

The rise of floating rate notes

Publié le 10 avril 2019

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In January 2014, the US Treasury began offering a new instrument to investors: US Treasury Floating Rate Notes (FRNs). These notes were the first new security the Treasury has offered since Treasury Inflation Protected Securities (TIPS)¹ back in 1997. Floating rate notes bring more diversity to the Treasury's current portfolio, an important consideration given burgeoning financing needs.

This is the first type of Treasury note that has coupon payments that are floating and has provided investors with a way to reduce interest rate exposure while significantly reducing credit risk. In the past, investors looking for floating rate instruments had to consider floating rate corporates which have inherent credit risk. In other words, risk that the borrower will not be able to meet its financial obligations. When considering floating rate instruments, it is also important to understand that at today's interest rate levels, investors could potentially receive lower coupon payments relative to fixed coupon bonds of a similar maturity.

Understanding the basics: What is a floating rate treasury note?

US Treasury Floating Rate Notes (FRNs) are securities whose coupons are linked to movements in short interest rates. Floating rate Treasury notes make payments to bondholders each quarter with the coupon amount linked to movements in short term interest rates.

Coupon rate is reset daily in reference to the highest accepted discount rate of the most recent 13-week Treasury Bill auction, plus or minus a fixed spread² determined at the securities' initial issuance. Since auctions for new 13-week Treasury Bills (T-bills)³ occur once a week, that means the coupon rate effectively changes weekly, however, interest is accrued daily and distributed quarterly. They are backed by the full faith and credit of the US government and have a 2-year final maturity.

The Treasury auctions a new US Treasury FRN quarterly in January, April, July and October with two re-openings⁴ of these initial auctions in the subsequent months of each quarter. Each quarterly FRN issue size is \$56 bn, \$20 bn initially with \$18 bn at re-opening in the two months that follow. There are eight outstanding US Treasury FRNs at any given time as they are issued with a two-year maturity.

In comparison to other US Treasury securities, T-bills don't pay a coupon and are instead issued at a discount to the principal at maturity. Income is generated as the security rises to par at maturity. Treasury notes, on the other hand, pay semi-annual coupons and repay the principal at maturity.

Given the longer-duration aspect of Treasury Inflation-Protected Securities (TIPS), there is higher sensitivity to increases in longer-term interest rates. US Treasury FRNs are more directly tied to changes in interest rates influenced by Federal Reserve rate moves.

Growth potential for this market

In comparison to when the US Treasury initially issued US Treasury Inflation-Protected Securities (TIPs) more than a decade ago, the US Treasury FRN asset class appears to be very large. Since the initial auction in January 2014, the outstanding market value for floating rate treasuries has grown to \$378 billion as of February 2019.

Utilising the same lifespan, the universe for TIPS was only \$145 billion. A sharp difference as US Treasury FRNs are 2.6 times bigger than TIPS when comparing similar stages for each instrument. In February 2019, the Bloomberg Barclays US Treasury Inflation Notes Index had a market value of more than a \$1 trillion.

Figure 1: How have US treasury FRNs performed relative to similar maturity treasury bills and notes?

Source: WisdomTree, Bloomberg. Period from 31 January 2014 to 28 February 2019 based on monthly returns. Period is since inception of the Bloomberg Barclays US Treasury Floating Rate bond index corresponding to the earliest available back-tested data for the Bloomberg Barclays US Treasury Floating Rate Bond Index – live data as of 3 Feb 2014. You cannot invest directly in an index.

Historical performance is not an indication of future performance and any investments may go down in value.

US Treasury FRNs as an asset class have performed well relative to similar short duration products with comparable volatility profiles since their common inception. Performance advantage of FRNs accelerated once the US Federal Reserve (Fed) began raising rates in December 2015, as can be seen in Figure 2.

Figure 2: US Treasury FRNs historical performance and volatility during rising rates environment

Index name	Ticker	Full Period		Rising Rates	
		TR	Volatility	TR	Volatility
Bloomberg Barclays US Treasury Floating Rate Bond Index	BTLTRUU	4.22%	0.22%	3.61%	0.18%
Bloomberg Barclays US Treasury Bills: 1-3 Months Index	LD12TRUU	3.37%	0.22%	2.86%	0.20%
ICE US Treasury Short Bond Index	IDCOTSTR	3.93%	0.23%	3.23%	0.21%
ICE US Treasury 1-3 Year Bond Index	IDCOT1TR	4.30%	0.79%	2.47%	0.88%

Source: WisdomTree, Bloomberg. Data as of 28 February 2019. TR: Total Returns. Full Period encompasses a period from 31 January 2014 to 28 February 2019 corresponding to the earliest available back-tested data for the Bloomberg Barclays US Treasury Floating Rate Bond Index – live data as of 3 Feb 2014. Rising Rates encompasses a period from 15 December 2015 to 20 December 2018. Volatility estimates are based on monthly returns and a period from 30 November 2015 to 31 December 2018. You cannot invest directly in an index.

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For investors looking for US Dollar solutions with no corporate credit risk, strategies that invest in short term US treasury yields such as US Treasury Floating Rate Notes can currently provide investors with higher yields than investing in longer maturity US Treasury Bonds.

Securities with floating or variable interest rates can be less sensitive to interest rate changes than securities with fixed interest rates but may decline in value if investors demand greater compensation over the reference yield than determined at initial auction. However, as of 27 March 2019, 10-year US treasuries were yielding about 2.38%, while the Bloomberg Barclays US Treasury Floating Rate Bond Index (BTFLTRUU) was yielding 2.52%.

1 Bonds issued by the US government whose coupon and principal payments are linked to the Consumer Price Index

2 Fixed spread is determined at the securities' initial issuance

3 Short-term debt backed by the US government with a maturity of less than one year

4 Re-opening: the US Treasury issues additional amounts of a previously issued security

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