HAVE YOU RATE HEDGED YET?

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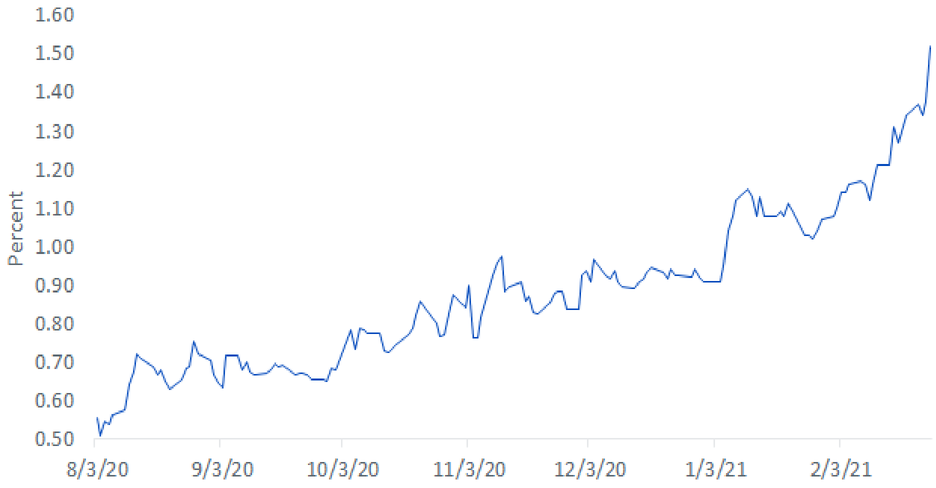
Thus far in 2021, the overarching theme in my blog posts and podcasts has been the 'Reflation Trade' and how investors should be considering rate-hedged strategies within their fixed income portfolios. Last week's spike in the U.S. Treasury (UST) 10-Year yield was a not-so-subtle reminder that rate hedging remains an active consideration for the bond market investment landscape.

The graph below takes a little bit of a longer look back, rather than just focusing on 2021 developments. As you can see, the rise in the UST 10-Year yield actually began in early August when the all-time low watermark of 0.51% was registered on August 4. As I write, the rate increase since that date has been an eye-opening 101 basis points (bps). However, the development that is getting the lion's share of attention is what has transpired thus far this year, when the rise has been pegged at a little more than 60 bps.

U.S. Treasury 10-Year Yield



Source: St. Louis Fed, as of 2/26/21

In fact, that's exactly the issue—60% of the increase in the UST 10-Year yield occurred in less than two months' time. So, what are the culprits? Here's a list of the top five:

1. The aforementioned Reflation Trade—inflation expectations have increased due to unprecedented monetary and fiscal stimulus, with an additional huge amount of the latter seemingly on the way
2. The Federal Reserve's (Fed) increasingly dovish policy stance, which was highlighted by Chair Powell at last week's Semiannual Monetary Policy Report testimonies—is the Fed in danger of falling behind the inflation curve?
3. Better-than-expected Q1 economic data, especially for consumer spending, which has led forecasts such as the Atlanta Fed's GDPNOW estimate to pin growth at just under +9% for this quarter
4. Budget deficits, maybe—up until very recently, it didn't look like they mattered, but the $62 billion UST 7-Year note auction last week was abysmal, perhaps

suggesting that investors are demanding higher yields to underwrite such enormous auction amounts

5. Technicals—various Fibonacci retracement levels have been 'blown through', with higher targets seemingly coming into play every week of late, if not every day

Solutions to Consider

Based on the fundamental and technical outlook, it appears as if a further rise in the UST 10-Year yield is still a distinct possibility. A retracement back to the pre-pandemic trading range of 1.75%–2.00% could be on the horizon.

Here are three rate-hedge solutions to consider:

- **UST-based**: WisdomTree Floating Rate Treasury Fund (USFR) vs. TIPS. 10-Year TIPS, or real, yields are not immune and have risen 50 bps this year.
- **Investment-grade**: WisdomTree Interest Rate Hedged US Aggregate Bond Fund (AGZD) vs. corporate floating-rate vehicles. Higher yield, with more diversification (representative of the AGG) and less concentration in the financial sector.
- **Core plus**: WisdomTree Interest Rate Hedged High Yield Bond Fund (HYZD) vs. bank loans. A quality screen that tilts for income and targets zero duration.

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DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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

Basis point : 1/100th of 1 percent.

Inflation : Characterized by rising price levels.

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.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

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

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Fibonacci retracement : A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Diversification : A risk management strategy that mixes a wide variety of investments within a portfolio.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

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.