HEDGE YOUR BETS! TERM PREMIUM IN U.S. FIXED INCOME MARKETS MAY BE POISED TO RISE

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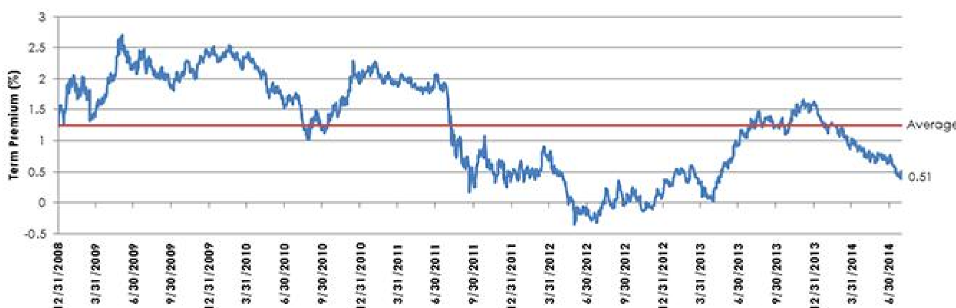
With stronger-than-forecast economic data and continued improvement in U.S. employment numbers, we believe that now may be the time to hedge U.S. interest rate risk. While rates in the U.S. have generally fallen so far in 2014, we believe that the market's reaction to the most recent round of economic data suggests that anxiety about rising rates may be bubbling up again. A quick look at expectations embedded in the bond market suggests that investors may be vulnerable to a sharp move higher in rates. This concern is highlighted by the limited amount of income that investors currently require to invest in longer- maturity securities (relative to rolling shorter maturities over the same horizon). In economic circles and the Federal Reserve (Fed), this measure is commonly referred to as the term premium. In the current environment, we believe that the market may be underpricing the risk of higher rates. Recently, noted Fed hawk Jeffrey Lacker sounded the alarm that rates may rise faster than the market currently anticipates.[1] As a result, we attempt to explain this rationale below. **Term Premium Explained** The term premium represents the incremental yield that investors require to hold a longer-term bond as opposed to a combination of shorter maturity bonds. There are many different ways to estimate the term premium, but a key factor is the anticipated evolution of short-term interest rates. Different models use market expectations embedded in futures, consensus estimates from strategists, or most recently, the Fed's forward rate guidance to project how short-term rates will evolve over time. In the chart below, we show the model employed by New York Fed economists. Their model derives the future path of short rates from current pricing of short-rate futures contracts. As we show in the chart, investors currently demand very little income for assuming interest rate risk. At 51 basis points (bps), the term premium is significantly below its five-year average and represents levels not seen since May 2013. In our view, investors should be demanding greater potential returns for bearing interest rate risk, given the changes in the economy and resulting Fed policy. **Federal Reserve Term Premium Estimate, 12/31/2008- 7/31/2014**



Source: Bloomberg, as of 7/31/14

Stronger Economic Data + Complacency = Higher Rates During the last week of July 2014, market participants saw a barrage of economic data that seemed to corroborate the same message:

the U.S. economy is continuing to grow, and the labor force is continuing to recover. Given that the Fed has focused on both of these factors as preconditions for eventually raising short-term interest rates, the Treasury market took notice. In the week after the better-than-expected economic data was released, U.S. two-year bond yields broke through 0.51%, the recent high that was set in September 2013 when the market was convinced that then-Fed Chairman Ben Bernanke would start "tapering" the Fed's bond-buying program. While the spike and eventual retracement in two-year yields may point to concerns about future tightening, longer maturities seem to paint a different picture. U.S. 10 Year and 30-Year Treasury yields are a full 44 and 57 basis points lower, respectively, than they were in September 2013.[2] In this scenario, the yield curve has flattened, narrowing the spread between these maturities and the two-year. This is consistent with investors being rewarded less for assuming additional interest rate risk. Put another way, we believe that the prospect of higher rates has increased, but the cost of hedging this risk has decreased. **How to Hedge** On December 18, 2013, the Fed began to reduce the pace of its asset purchases, and WisdomTree launched a suite of Funds that investors can use to help mitigate interest rate risk in their bond portfolios. In the current market environment, we believe that both the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund (AGZD) and the WisdomTree Barclays U.S. Aggregate Bond Negative Duration Fund (AGND) may appeal to a wide range of investors. In these strategies, an investor is able to maintain exposure to a basket of bonds from the Barclays U.S. Aggregate Index, combined with an interest rate overlay that targets a zero or negative five-year duration for the overall portfolio. In these strategies, the portion of the portfolio invested in bonds helps offset the cost of maintaining the interest rate overlays. While the zero-duration strategy simply seeks to hedge the risk of rising rates, the negative duration approach is more aggressive. In a negative duration position, investor returns could be higher if interest rates rise at the intermediate part of the yield curve. However, this strategy entails more risk, since it is possible that rates may not rise (or could even fall) at that particular part of the curve. Generally, this strategy would perform well if the yield curve steepens. **Outlook** While it is possible that our current forecast may prove incorrect and interest rates may actually fall, we still favor the risk-return tradeoff embedded in this particular position. In our view, the risk of higher interest rates far outweighs the potential benefits of a bet on lower rates in the current market environment. [1]Craig Torres, "Lacker Says Markets May Be Surprised by Pace of Rate Rise," Bloomberg, 8/4/14. [2]Source: Bloomberg, as of 7/31/14.

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DEFINITIONS

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

Maturity : The amount of time until a loan is repai.

Term premium : The term premium represents the incremental yield that investors require to hold a longer-term bond, as opposed to a combination of shorter-maturity bonds.

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

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Five-year government bond yields : The single discount rate that equates the present value of a government bond’s cash flows to its market price which matures in 5 years.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

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.

Flatten : to effect a zero positio.

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.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

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.