AN UNEXPECTED WAY TO BENEFIT FROM RISING U.S. INTEREST RATES

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While we all know that U.S. interest rates have, by and large, been in a downward trend since the early 1980s, over the past few years market participants have begun to think about positioning portfolios for rising interest rates.

As the markets prepare for a transition period in which the U.S. Federal Reserve (Fed) starts to reduce its balance sheet, talk of global accommodation from the European Central Bank (ECB) starts to wane and the U.S. government increases its deficit, we think it is helpful to consider strategies that are tied to interest rate sensitivity, as they can help investors align their equity portfolios with their interest rate viewpoints.

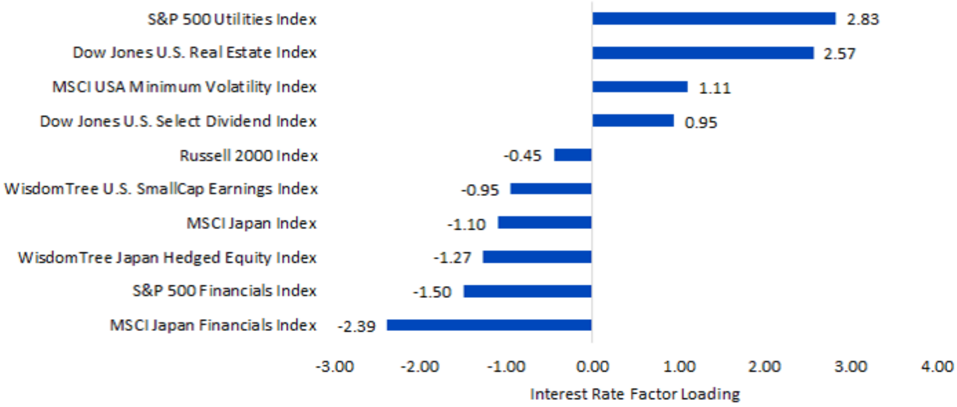
What Strategies Have Been the Best for Rising (or Falling) U.S. Interest Rates?

We chose a period from November 30, 2012, to September 30, 2017, and we utilized a regression analysis in order to see how effective fixed income returns were at explaining the variability of returns across a series of equity strategies. Specifically, our independent or explanatory variables were:

- **Market Minus Risk-Free Rate:** Typically, equity strategies have a sensitivity to movements of the broad market, so we wanted to isolate this factor in order to better zoom in on the sensitivity to shifting interest rates with our other variable.
- **Interest Rates:** Here, we utilized a measure of intermediate-maturity government bond[1] returns such that ***NEGATIVE*** coefficients indicate that equities were going up when interest rates were going up (i.e., bond returns were going down) and ***POSITIVE*** coefficients indicate that equities are sensitive to falling interest rates, with prices of stocks and bonds moving together. Simply speaking, negatively oriented regression coefficients are leading us toward RISING rate strategies, whereas more positively oriented coefficients are leading us toward ***FALLING*** rate strategies.

The Surprise: Japanese Financials Had More Interest Rate Sensitivity than U.S. Financials

Interest Rate Sensitivity (Nov. 30, 2012, to Sept 30, 2017)



Sources: WisdomTree, Bloomberg, Kenneth French Data Library, Morningstar Direct, Ibbotson. Period is from 11/30/12 to 9/30/17. Start date of 11/30/12 selected due to implementation of the export screening methodology for the WisdomTree Japan Hedged Equity Index and the beginning of the "Abenomics" period.

Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

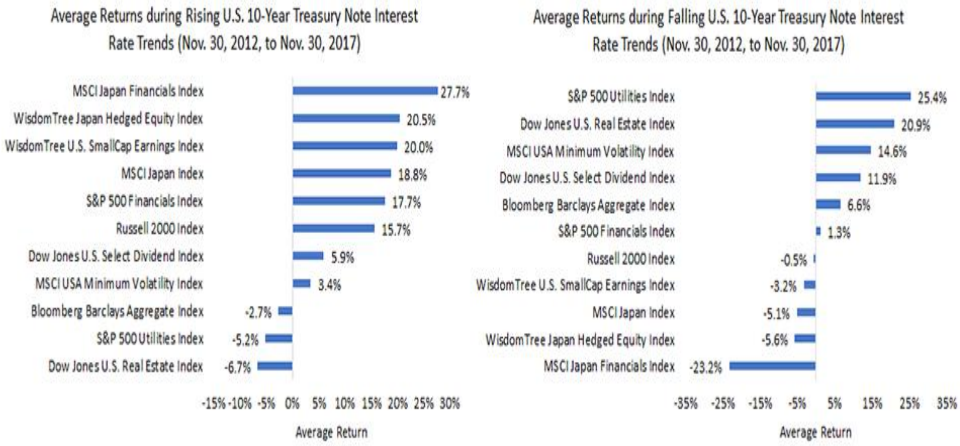
For definitions of indexes in the chart, visit our glossary.

