AIN'T NO CURE FOR THE SUMMERTIME BLUES

Kevin Flanagan – Head of Fixed Income Strategy
07/11/2017

Since Election Day, the focus in the U.S. Treasury (UST) market has been essentially domestic-driven. In other words, market participants have been setting their sights on potential fiscal policy developments and, of course, the latest actions from the Federal Reserve (Fed). However, as the calendar turned to summer, investors were greeted with a new twist for Treasuries—more-hawkish-than-expected rhetoric coming from other developed markets' central banks, elevating global bond yields in the process. The question that lies ahead on the rate front is whether words become deeds; if so, the fixed income arena could be in for a case of summertime blues.

Two of the more noteworthy developments from the global central bank perspective involved the European Central Bank (ECB) and the Bank of Canada (BOC), each occurring in just the last few weeks. The genesis was at an ECB forum in Sintra, Portugal, where President Draghi made remarks that the bond market viewed as being on the hawkish side. Although the ECB tried to walk back the comments, stating they were misinterpreted, the damage was done, and yields nevertheless finished higher. Interestingly, the FOMC minutes released last week were a nonevent, but the ECB minutes were a different story, as the headlines stated that policy makers "discussed removing the easing biases in their policy communication," specifically on their Quantitative Easing (QE) program. These news events were accompanied by earlier comments from BOC president Poloz that intimated that Canadian policy makers may be considering a rate hike at one of their upcoming meetings.

U.S. 10-Year vs. 10-Year German Bund

Source: Bloomberg, as of 7/7/17. Past performance is not indicative of future results.

Needless to say, the shift in tone was not expected in the global bond markets. In the eurozone, 10-Year German bund yields have risen more than 30 basis points (bps) since June 26 and are now at their highest levels since January 2016. From a technical

WISDOMTREE®

perspective, as of this writing, the 10-Year bund was just 1 bp below its one-year 100% retracement level. Along the same lines, UK and French 10-Year yields were also up at least 30 bps during this time frame, with Italian 10-Year rates posting an increase of nearly 45 bps. On this side of the Atlantic, CAD 10-Year yields now reside at two-year highs, and the implied probability for a rate hike at tomorrow's policy meeting has risen to 94.7% versus 34.9% on June 26.

So, what does that mean for the UST market? Well, utilizing the same period, the 10-Year yield has risen by just under 25 bps. Even though both bund and UST 10-Year yields have moved higher, the spread between the two has continued to narrow from its post-election high-water mark, as the increase in German rates has outpaced its U.S. counterpart. Thus, much like the spread widening to its highest readings since 1989 was viewed as Treasury supportive, it would seem logical to reason that this narrowing trend to pre-election levels could represent a negative development for Treasuries, if it is sustained.

Conclusion

The bottom-line message is that developed countries' government bond markets had become too complacent and were not priced for any "counter" news. So, what we're seeing are adjustments, especially from a potential monetary policy perspective. News stories that the "bond bulls" are capitulating and that higher yields are in the offing are already circulating. In my opinion, for the UST 10-Year, we've already seen well-established resistance once we get to the 2.64% mark, so barring any surprises, in the near term that would seem to still represent a top, but things look like they're going to be fluid as we get deeper into summer. Against this backdrop, fixed income investors may wish to consider shortening duration in their portfolios in order to mitigate the potential risk for higher rates.

Unless otherwise noted, data source is the Federal Reserve, as of July 7, 2017.

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.

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

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.

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.

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

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

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

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.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Basis point : 1/100th of 1 percent.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

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.

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

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.