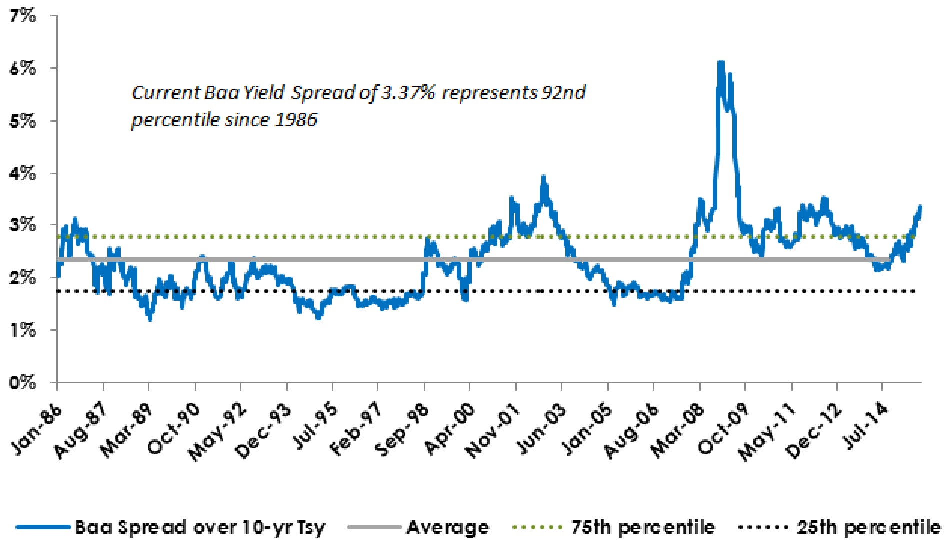
WHAT DO THE FED AND BBQ HAVE IN COMMON?

Rick Harper – Chief Investment Officer, Fixed Income and Model Portfolios
10/26/2015

The phrase "low and slow" commonly refers to the proper method for cooking barbecue. Cooking over low heat for a long, long time is the pathway to BBQ bliss. These days it feels like the Fed is applying the same philosophy to normalizing rates—the terminal rate being lower and the process taking much longer. So what are fixed income investors to do while the Fed simmers? Search for yield. As long as weakness abroad is counterbalanced by improvement domestically, Treasury rates are likely to trade stepwise within ranges. Additionally, the credit cycle will be extended. Corporate credit spreads should provide value, and even though they may be less attractive on a valuation basis, residential and commercial mortgage-backed securities (MBS and CMBS) should supplement the income offered by Treasuries. Corporate credit spreads have recently been pushed higher by liquidity and growth concerns to attractive levels, in our view. As shown by the graph below, yield spreads over Treasuries have risen to levels typical for a recession; at quarter-end, current 10-year Baa spreads ranked in the 92nd percentile relative to their history since 1986. While this is a concern, we would argue that a recession is not imminent. The domestic economy as a whole has been more resilient, and global leaders are willing to initiate policies to reduce financial distress and volatility. **Baa rated Corporate Bonds** over **10-Year Treasuries**



Past performance is not indicative of future results. You cannot invest directly in an index.

Source: Bloomberg, as of 9/30/15.

Credit ratings apply to the underlying holdings of the Index, not to the Index itself. 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 & 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.

Given this view, the recent sell-off in corporates seems overdone; we expect this sector of the fixed income market to outperform. In particular, clipping Treasury coupons seems less attractive when some investment-grade corporates are currently offering over twice the income. But back to our low and slow analogy: The world is still a little fragile, and blindly grabbing yield could still be risky. A more prudent approach may be to add yield gradually. At each step, investors should consider if the increase in income potential is going to materially alter their portfolio's risk profile. The Barclays U.S. Aggregate Enhanced Yield Index (Agg Enhanced Yield) takes this very approach in altering the composition of the Barclays U.S. Aggregate Index (Aggregate). The index first decomposes the Aggregate into 20 different buckets stratified across sector, credit quality, and maturity. It then reassembles the pieces to maximize yield within specified tracking error limits and bands on relative duration and sector exposures. Through this approach, the portfolio remains 100% investment grade but enhances the income potential of the portfolio. In most environments, this methodology will lead to allocations that have more credit exposure than the composition of the Aggregate. The guardrails ensure that the approach to adding corporate risk is measured. For example, each major asset sector cannot exceed a variance of 20% to its weight in the Aggregate. Thus exposure to credit-sensitive bonds is capped at 50%, roughly 20% above its current weight in the Aggregate. As we show below, the Agg Enhanced Yield provides an 82 basis point pickup in yield compared to the Aggregate. The credit allocation increases to 50% (against the 30% currently in the Aggregate), while exposure to U.S. Treasuries is reduced. In our view, this shift in positioning makes intuitive sense in the current environment. Index Statistics as of September 30, 2015

	Yield to Worst	Duration	Corporate %	Government %	Securitized %
Barclays U.S. Aggregate Yield Enhanced Index	3.14%	6.56	50.2%	17.3%	32.5%
Barclays U.S. Aggregate Index	2.31%	5.60	24.0%	45.1%	30.9%
Difference	0.83%	0.96	26.2%	-27.8%	1.6%

Past performance is not indicative of future results. You cannot invest directly in an index.

Sources: Barclays, WisdomTree, as of 9/30/15.

For the last seven

years, we have bumped along in this low-rate environment. If concerns about global conditions keep the Fed lower and slower, increasing your corporate exposure with your core portfolio may tide you over until the BBQ is ready (so to speak.)

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. 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. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on.

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

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.

credit cycle : the process in which the pricing of and access to credit evolves over time.

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

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.

Commercial mortgage-backed securities : a fixed income security that is composed of multiple underlying commercial mortgages.

U.S. Treasury Bond : a debt security issued by the United States government.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Yield spread : the amount of incremental income a bondholder receives for assuming credit risk.

10-Year Baa Spreads : refer to the difference in yield in Baa rated corporate bonds and the U.S. 10-Year Treasury Bond.

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

Corporate Bonds : a debt security issued by a corporation.

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

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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.

Credit quality : A measure of a borrowers potential risk of default.

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

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

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.

Basis point : 1/100th of 1 percent.