WHERE WILL THIS RATE HIKE CYCLE TAKE US?

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With much fanfare, the Federal Reserve (Fed) has finally begun its long-awaited rate hike cycle. Unfortunately, now comes the hard part. In other words, how is this process going to play out in terms of not just what the individual rate hikes will look like—25 basis points (bps) or 50 bps?—but also, where the terminal rate for the Fed Funds target range will ultimately climb to, and when? It is important to remember that the Fed will be drawing down its balance sheet at the same time, in what should be referred to as the polar opposite of quantitative easing (QE): quantitative tightening or QT.

THE STARTING POINT

The best place to begin this analysis is to focus on where the policy makers are starting from. Indeed, concerns have already arisen about the prospects for “stagflation,” with the Fed tightening too much and potentially even pushing the economy into a recession. However, this is where the “starting point” comes into play. The Fed is only in the initial stages of removing “emergency” policy measures stemming from the pandemic.

To provide some perspective, rate increases began at zero, while the balance sheet “run-off” will be coming from a roughly $9 trillion level, or more than twice the amount that was in place as a result of the financial crisis. The graph below (figure 1) highlights how high the level of Fed Funds reached before a recession then ensued. Obviously, the late 1980s stands out because the effective Fed Funds rate hit “double-digit” territory prior to the early 1990’s economic downturn. The subsequent episodes show Fed Funds increasing to at least the 5% threshold pre-recession. One might ask, what about the last rate hike cycle, when the top band of the Fed Funds trading range was only 2 ½%? Well, the short-lived 2020 recession was due to a once-in-a-generation pandemic. Without COVID-19 lockdowns, I would argue that the U.S. economy would have avoided a recession. In other words, at present, monetary policy has a long way to go before it enters “restrictive” territory.
ON THE “QT”

Fed rate hikes certainly garner the lion’s share of the headlines, and rightfully so. But the policy makers’ plans to reduce its balance sheet are rather important for the rate outlook as well.
The Fed wrapped up its latest quantitative easing (QE4) program in March, when the policymakers bought an incredible $4.8 trillion in U.S. Treasuries (USTs) and mortgage-backed securities (MBS) (figure 2). (The Fed did not buy any federal agency securities in this round of QE.) Think about that number for a minute. QE1, QE2 and QE3 purchases all added up to bring their total securities holdings to about $4.25 trillion over a six-year period (2008–2014). The just-completed QE4 surpassed that total in just two years.

So, let’s look at where and how the Fed added to its balance sheet (figure 3) from its pre-COVID-19 readings in early 2020. As I just mentioned, total holdings more than doubled to roughly $8.5 trillion, with USTs making up 72% of the overall increase, or $3.4 trillion. For the record, MBS purchases made up the remainder, with an increase of $1.3 trillion. Within the UST component, 42% of the Fed’s buying occurred in maturities that are five years or greater. Against this backdrop, it is reasonable to assume that this sector of the UST curve, which includes the 10-Year maturity, will see a visible drawdown once the Fed begins this part of its exit strategy.

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<thead>
<tr>
<th>Figure 3: Federal Reserve Holdings of U.S. Treasuries, Mortgage-Backed Securities and Federal Agency Securities Balance Sheet (millions of dollars-details may not add due to rounding)</th>
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<tr>
<td><strong>Change</strong></td>
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<tr>
<td>Total Holdings</td>
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<tr>
<td>U.S. Treasuries</td>
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<tr>
<td>1-Year or less</td>
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<tr>
<td>Over 1-Year to 5-Years</td>
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<td>Over 5-Years</td>
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<td>Mortgage-Backed Securities (MBS)</td>
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<td>Federal Agency Securities</td>
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Source: Federal Reserve, as of 3/24/22.

Not to get too technical, but there are two ways the Fed can reduce its securities holdings. The most obvious method would be to implement outright sales of its UST and/or MBS positions. This option will more than likely come later rather than sooner. That brings us to option 2, which is more passive in nature. This method allows its maturing/redeemed holdings to roll off without full replacement, which is the Fed’s first choice. So, what should investors expect to see from QT? According to Federal Reserve Chair Jerome Powell (Chair Powell), the balance sheet drawdown will “look similar to last time” but “move faster than last time.”

THE RATE HIKES

The money and bond markets have certainly exhibited an interesting pattern when trying to figure out what Fed rate hikes might look like. Earlier in the year, the implied probability for Fed Funds Futures revealed a more deliberate path for rate hikes in 2022, with 25-bp moves being the norm. A 50-bp increase was really yet to be considered. Indeed, “only” three increases were priced in to begin 2022, but as investors witnessed, this outlook changed quickly. By the end of January, expectations shifted for five hikes, and February began the move to potentially factor in a 50-bp move to the upside.
Led by recent comments from Chair Powell, as of this writing, Fed Funds Futures have now priced in a total of 200 bps more in additional tightening this calendar year. In order to achieve this number of rate increases, the math points you to the possibility of more than one 50-bp hike, which would bring the Fed Funds trading range to 2 ¼%–2 ½%. Interestingly, this was the exact level of Fed Funds when the Fed finished its previous rate hike cycle in 2018.

The difference this time around is that this level would more than likely not be the terminal rate for Fed Funds. We still have 2023 rate hikes to look forward to. Thus, it is entirely possible the markets could be looking at a top end of the Fed Funds trading range of 3%, 3 ¼% or maybe even 3 ½% when all is said and done.

