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# THE MIDTERMS ARE OVER ... TIME TO MOVE ON TO THE SECOND SEMESTER

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11/08/2018

## Relief Rally in Equities

In market commentary from Professor Jeremy Siegel ahead of the midterms, we suggested that if the widely expected outcome of Democrats taking the House and Republicans keeping control of the Senate were to actually occur—as it did on Tuesday in the midterm elections—we thought there would be a bounce higher in equity markets due to “nothing bad happening.” There were no major surprises in the election results, and we saw this rally in equities come through.

With the uncertainty over the election out of the way, a main issue confronting equities now will turn to how fast interest rates will increase from the Federal Reserve (Fed) tightening [monetary conditions](#) and the readjustments in portfolio allocations as the [risk-free rate](#) ticks higher. We had very strong growth in earnings in 2018 as a result of the tax cut, and that earnings growth rate was front-loaded—we will not see the same type of continued growth next year. Rather, one of the challenges for the market next year is that earnings estimates may still be too high and will have to be marked down.

This challenge from earnings markdowns for 2019 is one reason we prefer strategies that are priced at reasonable [valuation](#) multiples.

Across the U.S. markets, WisdomTree has been discussing three strategies as our best ideas for U.S. equity exposure: quality [dividend growth](#) and [mid-](#) and [small-cap](#) earnings. Each of the three Funds have lower than 16x [estimated P/E ratios](#)—while the mid- and small-cap Funds are both around 15x even on a trailing 12-month earnings figure.

In contrast to many who think small caps are expensive because of the large percentage of unprofitable companies in traditional [market cap-weighted](#) small-cap indexes like the [Russell 2000](#), we see a 15.5x P/E ratio for our small-cap earnings Fund as being quite attractive.

Small caps and mid-caps are also more particularly sensitive to local conditions in the U.S. economy—with revenue from the U.S. just over 80% in the [WisdomTree U.S. SmallCap Earnings Fund \(EES\)](#), compared with the [WisdomTree U.S. Quality Dividend Growth Fund \(DGRW\)](#), which has revenue from the U.S. of about 62%.<sup>1</sup>

Fund	WT U.S. Quality Dividend Growth	WT U.S. MidCap Earnings	WT U.S. SmallCap Earnings
Ticker	DGRW	EZM	EES
Price/Earnings	20.60x	14.98x	15.53x
Est. Price/Earnings	15.49x	14.39x	13.37x
Price/Cash Flow	13.35x	10.00x	9.30x
Dividend Yield	2.34%	1.78%	1.42%
Net Buyback Yield	2.61%	1.66%	0.93%
Total Shareholder Yield	4.96%	3.44%	2.35%

Sources: WisdomTree, FactSet. Data as of 11/6/18. Past performance is not indicative of future results.

**Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at [wisdomtree.com](http://wisdomtree.com).**

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total Returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

For standardized performance of each Fund in the chart, please click their respective ticker: [EZM](#), [DGRW](#), [EES](#). For definitions of terms in the table, visit our [glossary](#).

We also have suggested expectations for large-cap U.S. equities were to see [real returns](#) being 5.5% with 2% [inflation](#) added, giving longer-term expectations of 7.5%. Our quality dividend growth Fund, DGRW, which has a 2.34% [dividend yield](#) and a [net buyback yield](#) of 2.61%, shows a current cash [distribution yield](#) of 4.96% (i.e., total [shareholder yield](#)). As we have written before, this current distribution requires no growth on top of current cash flows to return nearly 5% to investors. If any of the investments that firms are making translate to future cash flow growth, returns can move even higher than 5% real returns. We thus believe DGRW serves as a great anchor to core U.S. equity portfolios, both for the current environment of the late stage of an economic cycle and also current valuations being attractive on these stocks.

Further, given the rising interest rate pressures we continue to see from the U.S. economy outperforming some of the other global economies, we like the mid- and small-cap earnings strategies, like the [WisdomTree U.S. MidCap Earnings Fund \(EZM\)](#) and EES, as Funds with more exposure to the U.S. economy but priced at very reasonable multiples.

### Bonds Move on Quickly

Unlike the 2016 U.S. election, the fixed income arena was not greeted with any surprises this time around, so based upon the initial reaction, it appears as if the bond market has moved on quickly. The focus shifts right back to the domestic fundamental setting—namely, growth prospects, inflation expectations and any attendant monetary policy decisions from the Fed.

Once again, the outlook for U.S rates needs to be broken down into two parts: short-term and intermediate to longer-dated yields. For the former, it appears as if the Fed will continue on its gradual rate hike path, with some [balance sheet](#) normalization thrown into the mix. With respect to its balance sheet, the Fed may actually need to make some tweaks to its current path because of operational issues in the funding markets, but that's a topic for another blog post.

As far as future rate hikes go, an increase at the December [FOMC](#) meeting followed by at least two more in 2019 (March and June) seems to be the more probable outcome. So, if you do the math, by mid-2019, the top end of the [Federal Funds Rate](#) target could be 3%.

For the [U.S. Treasury \(UST\) 10-Year yield](#), one could argue that a good portion of the backup in rates has already occurred because the market's pricing mechanism has allowed for improved economic growth, a moderate increase in inflation and increased Treasury supply. Developments on the wage front will need to be monitored closely, with any upside surprises potentially putting upward pressure on yields. Taking the midterm election results into consideration, the only potential boost from fiscal policy seems to be in the area of infrastructure, but that would require both sides of the political spectrum working "across the aisle."

And don't forget those flight-to-quality issues that have a way of showing up when least expected. Keep your eye on any headlines stemming from the Italian budget saga on this front, to name one example.

So, what's an investor to do? We continue to advocate an approach that concentrates on a [Treasury floating rate](#) strategy. The [WisdomTree Floating Rate Treasury Fund \(USFR\)](#) offers investors a solution that not only could provide a rate hedge but also offers protection for future Fed rate hikes. In the process, as the USFR yield "floats up with the Fed," this strategy can also help solve income needs without the duration risk.

#### Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new, and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

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](#)

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## DEFINITIONS

**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 fast.

**Risk-free rate** : Typically an interest rate on a bond issued by a government entity, where the risk of default is so small as to be deemed nonexistent.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Dividend growth** : The growth in trailing 12-month dividends for the specified universe.

**Mid-Cap** : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

**Small caps** : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**Estimated P/E ratios** : Share price divided by estimated 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of estimated 12-month earnings per dollar invested.

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

**Russell 2000 Index** : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Real yield** : the annual interest rate that an investor demands for holding a bond to maturity including the impact of inflation.

**Inflation** : Characterized by rising price levels.

**Dividend yield** : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

**Net Buyback Yield** : A company's net share buyback is the difference between the capital raised by issuing new shares and the money the company spent on buying back any outstanding shares. A positive net share buyback means that more was spent on buying back existing shares than received from issuing new shares. Net buyback yield is the amount of a company's net buybacks divided by its market capitalization. Please note that net buyback yield does not represent a dividend paid by the company.

**Distribution Yield** : Calculated by annualizing the most recent fund distribution and dividing by the fund's current NAV. The yield represents a single distribution from the fund and does not represent the total returns of the fund.

**Shareholder Yield** : A data point that references the combination of dividend yield and buyback yield.

**Balance sheet** : refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new positions.

**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.

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

**Floating Rate Treasury Note** : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.