THE HIGHEST-YIELDING TREASURY SECURITY…REVISITED

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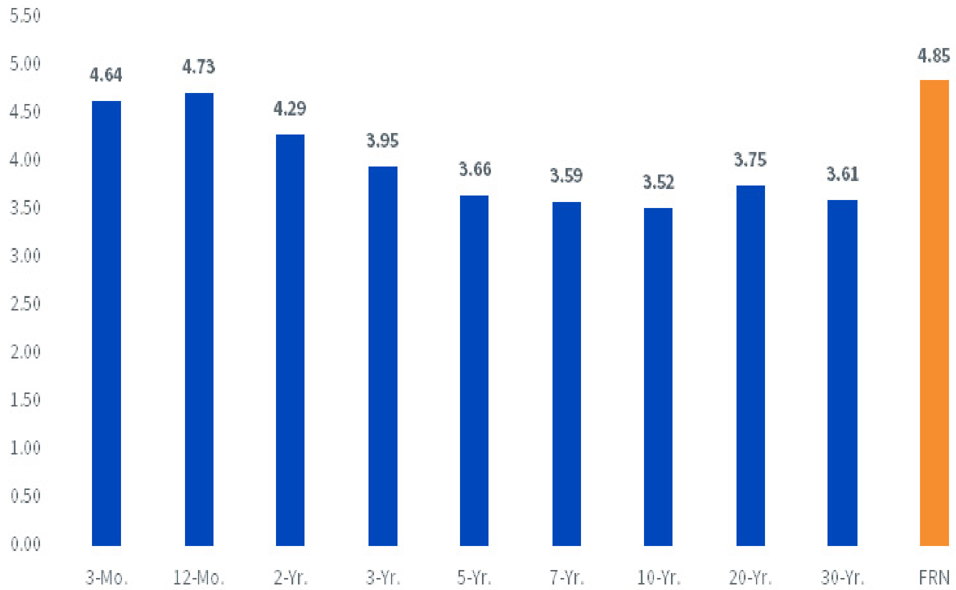
With 450 basis points (bps) worth of Fed rate hikes on the books since last March, the U.S. Treasury (UST) market has now arrived at another milestone. UST floating rate notes (FRN) are now the highest-yielding Treasury security, at 4.85% as of writing.

The natural question to ask is where does it go from here? Well, where we go from here just got a lot more interesting following the January jobs report. Total nonfarm payrolls surged by an entirely unexpected 517,000—the rest of the report was also solid, highlighted by a 3.4% unemployment rate, the lowest since 1969! In fact, it prompted San Francisco Fed President Daly to describe the jobs report as a "wow number."

U.S. Treasury Yields



Source: Bloomberg, as of 2/4/23. Past performance is not indicative of future results.

The UST market may have reacted positively to Chairman Powell's post-FOMC meeting presser last week, but I never really thought the Fed outlook had changed all that much. Given bond market sentiment since the beginning of the year (if not even a little further back), absent Powell declaring a 'you've got it all wrong' approach, it seemed that lower UST fixed coupon yields were going to be the path of least resistance.

Well, now that the money and bond markets are faced with that unexpected labor market setting, perhaps some newfound monetary policy reflection will be in order. In other words, another rate hike certainly looks like it's coming at the March FOMC meeting. And, if the jobs numbers don't weaken significantly after that, another rate hike could be in the offing for May. Perhaps more importantly, the Fed could be on a longer period of 'pause,' and hence the timing for potential rate cuts gets pushed back accordingly.

That brings us back to the USR FRN yield. A scenario whereby the Fed raises rates at least once more and goes on hold for an extended period will more than likely keep this security among the highest yielders in the Treasury market. Even with the backup in UST fixed coupon yields post-jobs, the UST FRN yield is still close to 60 bps above the 2-Year level and an eye-opening 133 bps over the 10-Year yield, as of this writing.

Conclusion

As I blogged in late November, I keep going back to the shape of the Treasury yield curve and what investors are (perhaps 'are not' is a better way of looking at it) being compensated for. At current yield levels, UST fixed coupon securities remain vulnerable to economic data surprises such as the aforementioned jobs report, especially with the Fed apparently now in full data-dependent mode. You need to ask yourself the question: why should I expose myself to heightened volatility and speculative rate risk when I can use UST FRNs to avoid such outcomes AND receive a higher yield than from Treasury fixed coupons? The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means of investing in the UST FRN space.

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DEFINITIONS

Basis point : 1/100th of 1 percent.

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

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.

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.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

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

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Coupon : The annual interest rate stated on a bond when it’s issued. The coupon is typically paid semiannually. This is also referred to as the “coupon rate” or “coupon percent rate.&rdquo.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .