FIXED INCOME: WEATHERING THE STORM

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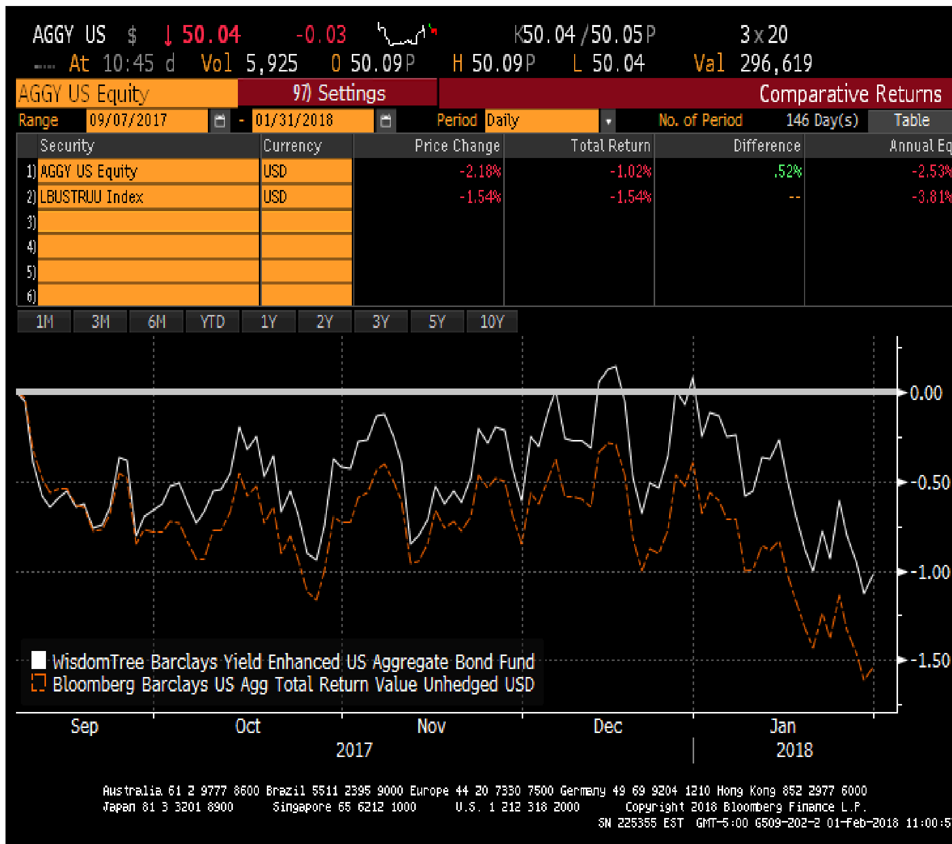
02/07/2018

One of the more noteworthy developments during the first month of the new year was the steady sell-off in the U.S. Treasury (UST) market. While the headlines have tended to focus on January 2018 developments, the rise in rates has actually been occurring for an even longer period. For fixed income investors, the key question is: How has my core position weathered the storm of higher rates?

I've written extensively about the Fed's role in pushing short-term rates higher, but this time around, the whole yield curve has experienced an elevated trend. Going back to my earlier point, the increase in rates actually goes back to September 7 of last year when the UST 10-Year yield printed its most recent low watermark of 2.04%. Since then, as of this writing, the yield has risen 67 basis points (bps) through the end of January, revisiting levels not witnessed since 2014.



Source: Bloomberg, as of 1/31/18. Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end performance can be found at the link below. You cannot invest directly in an index. LBUSTRUU Index: Bloomberg Barclays U.S. Aggregate Index.

Click here for AGGY standardized performance.

For many fixed income investors, their core fixed income strategy focuses on the Bloomberg Barclays U.S. Aggregate Index, or the Agg. However, as discussed in our July 19, 2017, blog post "Fixed Income Smart Beta: An Evolutionary Tale", WisdomTree sought to address the counterintuitive features of market cap-based indexing and applied a rules-based approach to core fixed income, where we reweighted the sectors of the Agg. The result was the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index, which is over-weight in investment-grade credit and under-weight in Treasuries. By reducing the market cap-based allocation to Treasuries, this index can potentially help to mitigate the elevated interest rate risk that Treasuries may experience.

The current back-up in UST yields offered a "real-time" illustration to see how these two different approaches to core investing performed. When interest rates rise, as we have seen since early September, it is difficult for core fixed income investments to avoid a negative outcome of some sort, with the goal being that one can keep losses to a minimum. As the chart shows, the WisdomTree Barclays Yield Enhanced U.S. Aggregate Bond Fund (AGGY), which is designed to track the Bloomberg Barclays U.S. Aggregate Enhanced Yield Index, has outperformed the Agg by 52 bps during the period under review, keeping the negative return at a modest -1.02% versus -1.54% for the Agg.

Conclusion

The debate on where the UST 10-Year yield is going for the remaining 11 months of 2018 will no doubt continue. There are many forces to consider, such as global central bank policies, increased Treasury supply and potential geopolitical developments to name a few. However, at some point, it would seem the fundamentals—the economy and inflation outlook—will move front and center, and more than likely be a key arbiter as to whether this latest rise in the UST 10-Year yield has more room to run or whether investors view the higher rate level as a renewed buying opportunity. Either way, we believe investors should utilize a core fixed income strategy that can weather various outcomes and consider AGGY to fill this need.

Unless otherwise noted, data source is Bloomberg as of January 31, 2018.

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DEFINITIONS

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

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.

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

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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

Basis point : 1/100th of 1 percent.

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.

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

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

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.