As we zoom in on the coefficients of our interest rate factor, we can note:

- The MSCI Japan Financials Index has exhibited some of its strongest returns during rising rate periods, as noted by its -2.39 coefficient. In fact, over this nearly five-year period, Japanese Financials have indicated even greater sensitivity to rising U.S. interest rates than U.S. Financials, as seen by the S&P 500 Financials Index having a coefficient of -1.50.
- The WisdomTree Japan Hedged Equity Index is designed to exclude companies that derive more than 80% of their revenues from within Japan, thereby indicating an export tilt. Since the September 21, 2016, Bank of Japan policy of "yield curve control,"[2] a rising rate picture in the U.S. 10-Year has been very closely related to a weakening of the Japanese yen against the U.S. dollar. It therefore makes sense that this strategy is a bit more sensitive to rising rates than the broad-based MSCI Japan Index benchmark.
- Rising interest rates do tend to have an association with increasing economic growth and increasing inflation. As long as the growth improvement is a major component of the equation, small-cap stocks also tend to respond. The WisdomTree U.S. SmallCap Earnings Index comprises profitable U.S. small caps, and the earnings-weighted approach is very highly geared to taking advantage of any price-to-earnings (P/E) multiple expansion, like what we saw in 2013 where the P/E multiple of this strategy went from 12.6x to 17.0x (approximately 35% multiple expansion!).[3]

How Did the Regression Coefficients Coincide with Returns?

Let's connect these regression factor loadings to actual returns. Actual returns, of course, are what people care about.



Sources: WisdomTree, Bloomberg, with data from 11/30/12 to 11/30/17. Past performance is not indicative of future results. You cannot invest directly in an index. Rising rate periods include: 5/2/13 to 12/31/13, 1/31/15 to 6/26/15, 7/8/16 to 12/15/16, and 9/8/17 to 11/30/17. Falling rate periods include: 12/31/13 to 1/31/15, 6/26/15 to 7/8/16, and 12/15/16 to 9/8/17. Returns for periods of more than one year are annualized; otherwise, cumulative returns are used to calculate the averages.

- **Japan:** Since the beginning of the Abenomics period, the performance of Japan's equities has ebbed and flowed, but if one were to ask what were the best times to allocate toward Japan, the data here suggests that it was clearly during rising U.S. rate periods. Financials and exporters did very well, on average, over these periods, as did U.S. small caps.
- **Building Portfolios:** Of course, predicting the direction of U.S. or any interest rates is challenging, but what this data also suggests is that an allocation to Japan could be a good hedge to any duration-sensitive assets—things like U.S. real estate,[4] U.S. Utilities[5] or U.S. minimum volatility.[6] If used in concert, history has shown that a piece of a portfolio would have the potential to do well during both rising and falling rates.

Why It's Important to Know Your Portfolio Sensitivities

In general, many investors have been over-weight yield-sensitive assets in recent years—from high-dividend stocks, Utilities, minimum-volatility stocks and just general exposure to bonds. As pressures build for rising interest rates, we believe investors should consider both Japanese broad market exposure and ETFs like the WisdomTree Japan Hedged Equity Fund (DXJ), as well as Japanese Financials, such as the WisdomTree Japan Hedged Financials Fund (DXJF), to supplement some other U.S.-sensitive rising rate plays like U.S. Financials.

[1]Refers to the Ibbotson Associates Stocks Bills Bonds & Inflation (SBBI) U.S. Intermediate Government Bond Total Return Index universe. Sources: Morningstar Direct, Ibbotson.

[2]Source: "New Framework for Strengthening Monetary Easing: 'Quantitative and Qualitative Monetary Easing with Yield Curve Control,'" Bank of Japan, 9/21/16.

[3]Sources: WisdomTree, FactSet.

[4]Refers to the Dow Jones U.S. Real Estate Index universe.

[5]Refers to the S&P 500 Utilities Index universe.

[6]Refers to the MSCI USA Minimum Volatility Index universe.

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You cannot invest directly in an index.

DEFINITIONS

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

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.

Government deficit : A status of financial health in which expenditures exceed revenue.

Regression analysis : statistical process for estimating the relationships among variables. It helps one understand how the typical value of the dependent variable (Y- variable) changes when any one of the independent variables is varied, while the other independent variables are held fixed.

MSCI Japan Financials Index : designed to measure the equity market performance of the Financials sector of Japan.

S&P 500 Financials Sector Index : comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

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

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

Earnings multiple : another way of saying price-to-earnings multiple.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

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.

Dividend : A portion of corporate profits paid out to shareholders.

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

Ibbotson Associates Stocks Bills Bonds & Inflation (SBBI) U.S. Intermediate Government Bond Total Return Index : an unweighted index which measures the total return of five-year maturity U.S. Treasury Bonds. Each year a one-bond portfolio containing the shortest noncallable bond having a maturity of not less than five years is constructed.