HOW VULNERABLE IS SHORT DURATION FIXED INCOME TO FED TIGHTENING?

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09/30/2014

In recent research released by the Federal Reserve Bank of San Francisco and echoed in statements by several Fed regional bank presidents, Fed officials have voiced concerns that the market is underestimating the probability and timing of a change in monetary policy.[1] If previous market cycles are any indication, heavy positioning and an earlier-than-anticipated tightening cycle by the Fed could leave many investors vulnerable to a shift in policy. In today's market, two- year Treasury yields are anchored near 0.50%.[2] We believe it is possible that yields could breach 1% for the first time in nearly five years in anticipation of the first Fed rate hike. Absent other factors, this could result in a loss in price terms from current levels of approximately 1%. While not a devastating loss, it does significantly raise the prospect of negative total returns in this part of the yield curve given the current low levels of income potential. As we explore below, from a timing perspective, Morgan Stanley has determined that during the most recent tightening cycle of 2003–2004, markets began to price in a change in Fed policy approximately six months before the actual change.[3] With current forecasters calling for the first rate hike in mid-2015, we believe that now may be a prudent time to reduce interest rate risk in anticipation of this shift in policy. **Yields and Total Returns of 2-Yr Treasury Notes during Past Tightening Periods- Yield and Rate Levels**

6 months before the first hike	8/4/1993	12/29/1998	12/29/2003	Current, 8/31/2014
2-Yr Treasury Yield	4.16%	4.66%	1.78%	0.49%
Fed Funds Target	3.00%	4.75%	1.00%	0–0.25%
Difference	1.16%	-0.09%	0.78%	0.24%–0.49%

Day before the first hike	2/3/1994	6/29/1999	6/29/2004
2-Yr Treasury Yield	4.28%	5.68%	2.81%
Fed Funds Target	3.00%	4.75%	1.00%
Difference	1.28%	0.87%	1.81%

Cumulative Returns for BAML Current 2-Yr Treasury Index

6 months before the first hike to last hike	8/4/1993 2/1/1995	12/29/1998 5/16/2000	12/29/2003 6/29/2006
Price Return	-4.62%	-4.48%	-4.99%
Income Return	7.96%	7.63%	8.02%
Total Return	3.34%	3.15%	3.03%

Sources: BofA Merrill Lynch, Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms and Indexes in the chart, visit our glossary. While today's path to tightening is in many ways unprecedented, we believe looking at past tightening periods can provide valuable insight into the possible future path of rates. The most significant difference between today's markets and past periods is the initial level of interest rates. In each of the three previous tightening periods, much higher yields provided a sizable cushion

to offset losses related to lower bond prices as interest rates rose. For example, two-year Treasury yields rose by 103 basis points (bps) in the six months preceding the first Fed rate hike in 2003. In 1998, rates rose by 102 basis points.[4] However, in both instances, total returns remained positive given the higher starting levels of yields. While it is noteworthy that rates rose by approximately the same amount in the six months preceding the first rate hike during the previous two cycles, we do not believe this will necessarily occur in 2015. This view is primarily driven by our outlook not only for the timing of the first rate hike, but the pace of subsequent hikes and the ultimate "neutral" policy rate. The other interesting element of the table above relates to the total returns for the two years over each of the previous tightening cycles. While the duration and starting yield levels of each tightening period differ greatly, the total returns from each period are remarkably similar at approximately 3%. In higher-rate environments, the duration of the tightening cycle has historically been shorter. In the most recent tightening cycle, from 2003 through 2006, the longer period of tightening allowed bond investors to recoup losses through higher levels of income. While we don't anticipate that the pace of Fed tightening will be as aggressive as the periods seen in recent history, we do believe that in each previous period, the market underestimated the timing of a shift in policy. However, during previous periods, starting yields were significantly higher, thus increasing bond investors' margin of error. In our view, given the current low levels of income potential, the prospect of negative returns from short-duration fixed income remains at much higher levels than in past tightening cycles. To learn more about our interest rate strategies, click here.

[1]Source: Jens H.E. Christensen and Simon Kwan, "Assessing Expectations of Monetary Policy," Federal Reserve Bank of San Francisco, 9/8/14. [2]Source: Bloomberg, as of 8/31/14. [3]Source: Morgan Stanley, 6/9/14. [4]Sources: Bloomberg, WisdomTree.

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DEFINITIONS

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

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.

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

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.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Basis point : 1/100th of 1 percent.

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.