FED HIKES: HEDGE YOUR RATE BETS FOR 2017

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For the second year in a row, the Federal Reserve (Fed) has given the financial markets a rate hike in December. The natural question now is whether U.S. policy makers will follow this year's playbook for 2017, or will they blaze a new trail and potentially raise rates more than once per year? The Fed's new median forecast is for three rate hikes next year.

Certainly, the investment climate seems rather different than how it was 12 months ago, because the results of the U.S. presidential election have altered the dynamics of the financial markets. Within the fixed income arena specifically, the sell-off in the U.S. Treasury (UST) market after the election placed yields at levels investors haven't witnessed in well over a year. In fact, in the case of the UST Two-Year and Five-Year notes, yield levels reached their highest readings in the last five to six years.

The prospect for fiscal stimulus in the guise of tax cuts, infrastructure spending and regulatory relief has created an investment landscape where improved economic growth and the potential for higher inflation have dominated investor sentiment. As far as the current economic landscape is concerned, real gross domestic product (GDP) has improved from the first half of this year, while inflation gauges, such as the Consumer Price Index (CPI), have seen some elevation in recent months as the drag from lower energy prices gets removed from year-over-year comparisons, and wage trends have revealed signs of improvement as well.

The aforementioned economic conditions were key reasons for the Fed's latest tightening move. Where the voting members go from here is still subject to some uncertainty. Based on comments from a variety of Fed officials, they are not going to preemptively change their policy outlook based on the premise of upcoming fiscal stimulus. Rather, the Federal Open Market Committee (FOMC) seems to be entering more of a potential reactive phase to policy, with a tilt toward perhaps more rate hikes than Fed members currently envision if conditions warrant such action.

Source: Bloomberg as of 12/08/16. Past performance is not indicative of future results. You cannot invest directly in an index.

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Please click here for the standardized performance of the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

Given today's Fed outcome and the fixed income landscape being altered post-election, investors should examine their portfolios to ensure they are prepared for a potential volatile environment for the remainder of this year and into 2017. If fiscal stimulus, regulatory relief and additional Fed rate hikes are the base case for 2017, one should consider an approach to help mitigate potential interest rate risk.

The graph above clearly illustrates the importance of reviewing the need to help immunize a fixed income portfolio from potentially higher interest rates. Indeed, since the UST 10-Year yield reached its all-time low on July 8, investors who went unhedged and remained solely in a broad fixed income position as represented by the Bloomberg Barclays U.S. Aggregate Index (Agg) have witnessed a negative total return of more than 3%, as of this writing. In contrast, by dialing down rate exposure by using a zero duration strategy as represented by the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index, investors would have been able to reduce their risk of higher rates and see a positive total return of more than 6%, in the same time frame.

Conclusion

The WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund (HYZD), which tracks the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index, and the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund (AGZD) are two vehicles investors could utilize to achieve this goal. These Funds can be used to complement a "core" fixed income strategy or as "stand-alones" for this approach.

Investors looking to mitigate potential interest rate exposure may also wish to examine the potential benefits of floating rate Treasury securities (FRNs). FRNs are based on a reference rate that is determined at the weekly Three-Month Treasury Bill auction. Given the potential for additional increases in the Federal Funds Rate in 2017, some potential "Fed protection" seems warranted. Against this backdrop, we feel that utilizing a floating rate product, such as the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR), investors may be better able to insulate their bond portfolio compared with a more traditional fixed income investment.

Unless otherwise noted, source is Bloomberg, as of 12/9/2016.

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You cannot invest directly in an index.

DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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.

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.

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.

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

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

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

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

10-year government bond yield : Yields on the 10 year government debt security.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

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.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Three-month U.S. Treasury bill : a debt obligation of the U.S. government with an original maturity of 3 months.

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.