THE FED: NOT SO GREAT EXPECTATIONS

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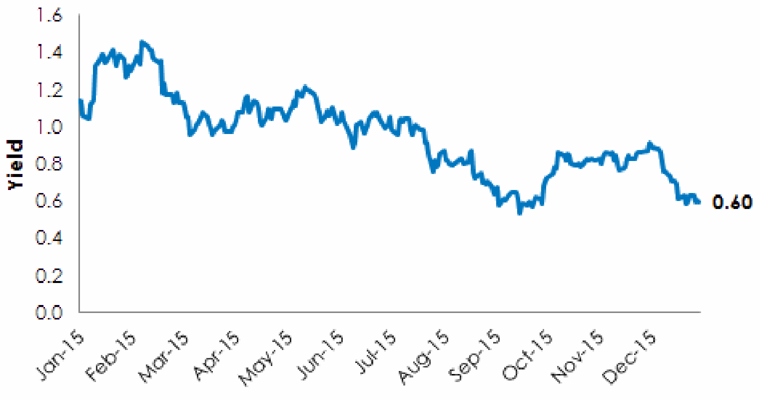
The first Federal Reserve (Fed) meeting for 2016 is now history, and to no one's surprise the policy makers did not announce a further rate hike following their quarter-point increase in the Federal Funds Rate in December. The financial markets were scrutinizing the accompanying policy statement for any hints of what future action the voting members might be considering. On that front, the Fed did not tip its hand. Rather, the policy makers seemed to acknowledge recent events, such as "economic growth slowed late last year" and "inflation is expected to remain low in the near term," while highlighting a continued reduction of slack in the labor market. Perhaps more importantly, investors were anxious to see if the Fed would make any mention of recent events from a global growth and equity market perspective. On that front the policy statement stopped somewhat short of the concern voiced at the September 2015 gathering, but it still stated that the "Committee is closely monitoring global economic and financial developments" and its implications for "the balance of risks to the outlook."[1] How did the fixed income markets perceive the Fed's language? One of the more interesting gauges to observe lies in the Fed Funds Futures arena. While these instruments do not necessarily have the greatest track record in accurately predicting actual Fed rate moves, they nonetheless offer a good sense of market sentiment. In addition, they can be rather volatile. In order to gauge market sentiment for this year, we looked at the December 2016 contract. There has clearly not only been the aforementioned volatility over the past 12 months, but a shift in expectations for Fed rate hikes since 'liftoff' occurred in mid-December. It is readily apparent that the developments the FOMC referred to in its policy statement have also weighed on expectations of where the Federal Funds Rate will finish 2016. This contract also reveals that investors never seem to have bought into the conventional wisdom of four additional rate hikes. However, sentiment did seem to be leaning toward a future 1% threshold. As of this writing, the pricing mechanism is geared more toward only one additional rate hike this calendar year, or a mid-point of roughly 60 basis points (bps) in the ½- to ¾-percent band.

Dec 16 Fed Fund Futures



Source: Bloomberg, as of 1/28/2016.
Past performance is not indicative of future results.

Needless to say, even with the Fed's recent policy statement in mind, there still seems to be a disconnect between what the market is expecting and what the policy makers are anticipating as the end result. In our estimation, the landscape for U.S. Treasury yields remains one of more range-bound activity and without any significant surge to groundbreaking levels. In fact, with the Bank of Japan's recent easing move, investors are now presented with two of the world's largest central banks (including the European Central Bank) having policy rates in the negative territory, a landscape that should continue to support our base case for U.S. rates. As we have witnessed over the last few years, in such an environment fixed income investors can tend to reach for yield by moving too far out on either the maturity or down the credit curve. WisdomTree feels fixed income investors should consider other ways to enhance their yield. One alternate approach to achieve this goal could be the WisdomTree Barclays U.S. Aggregate Bond Enhanced Yield Fund (AGGY), an exchange-traded fund (ETF) that tracks the Barclays U.S. Aggregate Enhanced Yield Index. This strategy looks to enhance yields relative to the Barclays U.S. Aggregate Index by re-weighting its components to enhance income while broadly retaining its risk characteristics. When utilizing this approach, investors have the potential to stay within a core fixed income strategy and avoid the possible negative effects of "reaching for yield."

[1]Press Release of the Board of Governors of the Federal Reserve System, 1/27/16.

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DEFINITIONS

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 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.

Inflation : Characterized by rising price levels.

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

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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

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.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

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

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.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

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