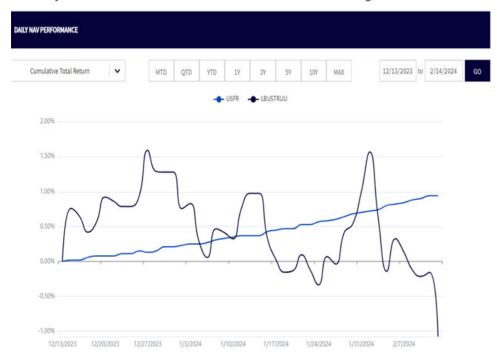
TREASURY FRNS: NOT JUST A RATE HEDGE

Kevin Flanagan - Head of Fixed Income Strategy 02/21/2024

This year marks the 10-year anniversary of the issuance of <u>U.S. Treasury (UST)</u> floating rate notes (FRNs). Back in January 2014, the nation's debt managers auctioned the first tranche of these new securities, and over the years, UST FRNs have grown to be an important part of the Treasury's regular financing calendar. However, arguably more pertinent, they have become an integral aspect of investors' fixed income portfolios. Typically, FRNs of any kind are viewed as being more of a tactical interest rate "play," but in the case of Treasury floaters, investors are discovering that they also offer a strategic solution beyond being just a rate-hedging strategy.

There is no doubt that UST FRNs served as a formidable investment strategy to help navigate the Fed's recent historic rate hike cycle and attendant surge in Treasury yields over the last two years. In fact, one could argue that at times during this rate increase period, it seemed as if investors had no place to hide but in UST FRNs, as a variety of different asset classes were in the negative column.



Source: WisdomTree, as of 2/15/24.

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For the most recent month-end and standardized performances and to download the respective Fund prospectuses, click here.



In order to take advantage of the opportunities Treasury FRNs could offer investors, we launched the <u>WisdomTree Floating Rate Treasury Fund (USFR)</u> back in early 2014 as well. In other words, <u>USFR</u> is also celebrating its 10-year anniversary this year. While investors quickly gravitated to the benefits of this strategy when the <u>Fed</u> was tightening monetary policy, it is becoming increasingly apparent that this approach is also a solution to consider from the current and prospective interest rate landscapes.

With the pivot from Fed <u>rate hikes</u> to the prospect of Fed <u>rate cuts</u> now apparently in full swing, investors have been getting a firsthand look at how Treasury FRNs have been performing versus the broader bond market. The "real" pivot occurred at the December <u>FOM C</u> meeting when Chairman Powell, as well as the <u>dot plots</u>, laid out the Fed's thought process that three rate cuts were being projected for this year.

Over this two-month period, it has been interesting to see how <u>USFR</u> has performed compared to the benchmark <u>Bloomberg U.S. Aggregate Total Return Index</u>, better known as the Agg. As the above graph highlights, the Agg has experienced a rather large amount of volatility as optimistic expectations for the timing and magnitude of potential rate cuts have undergone a visible transformation. It's not that rate cuts have been ruled out, but rather the Fed, along with the labor market and <u>inflation</u> data, has not validated the broader market's early enthusiasm. In fact, the money and <u>bond markets'</u> current rate cut expectations have gone from six to about four decreases, or closer to what the Fed is projecting. Meanwhile, <u>USFR</u> has experienced a steady ascending trend and, as of this writing, has produced a positive total return of just under +1.0% versus a decline of a little over -1.0% for the Agg.

Another important point to consider is the yield differential between the two, where the average yield to maturity for <u>USFR</u> is 5.49%, or about 60 <u>basis points (bps)</u> above the Agg. In addition, the <u>duration</u> profile is strikingly different, as <u>USFR</u> possesses a one-week duration while the Agg's is 6.25 years. In other words, the Treasury FRN strategy is offering visibly more yield without the added duration and elevated volatility of the Agg.

And don't forget the yield curve is still inverted; hence, UST floating rate notes (FRNs) are the highest-yielding Treasury security by a wide margin in many cases. So, even if the Fed cuts rates by 100 bps in 2024, UST FRN yields would more than likely still be close to or above the current fixed coupon Treasury yields.

The Bottom Line

When looking to position their fixed income portfolio, in my opinion, investors should consider using <u>USFR</u> as a strategic lynchpin, as it "checks the boxes" for a variety of rate outlooks.

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DEFINITIONS

<u>Treasury</u>: 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.

<u>Federal Reserve</u>: 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.

<u>Rate Cut</u>: A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

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

<u>Dot Plot</u>: a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

Bloomberg U.S. Aggregate Bond Index: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Inflation : Characterized by rising price levels.

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.

Basis point : 1/100th of 1 percent.

<u>Duration</u>: 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.

