DIVIDED HIGHWAY AHEAD?

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11/19/2020

Here we are two weeks out from Election Day, and at this point anyway, it looks as if the U.S. government could be a divided highway. Based on the results as of this writing, come late-January 2021, the money and bond markets could be looking at a President Biden, a Republican Senate majority and a Democrat House of Representatives.

A divided government as outlined above would seemingly mean there shouldn't be any dramatic shifts in the current fiscal policy setting. Sure, executive orders and attendant regulatory action could occur, but meaningful legislation on taxes and spending would more than likely not transpire in such an arrangement. Arguably, an additional pandemic-related fiscal stimulus package could get passed on a bi-partisan basis. However, as I recently blogged, the Fed would continue to be a key force on the bond market landscape, and as a result, it's 'pedal to the metal'.

In our opinion, 10-year Treasury yields could move higher in this scenario, but still remain low from a historical perspective. So, how does a bond investor get income without incurring too much risk?

Rather than attempting to enhance yield by extending duration, our preferred approach would be through credit within the high-yield (HY) space. But not just a blanket market cap-based approach to HY. Rather investors should consider a strategy that offers a quality cut for HY by including only public issuers and excluding those with negative cash flow. The WisdomTree U.S. High Yield Corporate Bond Fund (WFHY) has both these important investment attributes.

Typically, HY is viewed as having a relatively tight correlation to equities. However, WFHY has shown that its downside, compared to the broader stock market in the two most recent notable risk-off episodes, was visibly lower. Although different time frames may produce different results, consider these two periods under review:

- 2/19/20–3/23/20: S&P 500 was down -33.8% vs. WFHY at -20.5% at NAV; only a 60% correlation
- 9/20/18–12/24/18: S&P 500 was down -19.4% vs. WFHY at -4.5% at NAV; only a 23% correlation

Conclusion

Given the current and prospective interest rate setting for the year ahead, bond investors will once again be confronted with a challenging setting for finding income. With rates at historical lows, the typical equity hedge that longer-term Treasuries offered may not be applicable from an asset allocation standpoint. Against this backdrop, a solution such as WFHY may offer investors the opportunity to enhance income while taking a quality screen into consideration as well.

Unless otherwise stated, data source is Bloomberg as of 11/13/20.

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DEFINITIONS

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

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

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.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

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