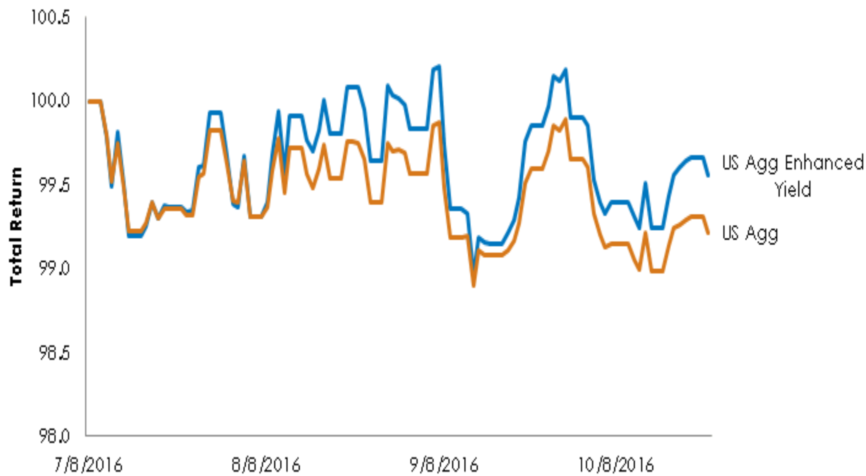
U.S. FIXED INCOME: GOING TO THE CORE

Kevin Flanagan – Head of Fixed Income Strategy
11/03/2016

With the Federal Reserve (Fed) "back in play" in the money and bond markets, investors are discussing rising rates once again. As one looks back over the last three to four months, it is interesting to note that U.S. Treasury (UST) yields—specifically, for the 10-Year note—have already moved off their summertime lows, despite no official policy action from the Fed. Against this backdrop, we feel it is prudent to examine how core fixed income strategies have performed in this environment.

When analyzing the impact of rising Treasury yields, studies often examine prior years of interest rate increases. However, given the magnitude of the rise in the 10-Year Treasury yield in recent months, one does not need to conduct a historical analysis. Indeed, a clear-cut case of rising rates has just occurred right before our eyes, and it occurred when events that surround the fixed income arena have profound relevance. In other words, the increase transpired against a backdrop that investors will likely continue to confront in the future—that is, potential Fed tightening, moderate economic growth at best, low inflation, occasional bouts of safe-haven demand and, of course, historically low developed sovereign debt yields abroad. And lest we forget, this is a U.S. presidential election year, and the outcome could very well have lasting effects well after the final votes are in.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index vs. Bloomberg Barclays U.S. Aggregate Index (Agg)



Source: Bloomberg, 10/25/2016. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Our case study begins on July 8 of this year, the day the UST 10-Year yield hit its all-time low of 1.36%. Since then, the UST 10-Year yield has risen more than 40 basis points (bps) as of this writing, hovering right around the 1.80% threshold. An increase of this magnitude certainly qualifies as a “rising rate event” and underscores the need for investors to carefully consider how their core fixed income positions are situated.

In our opinion, a disciplined approach for core fixed income is a key part of portfolio strategy. The primary focus should be on the relative value differentials that exist within the investment grade (IG) universe—in other words, reallocating positions among the interest and credit-sensitive arenas. One of the most closely followed bond indexes in the world is the Bloomberg Barclays U.S. Aggregate Index, known as the Agg. Because of the surge in government debt in recent years, this market cap-weighted index tilts a larger weighting toward U.S. Treasuries, which can reduce income potential in a low rate environment and can leave investors more susceptible to increases in interest rates.

A strategy to help address these issues can be found in the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index. Subject to a series of constraints, this index reweights the components of the Agg, which results in an under-weight to Treasuries and a higher allocation to investment-grade corporates. Not only has the IG sector provided a visible yield advantage to Treasuries, it can also offer some risk mitigation from rising rates if the economy improves.

During this recent back-up in the UST 10-Year yield, the graph above illustrates how the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index helped to mitigate interest rate risk and outperformed the Agg by roughly .35% as of this writing. A key factor behind this outperformance was the elevated exposure to IG corporates. Indeed, since the early July nadir in the UST 10-Year yield, IG spreads narrowed by more than 20 bps, helping to offset the visible rise in rates.

Conclusion

In a relatively low and range-bound interest rate environment (one that can include rate increases, as well), investors should examine the core fixed income aspect of their portfolio and balance the need for income potential and lessening rate risk where possible. The WisdomTree Barclays U.S. Aggregate Bond Enhanced Yield Fund (AGGY), which tracks the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index, offers investors a

solution on both fronts.

Unless otherwise noted, data source is Bloomberg, as of 10/24/16.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner, or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Due to the investment strategy of the 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.

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.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

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

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.

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

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.

Inflation : Characterized by rising price levels.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

Sovereign Debt : Bonds issued by a national government in a foreign currency, in order to finance the issuing country's growth.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Basis point : 1/100th of 1 percent.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

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.