WHY THE BOND MARKET CRIED UNCLE

Rick Harper — Chief Investment Officer, Fixed Income and Model Portfolios
12/01/2016

Over the two weeks ending November 18, the yield of the 10-Year Treasury soared 57.9 basis points (bps). Over the last 30 years, only two such periods saw larger increases—April 10, 1987, and November 23, 2001—making the third largest rise in the 10-Year Treasury yield . More inclusively, in a 30-year bull market in bonds, it is the eighth largest two-week move, regardless of direction.

10 Yr Treasury Yield

Bond Market Risk

Given the comparable periods, the 2016 election seems a little out of place. But a deeper look at the state of the bond market from a risk/return perspective might suggest that there is more substance in the move. The election surprise and its promise of fiscal policy simply offered the trigger that exposed those vulnerabilities.

The extraordinary level of monetary accommodation and the lower-for-longer rate environment has encouraged issuers to issue more bonds and in longer maturities. The large majority of bond investors are captured investors—they need to invest at least a portion of their assets in fixed income. While the decline in yields has pushed some marginal investors into equities, a large majority of bond investors have continued investing as yields declined, not just in the United States but globally.

That dynamic pushed real yields to negative levels, and investors tolerated assuming an increasing amount of interest rat e risk as durations soared. As a result, the bond market's overall sensitivity to interest rate risk soared to record levels, while the anticipated compensation continued to fall. The graphs below show the dynamics at play.

Yield v. Duration

Market Value at Risk from 100 bp Shock

Market Value 12-1

"Running to Stand Still" Becomes "Gimme Shelter"

That was fine as long as global risks remained front and center, the U.S. government remained gridlocked and a pervasive threat of deflation lingered. We were all, in the words of the great Irish poets U2, content with "Running to Stand Still."

Then, the shock of Brexit dissipated in a flash and prices in China ticked higher. Deflation fears ebbed. With yields depressed and the assumption of interest rate risk high, investors became more sanguine about bonds. They also became more cognizant that they were sacrificing yield in assuming duration risk (a negative term premium), and bond yields began to move higher. With the election surprise, the repricing simply got pulled forward in spectacular fashion. The Rolling Stones' "Gimme Shelter" might offer an appropriate musical backdrop.

Did we get ahead of ourselves? Quite possibly, the Treasury market reached technical oversold levels it had not seen since 1990. Investors also need to remember that the prospect of fiscal policy is quite different than its actual implementation. A key takeaway from the election is to expect the unexpected. Investors should hope for It's a Small World, but be prepared for Space Mountain, not spinning tea cups. Risks remain prevalent, and investors should probably use any recovery in the bond market as an opportunity to dial down their interest rate risks.

We believe anticipated fiscal reform, regulatory relief and tax cuts to be pro-growth in nature and to offer support for valuations in the credit market. Zero duration and negative duration strategies that combine credit exposure with more advantageous positioning for interest rates could thus serve as a useful complement to core fixed income strategies in the months ahead, in our view.

We encourage investors to think strategically in positioning portfolios toward year-end.

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

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.

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

Bullish : a position that benefits when asset prices rise.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

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

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

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

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.

Deflation : The opposite of inflation, characterized by falling price levels.

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

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.

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.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Zero duration strategies : Refer to WisdomTree's Interest Rate Strategies that target an overall portfolio duration of zero; namely, the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

Negative duration strategies : Refer to WisdomTree's Interest Rate Strategies that target a negative overall duration; namely, the WisdomTree Barclays U.S. Aggregate Bond Negative Duration Fund and the WisdomTree BofA Merrill Lynch High Yield Bond Negative Duration Fund. .