in the ensuing period to serve as a potential catalyst for this shift in Fed outlook? In one word: Italy. The political turmoil and attendant risk-off trade caused by the unsettled situation in Italy appears to be a notable factor for the aforementioned scaling back of rate hike expectations. Indeed, surging Italian bond yields combined with concerns of a contagion effect on eurozone banks created a flight-to-quality trade that not only pushed the UST 10-Year yield down more than 30 basis points (bps) at one point, but also apparently impacted expectations for potential Fed policy moves.

Based upon Fed public appearances and official press releases, it appears the FOMC is also rethinking future policy moves. With the upper band of the Fed Funds target range now at 2%, some officials have been questioning just how many more rate hikes will be needed in this cycle. One topic that has garnered increasing attention from policy makers is the shape of the yield curve. Various Fed members have stated that they are watching the yield curve very carefully and have also expressed their concern about not inducing an inverted construct due to FOMC rate hikes. However, one Fed official whose voice may carry more weight going forward, soon-to-be-N.Y. Fed President John Williams, has stated that he is also watching the yield curve but is not necessarily worried about how flat it is at this time.

Another hot-button topic is the Fed's forward guidance language, which is included in the FOMC policy statement. This subject was brought to light in the May FOMC minutes and received further attention recently from Fed Chairman Jerome Powell and Williams. The bottom line is that there is a growing sentiment that this policy tool might be past its shelf life, or in other words, it is not needed anymore, especially as the Fed Funds Rate gets closer to what is considered neutral. At the recently concluded June meeting, the voting members did deliver on this front by removing the forward guidance language in their policy statement.

Conclusion

Given the Fed's guidance and market outlook for additional increases in the Fed Funds Rate in 2018, if not beyond, some Fed protection seems warranted. Against this backdrop, we believe that by utilizing a floating rate product, such as the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR), investors may be better able to insulate their bond portfolios and focus on yield enhancement with essentially no duration.

Unless otherwise stated, data source is Bloomberg, as of June 8, 2018.

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DEFINITIONS

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

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

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Basis point : 1/100th of 1 percent.

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.