FED WATCH: THREADING THE NEEDLE

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For the second meeting in a row, the Fed implemented a 25 basis point (bp) rate hike, bringing the new Fed Funds trading range to 4.75%–5%. The question on everyone's mind now is will the Fed continue on its rate hike mission, or will there be a pause or even a rate cut in the near future? Given this newfound level of uncertainty, the Fed is trying to thread the needle.

According to its policy statement, besides the aforementioned rate hike, the policy maker is also now trying to give itself some flexibility for future decisions. Indeed, the language was changed to reflect such a dynamic. While it does not necessarily state the Fed is going to pause now (let alone consider rate cuts), it does suggest that future decision-making is now both data and financial condition dependent.

In the pre-Silicon Valley Bank (SVB) world, based upon economic data and Powell's Semiannual Monetary Policy testimony only two short weeks ago, the debate surrounding today's meeting would probably have been whether the voting members hike by 25 bps or 50 bps. However, the post-SVB world brought the debate to either no rate increase or the one-quarter point the markets ultimately received. There's no doubt the Fed was in a "pickle," as there were legitimate concerns that if Powell didn't raise rates at this convocation, the markets might have been "spooked" by the thought that perhaps bank/financial conditions were worse than previously thought.

What comes next? If the post-SVB world calms down in the financial markets and the economic data looks anything similar to the January/February reports up to this point, another rate hike at the May FOMC meeting should not be ruled out. Conversely, ongoing market dislocations could outweigh the data and push the Fed into pause mode. As of this writing, the implied probability for Fed Funds Futures looks for a rate cut during the summer. In my opinion, the only way that scenario comes to fruition is if the post-SVB world deteriorates from a market and/or economic perspective. And don't forget its balance sheet and quantitative tightening (QT) as being a potential part of the mix.

A Potential Investment Solution

There is no doubt that the investment landscape is fraught with elevated uncertainty and, of course, the volatility that comes with it. Although the U. S. Treasury (UST) market has been the safe-haven choice for investors, the level of volatility has risen to levels not seen since 2008, with wide swings being readily apparent in fixed coupon yields specifically. One sector of the UST market that has not witnessed this heightened volatility is floating rate notes (FRNs). UST FRNs are reset with the weekly 3-Month t-bill auction and, as such, have not been subject to the headline/speculative risk the post-SVB world has brought. The floating mechanism allows UST FRNs to be anchored by the Fed Funds Rate, not the 2- or 10-Year note, as an example.

Based upon this reference rate, UST FRNs have now become the highest-yielding security in the Treasury market, offering investors a means of capturing income, but without the volatility. In fact, one of the issues that has been brought front and center is that banks had failed to keep up with the increase in the Fed Funds Rate in terms of what they were offering on deposits. In addition, unlike vehicles such as certificates of deposit (CDs) or t-bills, there is no lock-up period. The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a solution and a means of investing in the Treasury floating rate market.

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DEFINITIONS

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

Basis point : 1/100th of 1 percent.

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.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

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.

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

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.

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

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.

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).

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.