FOMC WATCH: FLOAT LIKE A BUTTERFLY, DON’T GET STUNG BY A BEE

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The results of the May FOMC meeting are scheduled to be released at 2 p.m. Eastern time today. The usual accompanying policy statement will be made available, but there will be no economic projections or press conference this time around. The expectation is for no rate hike at this convocation.

As of this writing, the markets placed only a 34.2% chance for another rate increase at this meeting, according to the Fed Funds Futures implied probability figure. This is not a reflection of any shift in Federal Reserve (Fed) attitudes, as additional rate hikes are still anticipated for later this year and into 2019. To provide perspective, the implied probability for the June 13 gathering stands at 92.0%, underscoring the fact that another move is widely expected. In fact, a total of two further tightening moves for 2018 are fully priced in at this point, and depending upon how upcoming data comes in, there is still a debate about whether three additional hikes could be forthcoming. For the record, the Fed’s latest “blue dots,” or its in-house projections for the Federal Funds Rate, looked for two more increases this year and three hikes in 2019. In fact, the Fed also estimated that it would continue to raise rates twice in 2020, but let’s not get too far ahead of ourselves.

What Should Fixed Income Investors Focus On?

The second leg of the rise in the U.S. Treasury (UST) 10-Year yield came rather abruptly, and with a notable milestone. In the most recent two-week span, the yield jumped 25 basis points (bps), breaching the 3% threshold in the process. While we could all debate where we think the 10-Year yield is headed from here, there appears to be one crucial point not really up for such conjecture: The Fed is expected to continue raising rates.

Against this backdrop, investors should be considering strategies to address this potential outcome, as some Fed protection seems warranted. In our opinion, an optimal solution is the 2-Year Treasury floating rate note (FRN) space. The interest rate for an FRN “floats” or gets reset at the weekly 13-week t-bill auction. As the Fed raises rates, the rate hike is reflected in this t-bill auction, not only offering investors a rate hedge for their portfolios, but also providing the opportunity for higher yield enhancement.

UST FRNs vs. CDs

Some market participants may believe that certificates of deposit, or CDs, are a better

solution. However, there are some important items to consider. First up, UST FRNs are backed by the full faith and credit of the U.S. government. CDs are insured by the Federal Deposit Insurance Corporation (FDIC), but only up to $250,000 per person, per bank, per ownership category.

Let’s look at it from an income perspective. The WisdomTree Bloomberg Floating Rate Treasury Fund (USFR), which seeks to track the price and yield performance, before fees and expenses, of the Bloomberg U.S. Treasury Floating Rate Bond Index, posts an average yield to maturity of 1.81% as of this writing. According to Bankrate, formerly known as Bank Rate Monitor and a provider of various interest rate data, the top five rates for six-month CDs post an average of 1.86%, while the national average for a one-year CD is 2.10%.

The bottom-line message is that there is only a marginal increase in yield, but perhaps more importantly, investors would have to lock up these CD rates for a six-month and/or one-year period. Meanwhile, the yield for a UST FRN can be reset weekly. When one considers the fact that the Fed may be raising rates two if not three more times between now and year-end, USFR offers investors a better opportunity for more timely yield enhancement.

Unless otherwise noted, all data is Bloomberg as of April 27, 2018.

Important Risks Related to this Article

For the standardized performance and 30-Day SEC yield of USFR, please click here.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.

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For the top 10 holdings of USFR please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/usfr

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DEFINITIONS

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

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

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

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

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.

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

Basis point : 1/100th of 1 percent.

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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).

Bloomberg U.S. Treasury Floating Rate Bond Index : A rules-based, market-capitalization-weighted index engineered to measure the performance of floating rate U.S. Treasury notes.