U.S. TREASURIES: WHAT IF…?

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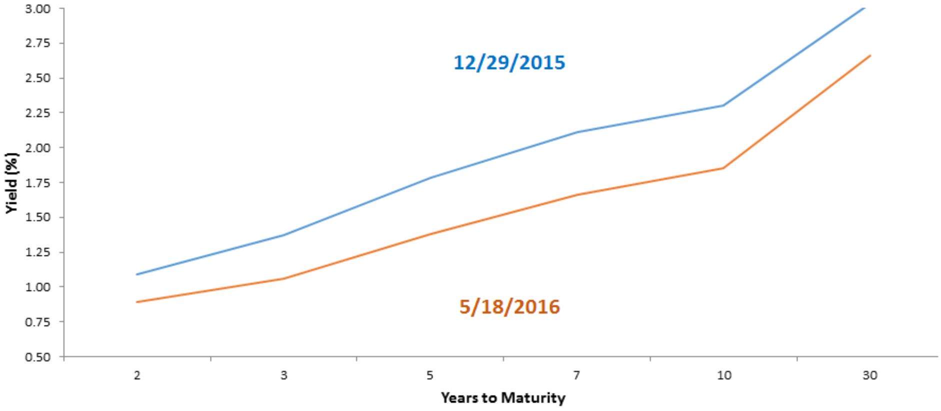
And so it begins…the conjecture surrounding Federal Reserve (Fed) policy. The money and bond markets are still discounting only one full rate hike in 2016, but recent price action and commentary have, at a minimum, brought back the idea that perhaps a move at the June FOMC meeting is not out of the realm of possibility. The mere fact that a potential June rate hike is even up for discussion is a rather interesting development, considering where sentiment stood in the U.S. Treasury (UST) market only a few short weeks ago. So, what changed? In terms of the Fed's dual mandate, inflation has moved a bit more in the direction the policy makers would prefer. Wages, as measured by average hourly earnings, have risen to the high end of the band that has existed for the last few years and returned to levels not seen on a consistent basis since 2009. With respect to the FOMC's key focus on global economic and financial developments, gross domestic product (GDP) figures for the eurozone and Japan revealed a good start for Q1 (although recent data from China has been on the disappointing side), while crude oil prices have maintained their recent upward trajectory. That brings us back to our title: "What If" the Fed were to raise rates in June? As mentioned in our May 4 blog post, "Don't Let the Door Hit You", we believe the Fed would telegraph such a move and not just spring a rate hike on the markets at the FOMC meeting. However, getting from point A (current UST yields) to point B (UST yields post-rate hike) could result in a visibly different setting than the present one. In fact, the recent price action mentioned earlier may offer some clues as to what to expect. Indeed, just within the last couple of weeks, the UST yield curve has experienced some shifts. Typically, during a Fed rate hike cycle, the shape of the yield curve will flatten, as shorter-dated yields move up more than their longer-dated counterparts. Within the last two weeks, this is exactly what has transpired, as the spread between the 2-Year and 10-Year UST yield has narrowed by about 10 basis points (bps). As of this writing, this differential has once again fallen below the +100 bps threshold (a situation that also occurred a handful of times in February and March of this year), the lowest readings since 2007. **U.S. Treasury Yield Curve**



Source: Bloomberg, 5/18/2016. Past performance is not indicative of future results.

For definitions of terms in the chart, visit our glossary. The graph above may provide some clues as well. Clearly, UST yields have moved collectively lower from their most recent high points, which not coincidentally occurred after the Fed's first rate hike in December. The graph also underscores the point that recent UST yields had not discounted additional Fed action and would be vulnerable to the notion of pushback from policy makers about a potential rate increase. The April FOMC minutes highlighted this fact, as “most participants” continued to leave the door open for a June rate hike if conditions warranted such a move, and as a result, UST yields rose in a knee-jerk fashion. While UST yields would more than likely mirror any rate hike , they don’t necessarily have to return to their late December readings. In fact, potential increases could be limited, depending upon how other markets respond—especially equities and energy. **Conclusion** In such a “What If” scenario, fixed income investors will likely be looking to mitigate the potential effect of interest rate risk from Fed policy decisions on their portfolios. The WisdomTree Bloomberg Floating Rate Treasury Fund (USFR) could represent an investment solution in such a setting. Given the floating structure, investors may be better able to insulate their bond portfolio as compared to a more traditional fixed income investment, and potentially receive greater compensation as well in the event the Fed were to maintain a course of additional rate hikes in the future.

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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.

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

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.

Inflation : Characterized by rising price levels.

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

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

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.

Basis point : 1/100th of 1 percent.