
THE WISDOMTREE Q2 2022 FIXED INCOME POSITIONING

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This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

We recently reviewed the [fundamental construction and ongoing management of our “strategic building block” fixed income Model Portfolio](#). As a quick reminder:

- 1. Investment Objective:** Deliver superior risk-adjusted total return and yield relative to its benchmark, the [Bloomberg U.S. Aggregate Index \(the “Agg”\)](#), which broadly tracks the performance of the U.S. investment-grade [bond](#) market and is composed of both government and investment-grade corporate bonds (including U.S. Treasuries and the debt of major industries including real estate, industrial companies, financial institutions and utilities).
- 2. Investment Strategic Framework:** Establish defined risk parameters for key fixed income attributes—[interest rate risk](#), [credit risk](#), [volatility risk](#), [currency risk](#)—to frame the investment approach in meeting the objective.
- 3. Investment Approach:** The portfolio is actively managed with respect to [duration](#), [credit quality](#) and security selection to achieve the desired objective through prudent investment management.

In our March Model Portfolio Investment Committee (MPIC) meeting, we voted to implement a small handful of changes to our fixed income Model Portfolios as we head into the second quarter of 2022. This blog post summarizes those changes and why we made them.

The WisdomTree Economic and Market Outlook for Q2 2022

Before we summarize our recent Model Portfolio changes, let’s put them in the context of our broad market outlook. We recently published our [Economic and Market Outlook for Q2 2022](#). We expressed our opinion that interest rates, with periodic retracements, will move higher as we move through the year, prompted in part by a now-[hawkish Fed](#) that, recognizing it is “behind the curve” with respect to [inflation](#), has embarked on what we believe will be an aggressive “[rate hike](#) cycle” regime.

A quick illustration of recent [yield curve](#) movement captures this point nicely.

Treasury Yield Curve



Sources: WisdomTree, Bloomberg and FactSet, as of 4/21/22. You cannot invest in an index, and past performance does not guarantee future results.

Another way of illustrating recent yield curve movement is by measuring the spread between short-term and long-term rates (i.e., measure the “shape” of the curve, not just its absolute levels). We will use the widely followed “10-year minus 2-year” spread. After briefly [inverting](#) for one day on March 29 (which always raises market concerns about an impending recession), this spread has since widened. This may be in response to Fed Vice Chair nominee Lael Brainard’s recent comments about the commencement of reducing the Fed’s [balance sheet](#) (i.e., “[quantitative tightening](#)”), which may have the effect of pressuring longer-term rates upward.

- 10 Year Treasury Rate (Percent)
- 2 Year Treasury Rate (Percent)
- 10-2 Year Treasury Yield Spread (Percent)



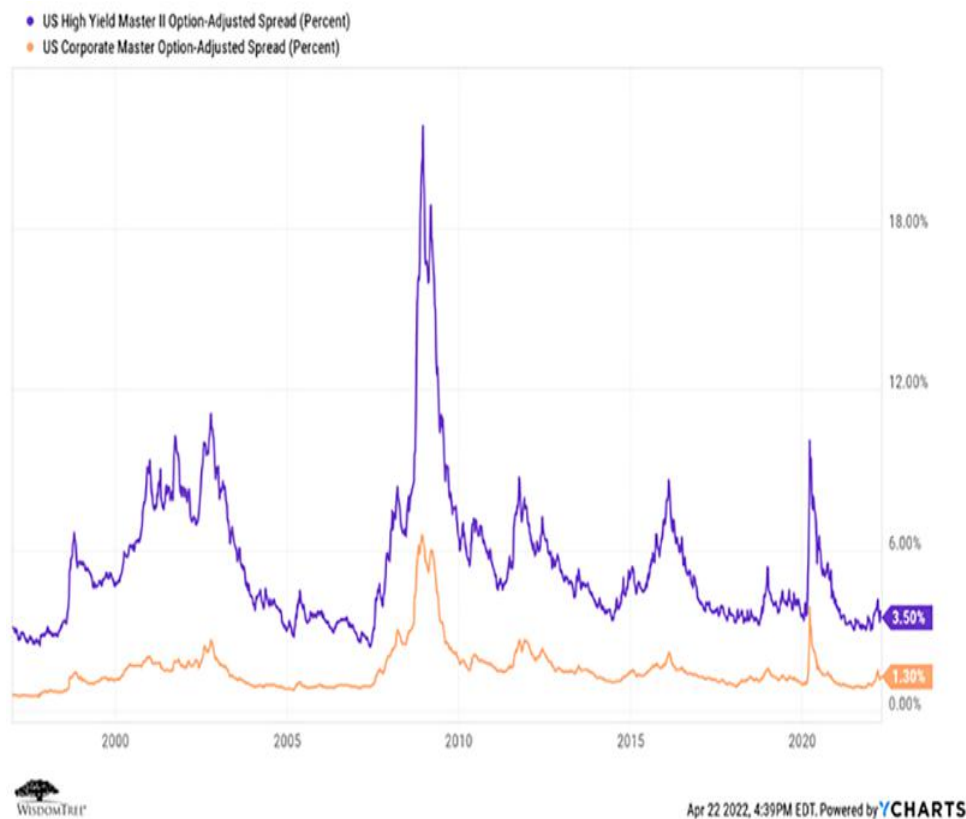
Apr 22 2022, 4:38PM EDT. Powered by YCHARTS

Source: YCharts, 12-month data through 4/21/22. You cannot invest in an index, and past performance does not guarantee future results.

