A FIXED INCOME STATE OF AFFAIRS

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With the dog days of August upon us, I thought it would be useful to take a step back to provide some thoughts and analysis on the current state of affairs in the fixed income arena.

It all begins with economic data. Up to this point, the money and bond markets have seen opposite ends of the spectrum on this front. As we've discussed, U.S. Q2 real GDP moved not just deeper into recession territory, but the reading was more like a depression. However, reports of a V-shaped recovery have been witnessed in a variety of other releases. Manufacturing and service-related surveys are now back into expansion territory, while Friday's jobs report revealed further improvement on the labor market front. Given the slowed pace of reopenings due to elevated COVID-19 cases, it seems reasonable to expect some deceleration in further progress, but the good news is that progress was still being made in July when these new cases were hitting the headlines. In fact, last week's jobless claims number (a leading indicator) fell by its largest amount in almost two months.

That leads us to the U.S. Treasury (UST) market, and we're learning you can't keep the UST 10-Year down. Last week, the yield fell to a new record low of 0.51% as uncertainty surrounding an additional fiscal stimulus package, escalating U.S.-China tensions and the aforementioned GDP report all provided support . Somewhat under the radar, a potentially important development came from the Treasury's August refunding announcement. The debt managers announced their plan of increasing future supply needs through "longer tenors" (longer-dated maturities) rather than T-bills. As of this writing, there has been minimal reaction, but it will be something to watch going forward, especially if the U.S. economic recovery continues.

What's going on in the U.S. corporate bond markets, you ask? Credit spreads continue to grind tighter despite the fact that the Federal Reserve (Fed) has not really turned on the spigots in its corporate bond-buying facility. High yield spreads are now below the +500 basis points (bps) threshold, while for investment grade (IG), the differential is around +125 bps, representing an 83% and 90% retracement, respectively, from their March peaks.

Conclusion

With Labor Day in our sights, the dynamics in the fixed income arena could get interesting. Sure, the usual suspects, such as economic data and Fed/fiscal policy, will have input in the market's pricing mechanism. However, I'm thinking the U.S. election headlines will only begin to heat up and could very well enter into the conversation as well. In terms of fixed income asset allocations, WisdomTree believes the UST yield curve could steepen, and we position fixed income portfolios to over-weight U.S. credit over rates, while keeping duration shorter than the benchmark.

Unless otherwise stated, data source is Bloomberg, as of August 10, 2020.

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Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Corporate Bonds : a debt security issued by a corporation.

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

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.

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.

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.