2022'S HIGH CONVICTION TRADE: RISING RATES

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In 2021, our primary theme was the reflation trade, which obviously turned into the inflation trade when the 'whites of the eyes' of inflation could first be seen back in May. The next step in this investment process is increasingly apparent. The natural next stage in this evolution means rising rates are becoming our primary investment theme for 2022.

It is interesting to note that Treasury (UST) yields have already begun to step into their leading role, with rates all along the fixed coupon yield curve residing at levels visibly above where they stood a year ago, and in some cases, just months ago. Let's take a look at three of the more closely watched Treasury maturities and compare where their yields are as of this writing versus New Year's Day 2021:

- UST 2-Year yield is up 55 basis points (bps)
- UST 5-Year yield is up 86 bps
- UST 10-Year yield is up 55 bps[1]

If you look closely, you'll see that, although yields have increased rather noticeably, the Treasury yield curve, as measured by 2s versus 10s, has actually remained the same. In other words, after a sawtooth pattern to the upside for the UST 10-Year yield, the UST 2-Year note has now caught up and registered an identical rate increase over the last 12 months. The increase of nearly 90 bps in the UST 5-Year note definitely stands out and underscores the reason why rates are poised to move higher from their current levels.

The increase in Treasury yields last year occurred essentially without any assistance from the Fed. Sure the policy makers started tapering their large-scale asset purchases, but that wasn't until November. Even at the December FOMC meeting, when the policy makers announced a quicker end to their tapering process along with a 'dot plot' looking for three rate hikes this year, this result was widely expected. In fact, if you think about it, rates rose with the Fed barely raising a finger in the process.

That is where the key, and arguably most important, part of the 2022 rising rate trade comes into play—namely, the Fed will now be joining the party. So, investors begin this process with the consensus call now looking for three rate hikes this year. The policy makers will be very data-dependent on this front, and if you believe, like we do, that inflation will remain stubbornly high, you may want to take the 'over' on those three rate hikes, not the 'under.' At this point, I believe Powell & Co. will maintain a deliberate approach, but that could change based on future inflation numbers.

Conclusion

Based on our rate outlook, here are three rate hedge solutions to consider:

- **UST-based:** WisdomTree Floating Rate Treasury Fund (USFR) versus short-term fixed coupon Treasuries and TIPS. UST 1–3-Year yields are susceptible to Fed rate hikes, while 10-Year TIPS, or real yields, are not immune to periods of rising rates either.

- **Investment Grade:** WisdomTree Interest Rate Hedged U.S. Aggregate Bond Fund (AGZD) versus corporate floating rate vehicles. Higher yield, with more diversification (representative of the Bloomberg U.S. Aggregate Bond Index) and less concentration in the financial sector.

- **Core Plus:** WisdomTree Interest Rate Hedged High Yield Bond Fund (HYZD) versus bank loans. A quality screen that tilts for income and targets zero duration.

[1] Source: St. Louis Fed, as of 12/22/21

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USFR: There are risks associated with investing, including the possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

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DEFINITIONS

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.

Inflation : Characterized by rising price levels.

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

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Basis point : 1/100th of 1 percent.

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

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.

Dot Plot : 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.

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.

TIPS : Treasury Inflation Protected Securities.

Duration : 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.