IT'S THE GREAT PUMPKIN, CHARLIE BROWN

Kevin Flanagan — Head of Fixed Income Strategy
10/26/2016

The money and bond markets' Federal Reserve (Fed) expectations for 2016 have, thus far, been akin to Linus waiting for the arrival of the Great Pumpkin. Indeed, heading into this year, conventional wisdom was centered around four potential rate hikes from the U.S. policy makers, but so far not even one increase has happened. Next week, the Federal Open Market Committee (FOMC) is scheduled to meet for the second-to-last policy session of the year, and based on market valuations, a Great Pumpkin sighting (i.e., a Fed Funds Rate hike) may continue to remain elusive.

Although the Fed is not expected to raise rates next week, the voting members have set the stage for a potential move before year-end, with their scheduled December 13–14 meeting representing a more likely time frame, data permitting. As we've mentioned before, we believe the Fed is not really in the business of surprising markets with policy decisions but rather seems to show a preference of preparing them for potential moves.

In this case. the process began back in August of this year. It was then that the "Big Thee," Chair Yellen, Vice Chair Fischer and New York Fed President Dudley, all put the potential for a rate hike back into the fixed income arena's mindset. Remember, prior to August, the collective markets were still dealing with the aftermath of a post-Brexit world, a world where at one time, the implied probability for Fed Funds Futures posted a more than 20% chance of a *rate cut*. Given the policy makers' outlook, they obviously felt the money and bond markets had become too complacent as summer progressed and saw the need to alter sentiment, which in hindsight, proved to be effective.
As of this writing, Fed Funds Futures-implied probabilities are at roughly 17% for a rate increase at next week's meeting and a 69% chance for the December convocation. However, it is interesting to note that the aforementioned Big Three have, once again, been in the headlines over the last week or so. This time around, it appears as if these Fed officials may be trying to guide market expectations for what might occur following a 2016 rate hike. Specifically, the underlying tenor seems to be that if an increase does occur before year-end, investors should not necessarily expect the Fed to embark on a steady tightening campaign, as was the case during the 2004–2006 period. Rather, the policy makers will take a more deliberate approach and perhaps allow a "high-pressure economy." This is essentially Fed speak for not tightening too much so as to avoid the need to reverse course if the economy were to falter or inflation did not reach their 2% threshold.

How the U.S. Treasury (UST) market would respond to this type of approach may have been put on display in small doses immediately following the Big Three's remarks. Rather than the intuitive expectation that the yield curve flattens when the Fed raises rates, the UST 2-year/10-year spread actually widened. Allowing a high-pressure economy could create concerns at some point that the Fed would fall behind the curve in terms of warding off potential inflation pressures and/or heightened expectations, typically increasingly negative factors the further out on the yield curve one goes.

Conclusion

Given the Fed's language in the September FOMC policy statement, if upcoming economic data does not soften from current readings, the outcome could ultimately be different than what Linus experienced. In other words, fixed income investors may very well see their Great Pumpkin—a 2016 rate hike.
Unless otherwise noted, data source is Bloomberg, as of 10/21/2016.

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

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.

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

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fas.

Inflation : Characterized by rising price levels.

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 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.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

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.