Why the Fed is Issuing Floating Rate Notes. Floating Rate Strategy.

Treasury is reducing issuance of T bills. At the same time they are starting issuance of 2 – 3 year FRNs. Why?

There is a strong consensus among investors that rates will rise and therefore they should reduce duration. As a result they are buying shorter and shorter maturities.

This trend is hurting Treasury’s ability to issue notes and bonds. The only way Treasury can issue outside of a year is to offer a short duration, long maturity instrument. Enter the FRN.

Now, in order for Treasury to control debt service the Fed Funds Rate will have to be kept at 0.25% for much longer since the FRN’s coupons are benchmarked to short rates.

This only confirms what I’ve already expected, that regardless of QE tapering or not tapering, the FFR will be kept low for multiple years.

Strategy:

Don’t expect floating rate credit to profit from rising rates, the short end will not move. Be that as it may, USD duration will still get punished, just not as soon as we thought. We still need USD floating rate funds.

European duration will likely be unaffected. That means you could even buy the EUR or GBP debt of a US issuer. This is interesting. The need for a Euro floating rate fund is perhaps not that urgent as in EUR, you want duration.

EM duration remains bad news. Outside of price controlled goods, inflation is actually a problem. I expect BRIC term structures to underperform. If ever floaters worked, they would work in EM, unfortunately, EM bank debt doesn’t trade.