"BLUE WAVE": THE OTHER SIDE OF THE TRADE

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Having spent a good portion of my career on a fixed income trading floor, I've always been appreciative of what "the other side of the trade" means. Put simply, a specific sentiment often moves "front and center," and investors fail to factor in the possibility of an opposing viewpoint coming to fruition instead. Last week, I blogged about how the U.S. Treasury (UST) market seemed to be viewing a "blue wave" at the upcoming election as being potentially "pro-growth," which could lead to higher UST 10-year yields, accordingly. But, for this blog post, I'm going to examine the possibility that a "blue wave" is not necessarily "growth-friendly" and how fixed income investors should plan for such an outcome.

In our Market Insights: Election Outcomes piece, we outlined two possible outcomes from a "blue wave." They are somewhat polar opposites. In the scenario I want to focus on in this blog post, a "blue wave" results in a potentially higher tax, an increased regulatory environment and a less "business-friendly" setting, which could ultimately result in slower economic growth.

However, there are two other key considerations. As I wrote last week, one common thread among these two opposing scenarios is that "deficit discipline" will go completely out the window. In other words, it seems likely trillion-dollar deficits for the U.S. will become the norm. For the record, for fiscal year 2020, the U.S. recorded a $3.1 trillion deficit. The other common thread will be continued easy monetary policy from the Federal Reserve (Fed). Chairman Powell & Co. have made it abundantly clear that rate hikes and/or balance sheet drawdowns will not be on the Fed's radar for possibly the next two years, at a minimum.

So how would the UST market view this scenario? More than likely, the broader UST market could initially be the beneficiary of a "risk-off" move (yields move lower), as investors weigh the prospects of higher taxes and increased regulation occurring against the backdrop of an already uncertain growth outlook. However, looking further down the road, the expanding budget deficit could curb enthusiasm for intermediate to longer-dated Treasuries. Another consideration for this part of the yield curve could be a rise in inflation expectations due to the Fed's "pedal to the metal" monetary policy approach.

Potential Fixed Income Solution

If the UST market does embrace "the other side of the trade," investors should take a more "strategic" approach to fixed income asset allocation and be mindful of the current and prospective shape of the yield curve (relatively flat now, potentially steeper later). A core approach with a shorter duration to consider is the WisdomTree Yield Enhanced U.S. Short-Term Aggregate Bond Fund (SHAG). This strategy offers investors the following key attributes:

- The opportunity for enhanced yield in a historically low rate setting
- An investment-grade core solution that doesn't reach for yield with riskier assets or increased leverage

- A short-duration strategy to potentially mitigate the risks of higher intermediate and/or longer-dated yields

Unless otherwise stated, all data sourced is Bloomberg, as of October 16, 2020.

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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.

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.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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.

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.

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.

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.

Inflation : Characterized by rising price levels.

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.