INCOME SANS THE VOLATILITY…A YEAR LATER

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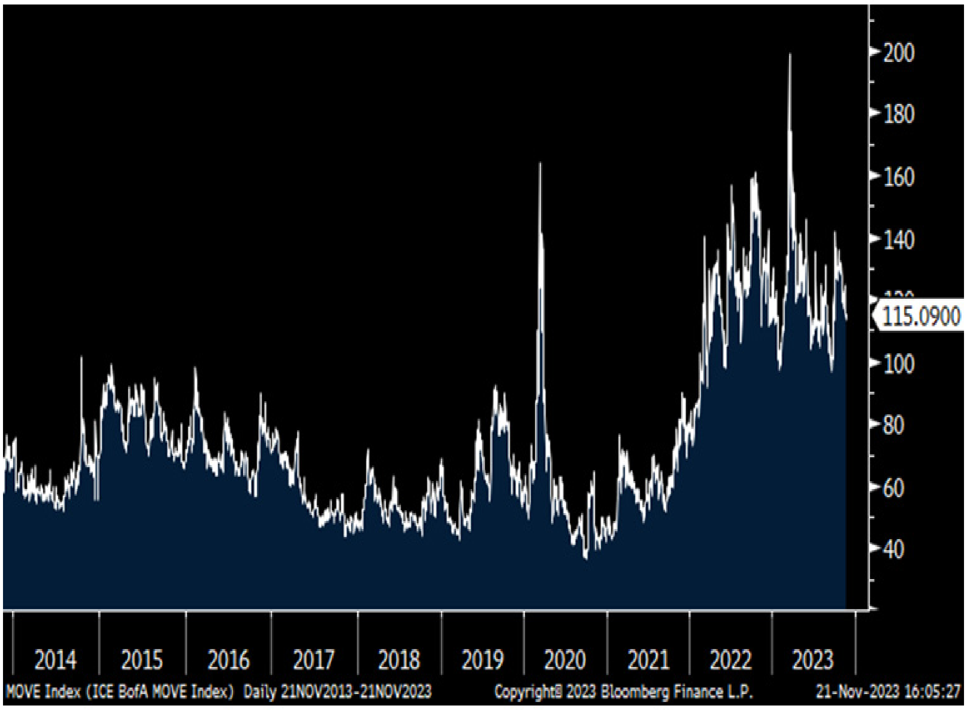
Time sure goes by quickly. A year ago, I wrote a post focusing on an investment solution that aims to provide investors with income but, more importantly, not the elevated volatility that has been witnessed in the bond market over the last two years. Make no mistake—I do believe investors are faced with a new rate regime as we get ready to enter 2024. But sometimes the more things change, the more they stay the same.

ICE BofA MOVE Index



Source: Bloomberg, as of 11/21/23.

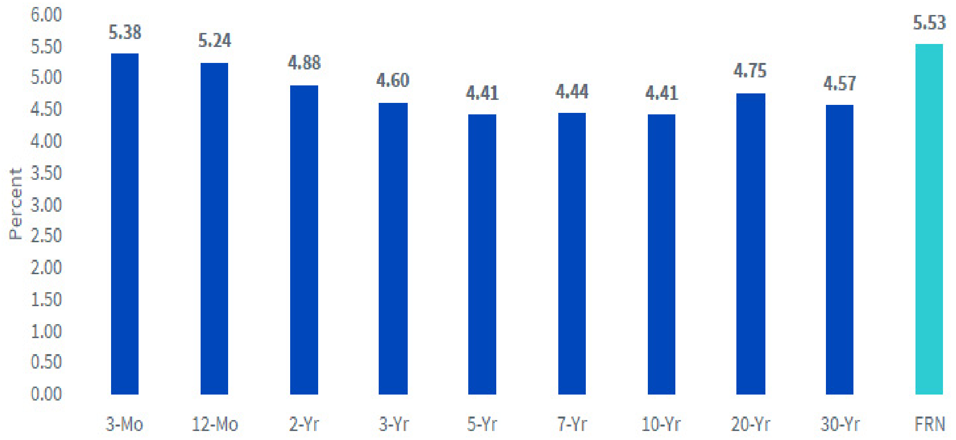
The Volatility Quotient

Let's take a look at trading activity in the U.S. Treasury (UST) market and how the volatility quotient has increased in a considerable fashion over the last two years. The ICE BofA MOVE Index measures the implied volatility of UST options across various maturities, such as the 2-, 5-, 10- and 30-Year securities. For those more familiar with the equity side of the ledger, think of the MOVE index as the bond market's version of the VIX.

As the above graph clearly illustrates, volatility has taken a noteworthy turn to the upside of late, after remaining somewhat stable and/or range-bound from late-2013 up to the Covid-related spike in early 2020. That begs the question: what will the future hold? Well, like in most markets, uncertainty is not a welcome factor in the mix. Unfortunately, it looks as if this issue is not going away any time soon, especially as it relates to monetary policy.

While it appears as if the Federal Reserve may have finally come to the end of hiking rates for this tightening cycle, the two key questions for 2024 will be: 1) how long will the Fed be on hold? and 2) when/how many rate cuts may be in the offing for next year? These unknowns will more than likely create a heightened sense of uncertainty, and when there is uncertainty, there is volatility.

U.S. Treasury Yields



Source: Bloomberg, as of 11/21/23.

The State of the UST Market

Although the Treasury yield curve has steepened over the last few months, it remains inverted. The magnitude of Fed rate hikes created an environment where ultra-short/short-dated maturities continue to have a yield advantage over their intermediate to longer-dated counterparts. Back to the point I made in the opening paragraph, the more things changed (higher rates such as for the UST 10-Year yield), the more they stayed the same (inverted yield curve).

So, let's take a look at where key Treasury yields stand to enter the final month of the year. The accompanying graph highlights the widely watched Treasury maturity spectrum, ranging from the 3-month t-bill on out to the 30-Year bond, and of course, the floating rate note (FRN). This way investors can get an up-close look for themselves at the various yield disparities. As we can see, the UST FRN yield stands at 5.53%, as of this writing, or an eye-opening 110 basis points above the UST 10-Year level.

Income without the Volatility?

From an investment perspective, I keep going back to the shape of the Treasury yield curve, and what investors are being compensated for, especially given the potential for continued volatility. With the Fed apparently in no hurry to cut rates any time soon, UST FRNs will continue to play an integral role in a bond portfolio. This strategy provides investors with both income potential and help mitigating the effects of volatility that can be found in fixed coupon securities. The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means of investing in the UST FRN space.

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DEFINITIONS

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

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.

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.

ICE BofAML MOVE Index (MOVE) : A measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

CBOE Volatility Index® (VIX®) : a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. It is the premier benchmark for U.S. stock market volatility.

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

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

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Inverted Yield Curve : An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

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.

Basis point : 1/100th of 1 percent.