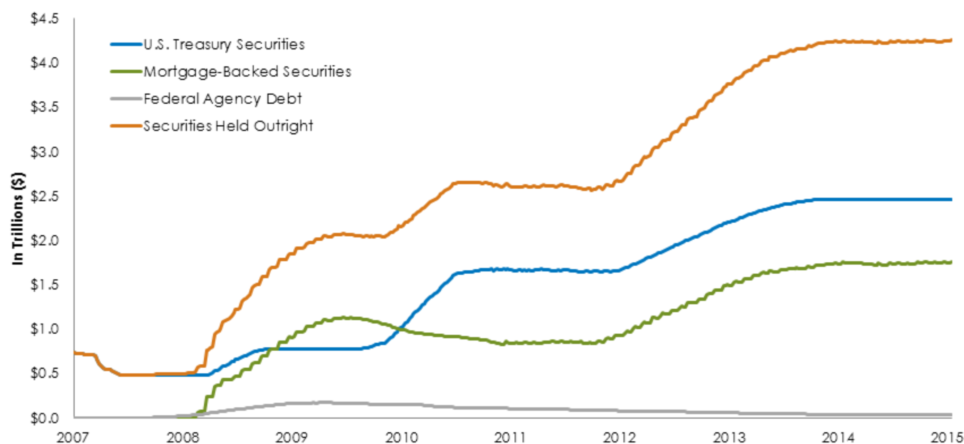
U.S. RATES: A CASE OF ONE STEP FORWARD, TWO STEPS BACK

Kevin Flanagan — Head of Fixed Income Strategy
01/28/2016

The Federal Reserve (Fed) finally gave the financial markets 'liftoff' in mid-December, but ever since, the U.S. rate development is a case of "one step forward, two steps back." Indeed, in the aftermath of the Fed's decision to raise the Federal Funds target by a quarter-point, the U.S. 10-Year Treasury (UST) yield reached a high point of 2.31%, only to reverse course and penetrate the 2% threshold in recent weeks. There is little doubt that the UST market's focus early in the new year has been on other financial arenas. The visible drop in crude oil and attendant decline in equity valuations have once again spurred safe-haven buying, a scene we've seen played out many times over the last few years. Slowing global growth concerns have also come into play, led by worries about China's economy, while global rates and monetary policy in the developed world also remain active considerations. Here in the U.S., the economic news has been a bit more mixed, as a robust jobs report has been offset by softer readings for manufacturing. Thus, real gross domestic product (GDP) for 2016 is not expected to be too far off the +2.2% average since the end of the Great Recession in mid-2009. What about the Fed? Consensus wisdom coming into 2016 has centered around the notion that policy makers would announce four additional rate hikes this calendar year (March, June, September, December), a view basically confirmed by Fed officials themselves. With the first Federal Open Market Committee (FOMC) meeting of the year now behind us, the Fed is left with seven future gatherings in which to effectuate these possible tightening moves. Given the newfound uncertainty at the beginning of the year, it seems difficult to envision four hikes will be in the offing; perhaps two, maybe three seem a better likelihood at this point. Within the UST arena, recent history has shown that one month's rate movement is not necessarily a harbinger of what lies ahead. Our current rate outlook anticipates a gradual low-trajectory rise in UST yields from here, with a range-bound seesaw type of pattern along the way. One of the key reasons we believe any increase will be tempered actually lies with the Fed and is due to not only the scaled-back rate hike expectations but also to balance sheet considerations.

Federal Reserve Securities Held Outright-Breakdown



Source: Federal Reserve, as of 1/13/2016.

Phase 2 of the Fed's "normalization" playbook involves its holdings of securities—Treasuries, federal agencies and mortgage-backed securities (MBS). As of this writing, its System Open Market Account, or SOMA, totaled $4.25 trillion, with Treasuries standing at $2.46 trillion or 58% of that amount. It has been reported that, for the first time, the Fed will have a sizeable amount of Treasuries (the figure has been placed at roughly $215 billion) rolling off the books in 2016. Recent Fed commentary has reiterated its intention to reinvest any maturing holdings until the normalization of rates is well under way. As a result, the UST market

WISDOMTREE®

should continue to receive support from the Fed this year to offset potential selling pressure from global central banks. When combined with the aforementioned forces, any rise in rates from current levels appears to be capped. Against this backdrop, WisdomTree feels fixed income investors would be prudent to enhance their yield. Rather than focusing on the Barclays U.S. Aggregate Index (Agg) an alternate approach to achieve this goal could be the Barclays U.S. Aggregate Enhanced Yield Index strategy. That Index looks to enhance yields vis-à-vis the Agg by re-weighting its components to enhance income while broadly retaining its risk characteristics. While investors have in recent years stretched for yield in more speculative credits, they might have overlooked the potential to get more income out of their core fixed income by looking inside the Agg itself.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. 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.

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, Kara Marciscano, 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

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.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

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.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

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.

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.

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

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Federal Agencies : Special government organizations set up for a specific purpose such as the management of resources, financial oversight of industries or national security issues.

Commercial mortgage-backed securities : a fixed income security that is composed of multiple underlying commercial mortgages.

System Open Market Account (SOMA) : An account that is managed by the Federal Reserve Bank, containing assets acquired through operations in the open market. The assets in SOMA serve as a management tool for the Federal Reserve’s assets, a store of liquidity to be used in an emergency event where the need for liquidity arises, and as collateral for the liabilities on the Federal Reserve’s balance sheet such as U.S. dollars in circulation.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.