CAN UNCLE SAM PROTECT YOU FROM HIGHER RATES?

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With nearly $23.0 trillion in marketable public debt outstanding, Treasury securities (UST) are viewed as the most liquid asset class in the fixed income universe, offering money and bond market investors a high-quality solution, with a variety of different investment aspects. When interest rates are rising, it is important to understand the dynamics behind the different Treasury securities available in order to make an educated decision for your bond portfolio. Let's take a quick lesson on the UST market.

WHAT ARE THE DIFFERENT TYPE OF SECURITIES OFFERED?

+ Certainly, a workhorse for the nation's debt managers, the T-bill[1] sector makes up roughly $3.8 trillion, or nearly 17%, of the total marketable amount outstanding. Primarily, T-bills are offered in 1, 2, 3, 6 and 12-month maturities. Oftentimes, Treasury will also issue cash management bills (CMBs)[2] to bridge potential gaps in their overall financing needs.
+ Treasury notes come in maturities between one and ten years and represent the largest grouping at a little more than $13.0 trillion, or nearly 58% of the overall amount.
+ Treasury bonds are offered in maturities over ten years, consisting of both 20 and 30-year issues. The amount outstanding here is $3.5 trillion, or 15% of the total.
+ Combined, T-bills, notes and bonds make up just under 90% of total marketable debt outstanding.
+ Treasury Inflation-Protected Securities (TIPS)[3] were added to the line-up in January 1997. TIPS are currently offered in 5, 10 and 30-year maturities and total more than $1.7 trillion.
+ While the 2-month T-bill was introduced in 2018, the newest Treasury note is the 2-year Floating Rate Note (FRN), which was first offered in January 2014. These securities are auctioned on a monthly basis and have grown to a total of $603 billion.

[1] 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).
[2] Cash management bill (CMB) is a short-term security sold by the U.S. Department of the Treasury. The maturity on a CMB can range from a few days to three months. The money raised through these issues is used by the Treasury to meet any temporary cash shortfalls and provide emergency funding.
[3] Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

UST TIMELINE

- **Dec 1929** 13-week T-bill introduced
- **1959** 26-week and 1-yr T-bills
- **1972** UST 2-yr notes
- **1976 & 1977** 5-yr notes 10-yr notes 30-yr bonds
- **1997** TIPS introduced
- **2001** 4-week T-bill
- **2008 & 2009** 3-yr and 7-yr notes reintroduced
- **2014** FRNs first auctioned
- **2018** 8-week T-bill
- **2020** 20-yr bonds reintroduced

TRADITIONAL RATE HEDGED-STRATEGIES

+ Since their inception, TIPS have been viewed as an interest rate-hedged strategy. While these securities do help to mitigate the effects of inflation on rates, they do not necessarily provide the rate protection fixed income investors may be looking for when the Federal Reserve ("Fed") is the primary catalyst for rising rates. In other words, TIPS yields can still increase in a rising rate environment.
+ In the bond market sell-off during the July 2016 – November 2018 period, 10-year TIPS yields increased by 125 basis points (bps)[4]. More recently, early in 2022, the 10-year TIPS yield rose, at one point, by just under 60bps.
+ In our opinion, a more optimal solution for higher rates, especially when looking for 'Fed protection' in a tightening policy setting, is the FRN space.
+ The interest rate for a FRN 'floats' or gets reset at the weekly 13-week T-bill auction (see below), with TIPS, the principal is adjusted for changes in the Consumer Price Index[5].
+ Thus, if the current bout of inflation has peaked, an investor could be exposed to higher rates from other factors, such as Fed rate hikes.
+ UST FRNs have revealed better liquidity[6] prospects when compared to TIPS, with the amount outstanding roughly 2.5 times the size at comparable stages of their life cycle.
+ As a result of the Treasury's supply needs, the auction size of the FRN has increased in a rather visible fashion over the last few years. Treasury views this sector as a key component in managing the weighted average maturity of U.S. marketable debt outstanding, expanding the UST investor base and helping to share the burden of escalating borrowing requirements.

[4] Basis point: 1/100th of 1 percent.
[5] Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.
[6] Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

THE CASE FOR AN FRN-BASED SOLUTION

The interest rate of an FRN changes, or “floats,” over the life of the FRN. The interest rate is the sum of two components: an index rate and a spread.

- **Index rate.** This rate is tied to the highest accepted discount rate of the most recent 13-week Treasury bill (3-mo. T-bill). The 13-week bill is auctioned every week, so the index rate of an FRN is re-set every week.
- **Spread.** The spread is a rate applied to the index rate. The spread stays the same for the life of an FRN. The spread is determined at the auction where the FRN is first offered. The spread is the highest accepted discount margin in that auction.

THE BOTTOM LINE

With the Fed guiding the markets towards multiple rate hikes over the next few years, we feel investors should be considering rising rate solutions for their bond portfolios. As the Fed raises rates, the rate hike is reflected in the weekly 3-month T-bill auction, not only offering investors a rate-hedge for their portfolios, but also providing the opportunity for higher yield enhancement as a result of the Fed’s tightening moves, with essentially no duration[7] risk.

The **WisdomTree Floating Rate Treasury Fund (USFR)** is a solution which seeks to track the Bloomberg U.S. Treasury Floating Rate Bond Index, before fees and expenses. Given the Fed’s guidance and market outlook for additional increases in the federal funds rate in 2022 & 2023, some ‘Fed protection’ seems warranted. As of this writing, 10-year TIP yields are solidly in negative territory, underscoring the potential vulnerabilities that may lie ahead for this class of Treasury securities.

[7] Duration: A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Unless otherwise stated all data source is WisdomTree.

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The Bloomberg U.S. Treasury Floating Rate Bond Index is a rules-based, market-capitalization-weighted index engineered to measure the performance of floating rate U.S. Treasury notes.

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