THE NEW RATE REGIME: PLAYING FOR RATE CUTS

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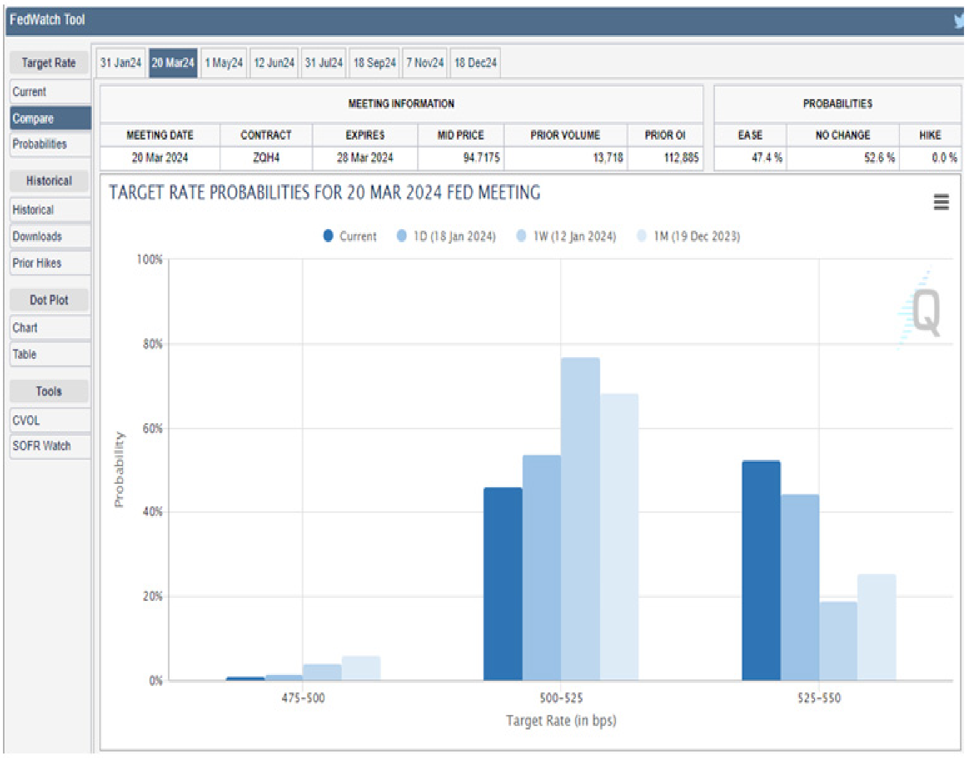
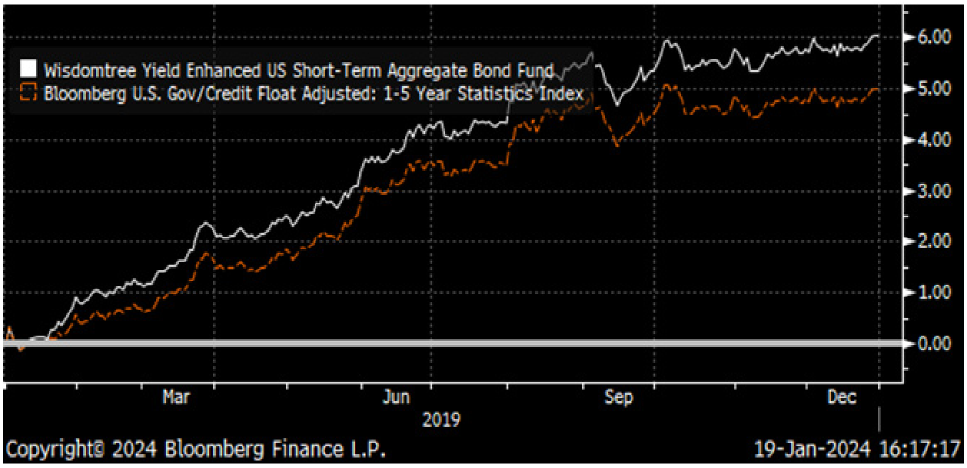
Last week, I wrote about the money and bond markets apparently doubling down on their optimistic expectations for Fed rate cuts this year. However, an interesting development occurred over the last week: Fed pushback. Now, this doesn't mean the Fed is not going to cut rates in 2024. It's just that the markets had apparently gotten too far ahead in their expectations for the policy maker's liking. Against this backdrop, investors should consider how to play this pivot in monetary policy.

Let's first take a look at recent developments. The chart below highlights how the market's narrative for the timing of the first rate cut has recently changed. Less than two weeks ago, the March 2024 FOMC meeting was widely viewed as the timeline for that first cut, with the probability coming in at just about 77%. Post-Fed comments over the last few trading sessions have pushed that probability down to 46%, with the May Fed meeting becoming the new frontrunner.



Source: CME Group, as of 1/19/24.

The implied probability for Fed Funds Futures has also scaled back rate cut expectations, albeit just slightly. As of this writing, five, rather than six, cuts worth a total of about 125 basis points (bps) appear to be priced in for this calendar year. In other words, the monetary policy pivot is still very much front and center for the money and bond markets. In fact, it will be interesting to see how rate cut expectations play out as 2024 progresses. If upcoming economic/labor market and inflation data continue to reveal resiliency and slow progress toward the Fed's 2% threshold, it would seem reasonable for the market to dial back its current outlook to align more closely with the Fed's dot plot, which called for three rate cuts this year.



Source: Bloomberg, 2019 total return performance (NAV). WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times. You cannot invest directly in an index. **Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.**

Performance data for the most recent quarter-end and month-end is available here.

So, what is one way investors can position themselves in this rate setting?

On Offense (Rate-Cut Strategy): WisdomTree Yield Enhanced U.S. Short-Term Aggregate Bond Fund (SHAG)

- SHAG is very correlated to the UST 2-Year yield, which is anchored to the Fed Funds Rate
- Thus, Fed rate cuts and/or rate cut expectations should show through here more directly than intermediate/long duration.
- SHAG's effective duration is 2.37 as of January 18, 2024.
- During the last normal rate cut cycle pre-Covid (three cuts like the Fed's current dot plot), SHAG outperformed the benchmark Bloomberg U.S. Govt/Credit 1-5 Year Index by more than 100 bps (see above).

Conclusion

Our primary 2024 theme for fixed income is that investors have entered into a New Rate Regime, reverting to the old or normal one, where zero interest rates are a thing of the past. It's an environment that a generation of investors have not witnessed before. And unlike 2022 and 2023, the current calendar year brings with it the prospect of rate cuts, not rate hikes.

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For the top 10 holdings of SHAG please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/shag

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.

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DEFINITIONS

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

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Basis point : 1/100th of 1 percent.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

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

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.

Bloomberg US Gov/Credit Float Adjusted 1-5Y Statistics Index : The Bloomberg U.S. 1–5 Year Government/Credit Float Adjusted Index includes U.S. Treasury and agency obligations, as well as investment-grade (rated Baa3 or above by Moody’s) corporate and international dollar-denominated bonds, all having maturities of 1 to 5 years.