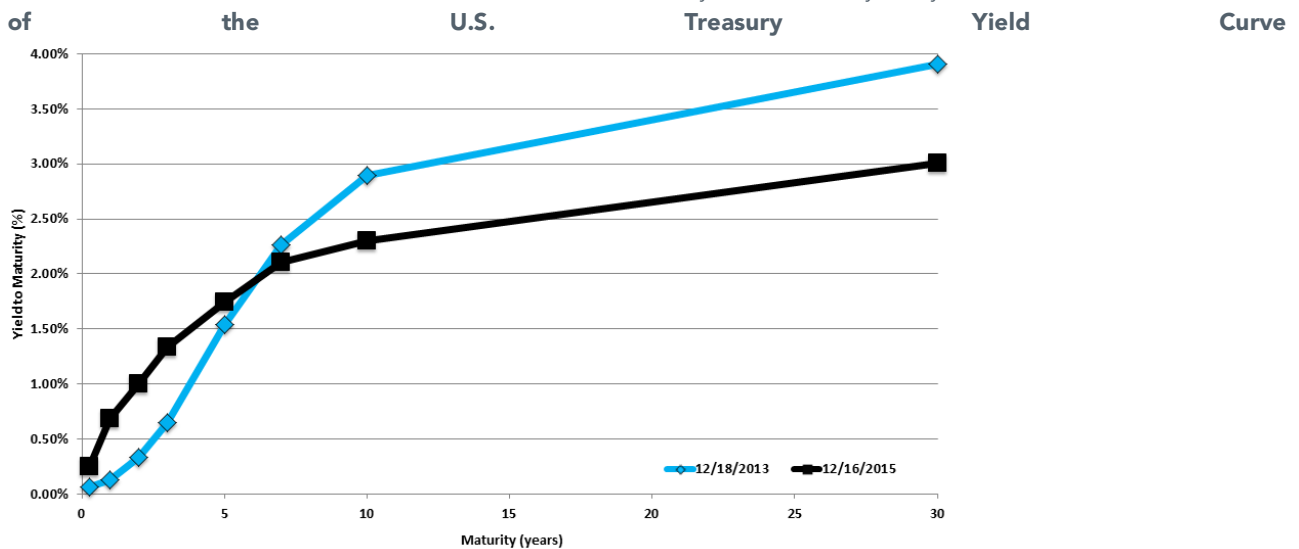


FROM TAPERING TO FIRST TIGHTENING: WHAT'S CHANGED IN THE BOND MARKET?

Bradley Krom — Head of U.S. Research
12/21/2015

When the [Federal Open Market Committee \(FOMC\)](#) voted to increase the [Federal Funds Rate](#) by 25 [basis points \(bps\)](#) last week, in addition to the first rate hike in more than nine years, this also marked the first unanimous decision by the FOMC since the previous [tightening](#) cycle began in 2004. While the vast majority of research commentaries will now shift their focus to 2016, we thought it might be instructive to take a look back. In this piece, we examine how U.S. fixed income has evolved since December 18, 2013, the day the Federal Reserve (Fed) began [tapering](#) its bond purchases in an intermediate step to liftoff. **Impact on U.S. Treasuries** As we show below, short rates have increased, while longer rates have actually fallen. The result is a [flatter yield curve](#), whereby Fed policy drives up rates to approximately six years and the outlook for global growth and [inflation](#) push the long end lower. Looking closer, [2-Year Treasury](#) yields have tripled over the last two years, rising by over 67 bps. Curiously, rates at the 10-year part of the curve actually fell by 60 bps, resulting in a net [flattening](#) of 127 bps. Today, economists forecast that 10-year rates could rise to 2.82% by the end of 2016.¹ However, any uptick in growth or inflation could drive rates even higher. In our view, while investors inevitably look to bonds for income, the current trade-off remains extremely unattractive by many historical measures. **Evolution**



Source: Bloomberg, as of 12/16/2015.

