RATES RISING...WHO YOU GONNA CALL?

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With Halloween less than a week away, investors are wondering if the bond market will be giving out tricks or treats. If recent trading activity is any guide, it looks like things are getting rather "spooky," as U.S. Treasury (UST) yields are rising all across the coupon curve, bringing absolute levels back to pre-pandemic levels in some cases. So, in order to obtain some potential future rate protection (and in honor of the time of year we're in), I have to ask the question: who you gonna call?

Based upon recent inflows, it looks like one rate-hedge solution that got the call was the WisdomTree Floating Rate Treasury Fund (USFR). Indeed, just last week USFR saw more than $600 million of inflows. Interestingly, this buying activity was juxtaposed against most other UST-based securities witnessing visible selling pressure, including TIPS and short-duration fixed coupon Treasuries.

Let's take a look at the rate backdrop for a minute. In my blog post from last week, "Five and Dime," I discussed how other parts of the Treasury market, namely the 2-year and 5-year sectors, had joined the 10-year maturity into higher yield territory. That trend was certainly built upon last week, highlighted by a 2-year yield at roughly 0.50%, a 5-year at 1.20% and the 10-year hitting the 1.70% threshold.

What's at the root cause, you might ask? It has become increasingly apparent the collective market is becoming more concerned about inflation. Indeed, the five-year breakeven spread (a widely watched measure of inflation expectations) rose to just under +300 basis points (bps), its highest reading since 2005. In addition, the outlook for future Federal Reserve (Fed) policy has also become less friendly for Treasuries. Sure, a tapering announcement at next week's FOMC meeting has been built in for awhile now, but as we've discussed on many occasions, the market's attention has quickly turned to the next phase of the policy maker's exit strategy, rate hikes. As of this writing, Fed Funds Futures have now essentially "priced in" two Fed rate increases for next year. Remember earlier this year when "taper talk" was just "talk" and virtually no one was thinking about rate hikes? My, have things changed!

Conclusion

Given the recent trading activity in the Treasury space, one could argue that investors appear to be starting the process of preparing their bond portfolios for further increases in rates. The intriguing aspect to all of this is that the Fed hasn't even moved toward "liftoff" quite yet. The natural question becomes what happens when the Fed actually does begin to raise rates? My suggestion: don't wait that long.

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DEFINITIONS

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

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.

TIPS : Treasury Inflation Protected Securities.

Maturity : The amount of time until a loan is repai.

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.

Inflation : Characterized by rising price levels.

Basis point : 1/100th of 1 percent.

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

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.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

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

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

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.