After widening earlier in Q1, credit spreads have since retreated to levels we’ve



experienced for most of the past several years, suggesting that investors remain comfortable with the default risk on their fixed income holdings—a view we agree with.



Source: YCharts, data through 4/21/22. You cannot invest in an index, and past performance does not guarantee future results.

Model Portfolio Positioning

As mentioned above, in our March Model Portfolio Investment Committee (MPIC) meeting, we voted to make a small handful of changes to our fixed income portfolios and allocations. Specifically, even though our portfolios were already shorter in duration compared to the Agg, we voted to further reduce that duration by reducing our allocations to our core bond strategy and intermediate-maturity Treasuries and using those funds to increase our allocation to our [Floating Rate Treasury Fund \(USFR\)](#), which offers rates that reset weekly based on the three-month [Treasury Bill](#) auction rate.

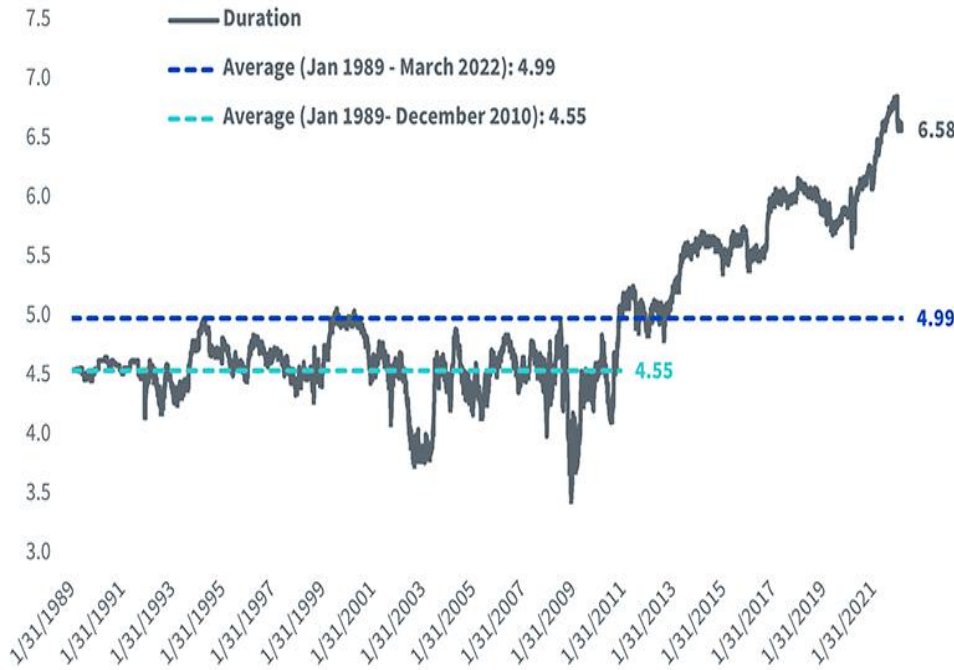
The net result is that we are short duration and over-weight in quality credit relative to the Agg. Typically, as mortgage rates rise, prepayments fall, thereby extending the inherent duration of mortgage-backed securities. We also maintain an under-weight allocation in that space.

Let's dive a little deeper into why we made these changes in the wake of the bond market rout in the first quarter.

1. History suggests "we have only just begun": Rates rose into past rate hike regimes. We examined the evolution of [Treasury yields](#) and core bond performance in each of the five previous "rate hike regimes" (beginning in 1988, 1994, 1999, 2004 and 2015, respectively). In each case, yields on 10-Year Treasuries only peaked after the Federal Reserve had delivered a significant amount of tightening. For example, the 1988 and 1994 cycles each saw the Fed hike rates 175 bps before the 10-Year Treasury yield peaked. The extended 2004 and 2015 cycles saw even more tightening before the Treasury yield plateaued. With only 25 bps of hikes to date, we believe we may still be in the "early innings" of the current ultimate interest rate rise. To us, there does not seem to be any justification for taking excessive duration risk.

2. Extended interest rate risk within core benchmarks: The potential interest rate risk in the Bloomberg U.S. Aggregate has grown exponentially in recent years. For the formative years of our careers, the duration of the “Agg” generally fluctuated between four and five years, feeding common investor perceptions about core bond risks. Zero interest rate policy changed all that. Since 2013, the Agg’s duration has marched steadily higher. Its current level of 6.58 years ranks in the 97th percentile of durations since 1989 and seems disconnected from our past perception of the core bond risk profile.

