

# WISDOMTREE 101: PRIMER ON REAL YIELDS

Lonnie Jacobs — Associate Director, Research Content

12/01/2022

If investors are looking for a single catalyst to explain capital markets (and flows) in 2022, our best answer would be the dramatic shift in U.S. real yields. In part two of our [market monitor series](#), we explain the underlying calculations and drivers of changes in real yields to better equip investors to navigate markets going forward and what may lay ahead.

## Nominal vs. Real

In part one of our market monitor series, we discussed the U.S. [yield curve](#) and current yields available by investing in various forms of fixed income. When you hear someone speaking about interest rates, most often, they are referring to nominal or non-[inflation](#)-adjusted rates. Interest rates quoted net of inflation are "[real](#)" yields, given that they attempt to show the "real" level of compensation.

## Consider an investment in a 5-Year [U.S. Treasury bond](#).

Let's say an investor receives 4% interest per year over the life of the investment. While the nominal returns on this investment are 4%, if inflation were positive over the period, the real return would be lower due to the erosion in purchasing power. If inflation averaged 4% over the life of the investment, real returns would actually be zero, given that the nominal returns were offset by a corresponding increase in the inflation rate.

As we show below (and in our [daily market monitor](#)), real yields can be directly observed from the [Treasury Inflation-Protected Securities \(TIPS\)](#) yield curve. This is because TIPS yields are quoted in real terms, i.e., nominal yields minus the expected inflation rate. As you can see, TIPS yields went from being negative across most tenors of the yield curve to firmly positive. Negative real yields indicate that investors are actually experiencing periods of negative returns net of inflation.

## Treasury Inflation-Protected Securities (TIPS) Yield Curve



Sources: WisdomTree, FRED, as of 11/28/22. YTM: Yield to Maturity (the total return anticipated on a bond if the bond is held to maturity).

## Market Implications

As noted in the introduction, this dramatic shift in real yields has been huge for financial markets. Rate hikes and the Fed's increasingly aggressive tightening stance played a key role in the rise in real yields, resulting in the real yield curve turning positive across all tenors.

This also helps explain why the U.S. dollar has appreciated so dramatically versus almost every foreign currency in 2022. In many countries, short-term rates remain much lower than in the U.S. The fact that investors can now derive positive [carry](#) net of inflation makes these assets more attractive, thus causing demand for them to increase. This demand for U.S. dollar-denominated assets versus foreign assets can lead to increases in the value of the U.S. dollar.

#### 10-Year Nominal vs. Real Yields – 1/2/03–11/28/22



#### 5-Year Nominal vs. Real Yields – 1/2/03–11/28/22



Sources: WisdomTree, FRED. Nominal Yields measured by Market Yield on U.S. Treasury Securities. Real Yields measured by Market Yield on U.S. Treasury Securities, Inflation-Indexed.

As we show in the above charts, real yields have increased to levels not seen since 2008 in both the 5-Year and 10-Year tenors. We view this trend to multi-decade highs as being important not only for contextualizing real yields versus other markets but also versus their history. The sharp increases this year have also contributed to the dramatic swings we've seen in global currency and interest rate markets.

Rising rates also matter for equities. An increase in rates impacts the cost of borrowing to finance new and existing projects as well as [earnings growth](#). Even more important is the impact on the [discount](#) rate that applies for discounting future cash flows of financial assets to today. With negative real yields connoting very low discount rates, companies with low (or negative) profitability saw their valuations expand. However, once the opportunity cost of capital went higher, the competition for capital weighed on valuations and negatively impacted returns.

### **Conclusion**

At the core, real rates represent the most fundamental measure of the cost of capital globally. In our view, the evolution of rates will continue to be a primary determinant of asset flows and returns going forward. As the dollar remains one of the most important reserve currencies in the world, investors should continue to focus on the evolution of real rates and what it means for the relative attractiveness of assets in the future.

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.

### **Related Blogs**

+ [WisdomTree 101: We're All Rates Traders Now](#)

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](http://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**

**Curve** : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

**Inflation** : Characterized by rising price levels.

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

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

**Treasury Inflation-Protected Securities (TIPS)** : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

**Carry** : The amount of return that accrues from investing in fixed income or currency forward contracts.

**Earnings growth estimates** : Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

**Discount** : When the price of an ETF is lower than its NAV.