FIXED INCOME: INFLATED EXPECTATIONS

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If there has been any lesson to be learned in the fixed income arena since election day, it is that, yes, interest rates can go up. There seems to be little doubt fixed income investors had become increasingly accustomed to the opposite scenario in 2016. In fact, a question which came up regularly in conversation was: How much lower can the U.S. Treasury (UST) 10-Year yield go? Given recent developments, the exact opposite question is now being asked.

When examining fixed income strategies for 2017, it is important to put the recent run-up in UST yields in perspective. In our opinion, the post-election movement has brought UST yields to levels comparable to what was registered roughly a year ago. If you were Rip Van Winkle and had fallen asleep in November 2015, only to just reawake, you'd probably be wondering what all the fuss is about. For those of us who were not in a deep slumber over the last 12 months, we have witnessed firsthand the volatility in Treasury yields in 2016 and now can't help but wonder: Where are we going from here?

U.S. Treasury

At current yield levels, the UST market has essentially "priced out" recessionary and deflation/disinflation fears and has also removed the flight-to-quality bid. However, the positive impact on economic growth from potential fiscal stimulus and any attendant increase in inflation expectations are not currently being reflected. In addition, a more hawkish Federal Reserve (Fed) rate hike cycle for next year is also not part of the current pricing mechanism in Treasuries. That leaves investors in a wait-and-see mode for now, but one could argue that the base case for 2017 is that we will likely see some form of fiscal stimulus and regulatory relief.

Elevated inflation expectations and actual inflation data will be watched more closely by the money and bond markets moving forward. The turnaround in energy prices from the lows witnessed earlier this year should result in higher overall readings in the months ahead, while the recent upward trend in wages will also need to be monitored. Against this backdrop, the "breakeven inflation rate," or the difference between the yield on a nominal bond (such as the U.S. Treasury 10-Year note) and an inflation-linked, or real yield bond with the same maturity (such as the 10-Year U.S. Treasury Inflation-Protected Securities or TIPS), will serve as a useful guide regarding inflation expectations. As of this writing, this rate has widened to 1.92%, a visible increase from the 1.20% low printed in February and the highest reading since summer of last year. However, this reading is still below the 2.04% five-year mean and well below the peak of 2.66% during that period (see graph).

Conclusion

With 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 your base case for 2017, you should consider an approach to help mitigate potential interest rate risk. The WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund (AGZD) and the Wisdom Tree BofA Merrill Lynch High Yield Bond Zero Duration Fund (HYZD) are two vehicles investors can utilize to help achieve this goal. These Funds can be used as a complement to a core fixed income strategy or as stand-alones for this approach.

Unless otherwise noted, data source is Bloomberg, as of 11/22/2016.

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DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than one year.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Deflation : The opposite of inflation, characterized by falling price levels.

Inflation : Characterized by rising price levels.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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 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.