

2017 UPDATE: ENHANCE YOUR AGGREGATE POSITIONS WHILE REDUCING RISK

Bradley Krom — U.S. Head of Research
05/24/2017

After [hiking rates](#) in March 2017, the Federal Reserve (Fed) remains poised to increase interest rates two additional times this year, we believe. Despite this consensus view, nominal interest rates are lower than they were to start the year at [maturities](#) of five years or greater.¹ Below, we highlight the likely driver of what we believe will prove to be a temporary decline in rates. In response, we believe investors should consider adding [credit risk](#) to their core bond portfolio while at the same time reducing [interest rate risk](#).

Year-to-Date Decline in Rates

While shifts in global markets seldom have a singular catalyst, we believe a significant contributor to the move lower in rates has been a result of the repricing in confidence of the Trump administration's ability to affect pro-growth policies with Congress. In our 2017 outlook, our 3.00% rate target for U.S. 10-year debt was predicated on the passage of pro-growth [fiscal policies](#) combined with a meaningful infrastructure spending bill. Any potential distractions from this agenda will likely continue to increase uncertainty and keep rates at more subdued levels. We believe it is no coincidence that rates peaked in early March after Trump issued his controversial "travel ban" executive order. In our view, this setback represents an annoying distraction in Trump's policy agenda, not necessarily a retrenchment. As such, we would continue to advocate that investors tactically shift to a position under-weight in [duration](#) in advance of any potential shift in the political winds of Washington.

Add Risk Worth Taking, Subtract Risk That's Not

While many investors may find themselves uncomfortably long in equity and credit markets, we do not currently forecast a marked deterioration in credit quality for the majority of U.S. [investment-grade \(IG\)](#) companies. In response, while credit currently may provide less value than when we initially advocated this positioning in 2015, IG corporates could still provide a meaningful pickup in yield relative to [U.S. Treasuries](#). While spreads of 113 [basis points \(bps\)](#)² remain near the tightest levels of the last 10 years, we believe this is largely a recognition by the market that U.S. corporate profits, as well as economic momentum, could be poised to accelerate in the coming quarters. As such, adding to positions in credit appears to us to be a risk worth taking.

On the other hand, we continue to advocate a more defensive positioning in U.S. interest rate risk. Currently, the market forecasts a 95% chance of a rate hike at the Fed's next meeting on June 14.³ In anticipation of this move, we believe most investors should continue to reduce duration across their bond portfolios. This view is primarily predicated on the fact that we believe rate markets continue to be biased to the upside in the face of [tightening](#) policy by the Fed. While it is true that changes in Fed policy may not directly affect longer-term interest rates, the market has digested a fairly robust amount of supply year-to-date. In fact, corporate issuance set an all-time record in the first quarter.⁴ While we do not believe the current pace is sustainable, absent a continued increase in marginal buyers, long-term interest rates should continue to rise in the U.S. over the course of 2017.

Identifying Opportunities in the Bloomberg Barclays U.S. Aggregate Index (Agg)



Enhancing Core Portfolios

After nearly two years of strong outperformance from our enhanced yield Agg strategy,⁵ we believe a shorter [duration](#) variant⁶ can also add significant value to investor portfolios. For investors who believe that the U.S. economy remains strong and corporate credit remains a buy, the [WisdomTree Yield Enhanced U.S. Short-Term Aggregate Bond Fund \(SHA G\)](#) combines our two favorite ideas in fixed income today: under-weight in duration and over-weight in credit. Given that the strategy focuses on the one-to-five-year segment of the Bloomberg Barclays U.S. Aggregate Index, the strategy seeks to maximize yield across the IG market while still adhering to constraints that strike a familiar balance between risk and reward. The resulting portfolio reduces duration by nearly three years while reducing income by only 37 bps relative to the Bloomberg Barclays U.S. Aggregate Index.⁷ As a result, we believe this approach may provide a powerful means of maintaining income, while reducing interest rate risk in the core of investor portfolios.

¹Source: Bloomberg, as of 5/11/17.

²As represented by the [Bloomberg Barclays U.S. Corporate Index](#)

³Source: Bloomberg, as of 5/11/17.

⁴Source: Bloomberg.

⁵The [Bloomberg Barclays U.S. Aggregate Enhanced Yield Index \(Enhanced Yield Agg\)](#) outperformed the Bloomberg Barclays U.S. Aggregate Index by 93 bps per year from 7/9/15 to 5/10/17.

⁶Represented by the Bloomberg Barclays U.S. Short Aggregate Enhanced Yield Index (Short Agg Enhanced Yield)

⁷Source: Bloomberg, as of 4/30/17.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. 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. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the 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](#)

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

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.

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

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

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

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.

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.

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

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Basis point : 1/100th of 1 percent.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Barclays U.S. Corporate Index : is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays U.S. Short Aggregate Enhanced Yield Index (Short Agg Enhanced Yield) : a constrained, rules-based approach that reweights the sector, maturity and credit quality of the Barclays U.S. Aggregate Index across various subcomponents in order to enhance yield maturing in one to five years.