FIXED INCOME STRATEGY: STAYING ON COURSE

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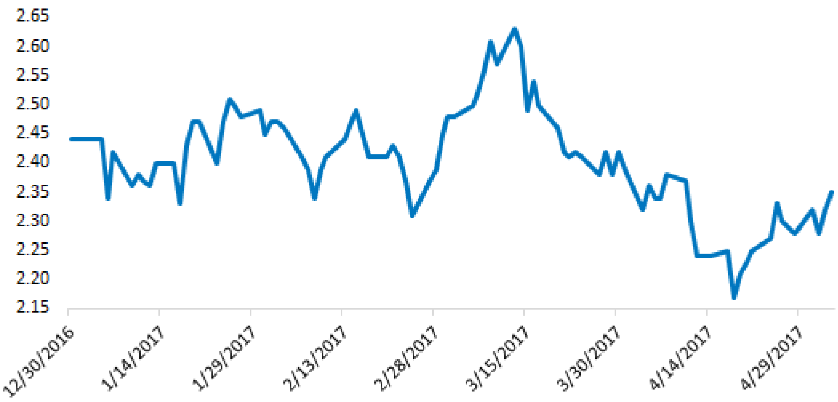
When examining the appropriate course for fixed income strategies thus far in 2017, we are already about halfway through Q2 and appear to be staying on course. What exactly is "staying on course," you might ask? The overall premise for fixed income investing has essentially been playing out according to our base case: blending a strategic core approach with a complementary solution for the potential of higher rates later in the year.

The graph below clearly illustrates that the U.S. Treasury (UST) 10-Year yield has been exhibiting a bit of a sawtooth pattern since the end of last year, but overall it seems to have found a trading range between roughly 2.15% and 2.65%. Interestingly enough, even with all that back-and-forth movement, as of this writing, the UST 10-Year yield stood at 2.35%, or only 9 basis points (bps) below the year-end 2016 reading of 2.44%. However, as we have seen with last week's FOMC meeting and the April Employment Situation Summary, the prospects for a new and elevated trading range in the months ahead remain alive and well.

U.S. 10–Year Treasury Yield



Source: Bloomberg, as of 5/5/2017. Past performance is not indicative of future results.

Let's take a look at the May Federal Reserve (Fed) policy gathering first. Heading into the convocation, there was some conjecture that the soft Q1 real GDP performance of only +0.7% could give the voting members some pause regarding their tightening plans for 2017. Based on the policy statement, the Fed appears to be on track with the guidance it has provided thus far: two more rate hikes this year, followed by the possibility of beginning a balance sheet normalization process either later this year or early in 2018. In fact, the Fed viewed the slowing in Q1 growth as "likely to be transitory," Fed-speak for temporary with a return to its own economic outlook in short order.

As far as the April jobs report is concerned, the underlying tenor of the data would tend to support that "transitory" assessment. The unemployment rate dropped 0.1 percentage points to 4.4% (its lowest level since 2007), while nonfarm payrolls grew by a stronger-than-expected +211,000. Average hourly earnings have been stuck in a year-over-year band of +2.5% to +2.9% (April came in at +2.5%), but other wage measures, such as the Employment Cost Index, have shown continued improvement. In the post-jobs-data market, Fed Funds Futures now reveal an implied probability of 100% for a June rate hike as compared to only 50% as recently as two weeks ago.

Conclusion

Fixed income investors should not expect the path to higher rates to necessarily be a one-way street; the more likely scenario is a sawtooth pattern, with the end result being a new and elevated trading range for the UST 10-Year yield, accompanied by a higher Fed Funds target range as well. Back to the point I made in my opening paragraph. Against this backdrop, investors may wish to pursue a fixed income strategy that blends a core approach, utilizing the WisdomTree Barclays Yield Enhanced U.S. Aggregate Bond Fund (AGGY), with a complementary rising rate solution such as the WisdomTree Interest Rate Hedged High Yield Bond Fund (HYZD).

Unless otherwise noted, source is Bloomberg as of 5/5/2017.

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DEFINITIONS

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.

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

Basis point : 1/100th of 1 percent.

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

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

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

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.

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.

Employment Cost Index : Measure of the change in cost of labor, free from the influence of employment shifts among occupations and industries.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.