DON'T GO CHASING WATERFALLS

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08/03/2022

What a whirlwind week for the bond market. Investors were greeted with an historic Fed rate hike, another 40-year high for inflation and a second consecutive negative quarterly reading for real GDP—in other words, a technical recession. There's no doubt these conflicting storylines present a confusing backdrop for fixed income investors when positioning their bond portfolios. My advice: don't go chasing waterfalls.

Prior to last week's disappointing Q2 real GDP report, there had been increasing discussion about whether rates, such as the UST 10-Year yield, had peaked and was it now time to 'go longer duration.' Obviously, the back-to-back negative readings for the economy gave that narrative something of a jump-start, as the UST 10-Year yield continued its descent to lower territory.

There are two very important considerations to keep in mind when addressing this question. Obviously, the first element is whether bond yields will rise again from current levels, fall further or, at best, remain stable. My concern revolves around the incredible volatility and whipsaw pattern the UST 10-Year yield has shown in the last three months. As highlighted by the graph below, investors have witnessed the UST 10-Year yield go from close to 3.25% back down to 2.75%, only to see it then rise to about 3.50%. It is now back to around 2.60%.

U.S. Treasury 10-Year Yield

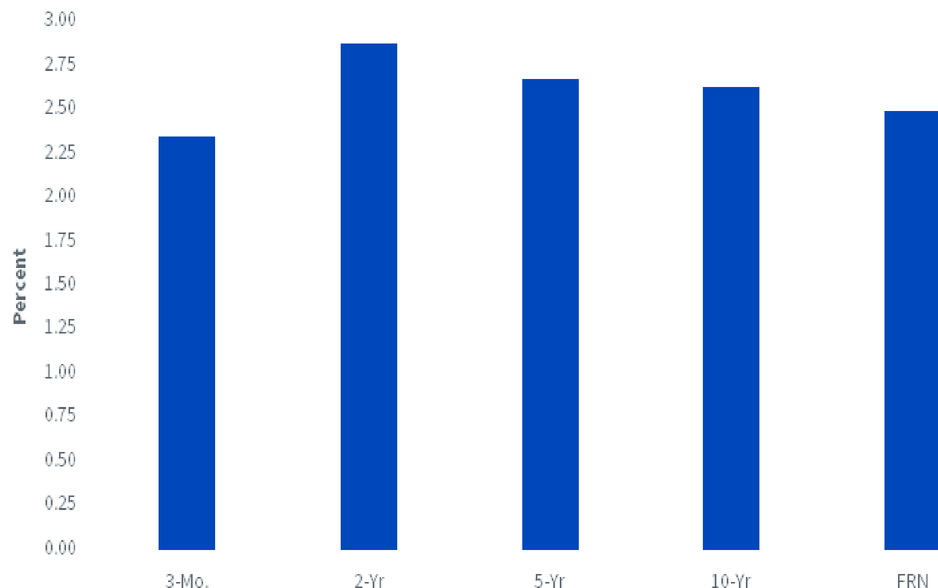
Source: Bloomberg, as of 7/29/22.

Typically, this is not the type of volatility an investor wishes to see in their bond portfolio. And I'm in the camp that believes this elevated volatility will remain a part of the investment landscape during the second half of this year.

Against this backdrop, one has to wonder if the UST 10-Year yield has gotten ahead of

itself a bit. From a monetary policy perspective, the Fed seems poised to continue raising rates this year. Quantitative tightening (QT) will soon be kicking into high gear, and as we've continued to see, inflation will more than likely remain 'sticky.' And, if you believe the latest economists' projections, real GDP could bounce back into positive territory in Q3. Most estimates are placing growth for this quarter around the 2% vicinity.

U.S. Treasury Yields



Source: Bloomberg, as of 7/29/22.

The second consideration is whether an investor is being compensated for the potential added interest rate risk by moving into longer duration. Quite a lot of attention has been centered on how flat and/or inverted the shape of the Treasury yield curve has become (see above). In other words, the present UST 10-Year yield level offers little, if any, cushion for potential mistakes that could result in another move to the upside.

Interestingly, UST floating rate note (FRN) yields have now closed the gap. They are currently higher than 3-month t-bills and within striking distance of the 5- and 10-Year maturities. To provide perspective, the UST FRN yield is only 13 basis points (bps) below the UST 10-Year rate but carries a duration profile of just one week.

Conclusion

With the Fed expected to continue raising rates during its three remaining FOMC meetings this year, it is very likely UST FRN yields could match, or even exceed, some fixed coupon securities along the Treasury yield curve in the not-too-distant future. Against this backdrop, investors may want to consider the risk/reward profile of their fixed income positioning. The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means of investing in the U.S. Treasury floating rate note space.

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DEFINITIONS

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.

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

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.

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.

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.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

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

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process 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.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

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.

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).

Basis point : 1/100th of 1 percent.

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