*For definitions of terms on the chart, visit our [glossary](#). As we noted last week, [investment-grade \(IG\)](#) credit performed fairly well during the 2004 tightening cycle. Examining the impact on the market since the tapering, the [BBB/Baa](#) segment of the market saw [credit spreads widen](#) by 62 bps, nearly offsetting the decline in [10-Year Treasuries](#). In sum, all-in borrowing costs of benchmark issues have not materially changed in the past two years, despite the evolution of Fed policy. Below, in addition to investment grade, we also examine the moves across the various [credit ratings](#) buckets of [high yield](#). **U.S. Credit***

U.S. Corporates	12/18/2013	12/16/2015	Change (bps)
Investment-Grade	118.2	165.2	+47.0
Aaa	59.7	78.2	+18.5
Aa	66.3	86.6	+20.3
A	94	123	+29.0
Baa	156.2	218.2	+62.0
High Yield	414.7	657.3	+242.6
Ba	318	445.9	+127.9
B	383.6	652.2	+268.6
Caa	613.4	1338.3	+724.9
Ca	2021.9	4611.9	+2590.0

Source: Barclays, as of 12/16/15. Past performance is not indicative of future results. Standard & Poor's, Moody's and Fitch study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings' financial condition and histories. The ratings displayed are based on the highest of each portfolio constituent as currently rated by Standard and Poor's, Moody's, or Fitch. Long-term ratings are generally measured on a scale ranging from AAA (highest) to D (lowest), while short-term ratings are generally measured on a scale ranging from A-1 to C.

Spreads across Ratings Buckets

With commodities down over 38%² in the last two years, the perceived risk of defaults from borrowers in the Materials and Energy sectors is having a profound impact on the high-yield bond market. With uncertainty surrounding the pace and timing of Fed rate hikes, a general desire to de-risk before the end of the year, and persistent concerns about bond market liquidity, spreads have widened materially in the past several days. Additionally, the restriction of redemptions by one high-yield mutual fund with concentrated positions in the lowest rated, least liquid segment of the market does little to improve investor sentiment/flows. In our view, current depressed valuations do not reflect [fundamentals](#), but absent demand, spreads could continue to languish in the short run. In response to changes at the Fed and a sustained improvement in the economy, we continue to believe that U.S. [interest rates](#) will rise over the coming year. While credit has come under pressure, particularly in the highest-yielding segments of the market, we believe that we are nowhere near the end of the current credit cycle. As a result, investors should consider [hedging](#) interest rate risk while maintaining exposure to credit as our favored approach to positioning for additional Fed tightening. For investment grade, the [Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration](#) shows the performance of the [Barclays U.S. Aggregate Index](#) with [duration](#) hedged to zero years. For greater credit risk, the [BofA Merrill Lynch 0-5 Year US high Yield Constrained, Zero Duration Index](#) tracks the returns of non-IG credit hedged to zero years. ¹Source: Bloomberg, as of 12/16/15. ²As proxied by the [Bloomberg Commodity Index](#).

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, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch 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 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.

Basis point : 1/100th of 1 percent.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Curve-flatten : a relative-value position that benefits if the spread between short and long maturity securities declines.

Inflation : Characterized by rising price levels.

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

Flatten : to effect a zero positio.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

BBB- : Standard & Poor's credit rating that implies the borrower has adequate capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating represents the lowest level of investment-grade.

Baa : Moody's credit rating that implies the borrower has capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating includes the lowest level of credit risk while still being investment-grade.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

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

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

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.

Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration : Combines long positions in the Barclays U.S. Aggregate Bond Index with short positions in U.S. Treasury Bonds to provide a duration exposure of 0 years. Market values of long and short positions are rebalanced at month-end.

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

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.

BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index : Tracks the performance of the combination of a long position in short maturity US high yield bonds and a short position in on the run US Treasuries where the net interest rate exposure of the index is adjusted to a zero year duration. Market values of long and short positions are rebalanced at month-end.

Bloomberg Commodity Spot Index : formerly known as Dow Jones-UBS Commodity Spot Index (DJUBSSP), tracks the spot prices of a broadly diversified basket of commodities that comprise the total return index.