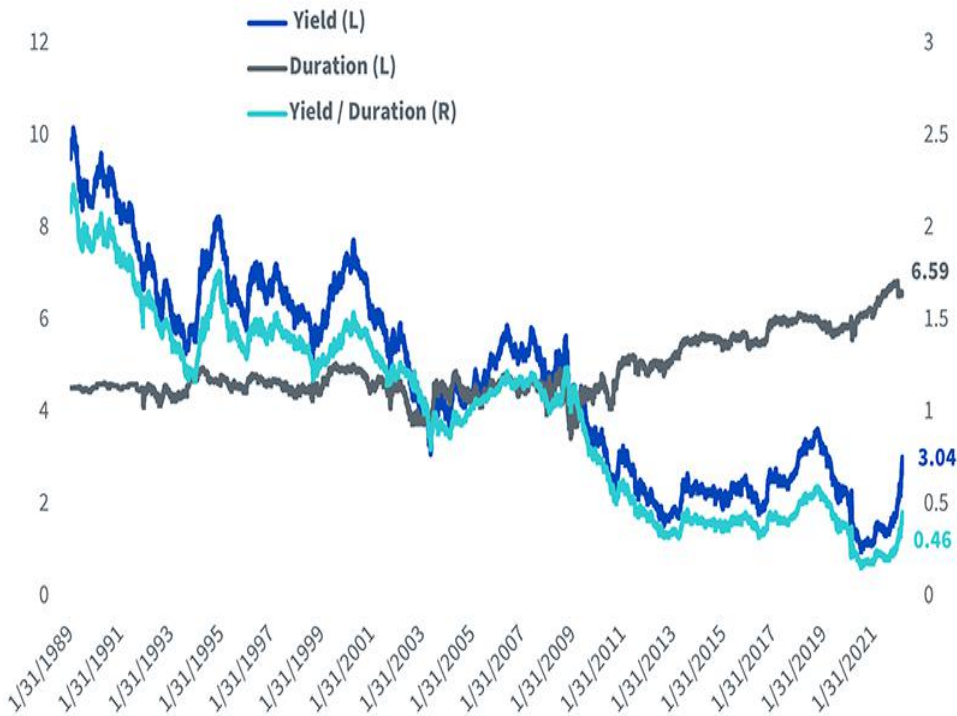
U.S. Aggregate Duration Characteristics



Sources: WisdomTree, Bloomberg, March 2022. U.S. Aggregate: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage- and asset-backed securities.

3. More risk, less compensation: Elevated interest rate risk levels are further complicated by the steady fall in compensation or income to offset this risk. Yields have fallen, and durations have risen, triggering a long-term decline in the “unit of return for unit of duration risk” ratio. You simply are not being as compensated for taking duration risk as you used to be.

U.S. Aggregate Yield and Duration Characteristics



Sources: WisdomTree, Bloomberg, March 2022.

The combination of aggressive Fed tightening cycle, heightened interest rate risk and limited [coupon](#) protection suggests caution is still warranted.

At the same time, one positive aspect of the recent low interest rate environment is that corporations were able to restructure their balance sheets and issue lower-cost debt. Regardless of economic uncertainty, most corporate balance sheets are in decent shape, and we view the overall default risk as low by historical standards. This is why we remain comfortable being over-weight in quality credit.

Conclusions

We tend to be strategic investors at WisdomTree and build and manage our Model Portfolios to seek to perform consistently and as expected over full market cycles. That said, we will make dynamic changes as market conditions change—something that certainly happened in Q1 2022.

Our fixed income Model Portfolios [have performed well and have beaten their benchmark](#) (the Bloomberg Agg) on a total return basis over almost every period since inception in 2013.

With our recent reallocations to further shorten duration and remain over-weight in quality credit, we believe we are well-positioned for the market conditions we expect to see over the remainder of 2022 and beyond.

You can learn more about all our Model Portfolios, including full transparency into allocations, individual securities, fees, yield and performance, at our [Model Adoption Center](#).

We invite you to take a look.

Important Risks Related to this Article

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For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

+ [Portfolio Pilates: Building a Strong Core, Part II](#)

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

Bloomberg U.S. Aggregate Bond Index: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Bond: A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

Interest rate risk: The risk that an investment's value will decline due to an increase in interest rates.

Credit risk: The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Volatility Risk: The risk of a change of price of a portfolio as a result of changes in the volatility of a risk factor.

Currency risk: the risk that an investment will decline in value due to a change in foreign exchange rates.

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.

Credit quality: A measure of a borrowers potential risk of default.

Hawkish: Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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

Inflation: Characterized by rising price levels.

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.

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

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.

Balance sheet: refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Quantitative Tightening: Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

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).

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."