Comparisons have been made to the Greenspan/Bernanke\(^1\) 2004–2006 rate hike episode (a 25-bp increase per each Federal Open Market Committee (FOMC) meeting). However, Powell & Co. seem to be guiding the markets to a more front-loaded approach for this go-round. Instead of getting caught up in the world of Fed Funds Futures (their track record does leave something to be desired), investors should focus on the broader picture, and the clear-cut message from the Fed is that rates are going higher.

**CAN’T FORGET THE YIELD CURVE**

Given the lion’s share of headlines of late, one has to address the shape of the yield curve. The UST 2-Year/10-Year spread is one of the more closely watched measures on this front, and yes, it has already touched into negative territory, albeit just barely. Nevertheless, this development certainly “hit the tape” in a noteworthy fashion. In what was an unusual scenario, going back to 1990, the shape of this construct was the narrowest it had ever been going into a rate hike cycle. So, an inversion was not really that much of a leap.

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\(^1\) Refers to Alan Greenspan’s (1987–2006) and Ben S. Bernanke’s (2006–2014) terms as Chairs of the Federal Reserve of the United States.
with maturities five years or greater. It is readily apparent this incredibly large sum of purchases has no doubt served to keep a lid of sorts on the UST 10-Year yield.

So, let’s take a look at an alternate yield curve measure in figure 5 that is also closely followed, the UST 3mo/10yr gauge. Once again, much like the UST 2s/10s differential, this construct has a very good track record as being a leading indicator of a recession following an inversion. However, if you look closely at these two graphs, you’ll notice two completely different landscapes. In the case of the UST 2s/10s curve, it is quite clear there has been a distinct narrowing trend, with the spread declining by 75 bps year-to-date. In contrast, the UST 3mo/10yr spread has actually widened 35 bps thus far in 2022.

Which curve should we put more weight on? At this juncture, I feel the UST 3mo/10yr curve aligns more closely with the earlier points I was making regarding the Fed’s “starting points.”

CONCLUSION

Powell & Co. have made it crystal clear where interest rates will be headed…up. Against this backdrop, investors should be considering strategies to mitigate the potential for higher yields in the bond market. As we’ve seen thus far in 2022, rising rates can and will most likely continue to occur across the board, with even short duration and Treasury Inflation-Protected Securities (TIPS) being susceptible to this trend.

With literally “nowhere to run or hide” in this environment, investors may wish to consider one solution that is actually designed for Fed rate hikes: Treasury floating rate notes (FRNs). These securities are offered in two-year maturities and are reset with the weekly 3-month t-bill auction. As a result, the UST FRN yield “floats with the Fed.”

The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means to tap into this strategy and help protect their bond portfolio for what could be looming ahead over the next two years.
Glossary:

Balance sheet: Refers to the cash and cash equivalents part of the Current Assets on a firm’s balance sheet and cash available for purchasing new positions. Basis point: 1/100th of 1 percent. Bond: A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental). Drawdowns: Periods of sustained negative trends of return. 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. Effective Federal Funds Rate: The interest rate banks charge each other for overnight loans to meet their reserve requirements. Also known as the Federal Funds Rate, the effective Federal Funds Rate is set by the Federal Open Market Committee, or FOMC. Fed Fund Futures: A financial instrument that lets market participants determine the future value of the Federal Funds Rate. Fed Funds target range: The interest rate band the Federal Open Market Committee decides to implement for the Federal Funds Rate. Fed interest rates: Refers to the Federal Funds Rate, which is 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. Fed tightening: Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth. Federal agency security: A low-risk debt obligation that is issued by a U.S. government-sponsored enterprise (GSE) or other federally related entity. Federal Funds (Fed Funds): Excess reserves that commercial banks and other financial institutions deposit at regional Federal Reserve banks. 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. Federal Open Market Committee (FOMC): The branch of the Federal Reserve Board that determines the direction of monetary policy. Federal Reserve: The Federal Reserve System is the central banking system of the United States. Floating rate notes (FRN): A bond that has a variable interest rate versus a fixed rate note that has an interest rate that doesn’t fluctuate. The interest rate is tied to a short-term benchmark rate. Interest rates: The rate at which interest is paid by a borrower for the use of money. Maturity: The amount of time until a loan is repaid. 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. Monetary tightening: A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast. Mortgage-backed securities (MBS): Fixed income securities that are composed of multiple underlying mortgages. 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. Quantitative tightening (QT): Quantitative tightening is the reverse process of quantitative easing whereby securities are either sold or the proceeds of maturing securities are not reinvested, with the goal of tightening economic conditions to prevent the economy from overheating. Rate hike: Refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the target Federal Funds Rate. Recession: Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment. Run-off: Reduction of a loan portfolio as loans are paid off at scheduled maturity dates or when borrowers prepay their loans. Spread: Typically refers to the difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely. Stagflation: A situation in which the inflation rate is high, the economic growth rate slows. Terminal rate: The terminal rate is what economists call the natural or neutral interest rate. It is the rate that is consistent with full employment and capacity utilization and stable prices. 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 (t-bill): A Treasury 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). 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. U.S. Treasury (UST): United States Treasury, the federal government division that manages U.S. finances. UST is commonly used to reference debt that is issued by the United States. 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. 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.
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