Upside Down…the Yield Curve Inverts

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Last week, the big news was that the U.S. Treasury (UST) 3-month/10-year yield curve became inverted for the first time since 2007. It is certainly a noteworthy development in bond-land. As of this writing, the closely watched UST 2-year/10-year spread is still on the positive side at 15 basis points.

Here are some quick insights:

- The effect of last week's Federal Reserve (Fed) meeting is still resonating, with any economic data being viewed through that prism accordingly.
- The catalyst for this latest inversion may have been the continued soft performances of the eurozone Purchasing Managers' Indexes (PMIs), specifically those of the manufacturing sector and Germany.
- The manufacturing PMIs for Germany, France and the eurozone are now all in recession territory, with Germany's at its lowest level since 2012.
- The 10-year German bund yield dropped into negative territory as a result of the PMIs.
- This is important for the U.S. rate outlook because the Fed mentions global growth as one of its primary concerns.
- U.S. economic data has been more mixed but does suggest a slowing in Q1 growth.
- The U.S. PMI came in below consensus for March, but still safely above the "50" threshold of contraction versus expansion.
- Existing home sales increased by 11.8% in February.
- The data on housing, an interest-rate sensitive sector of the economy, is important because if the rise in U.S. rates is going to start having negative repercussions, this is a logical place for it to start.
- At its meeting last week, the Fed lowered its 2019 gross domestic product (GDP) forecast by only 0.2 pp and kept core PCE unchanged. Three months ago, a somewhat similar scenario resulted in two rate hike projections, but now the result is none. Following the December FOMC meeting, the Fed may be operating with an overabundance of caution.
- The most important outcome of last week's Fed meeting may be that there was no mention of, or forecast for, *rate cuts*. In contrast, fed funds futures have now priced in one rate cut for this year.
- The UST 10-year yield broke through the five-year Fibonacci 61.8% retracement of 2.5178. The next level is 50% retracement at 2.2887.

- I'm not necessarily projecting this is where we go, but if upcoming U.S. economic data comes in soft, the glide path is there.
- What about U.S. economy surprises to the upside? The UST market is not priced for this scenario at all. In fact, the UST 10-year relative strength index is back in "overbought" territory. It's had a good track record.

Conclusion

How might an investor position their fixed income portfolio in the current environment? I think one should use the inverted yield curve to their advantage. With the WisdomTree Floating Rate Treasury Fund (USFR), investors can capture an average yield to maturity of 2.55%, as of this writing, with a duration of 0.02 years. Compare this to a UST 10-year note yield of 2.44%. The Treasury floating rate note strategy offers an innovative, strategic solution for the short-government allocation for fixed income.

Unless otherwise stated, all data is Bloomberg, 3/25/19.

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