NO ATTACK OF THE KILLER BBBS

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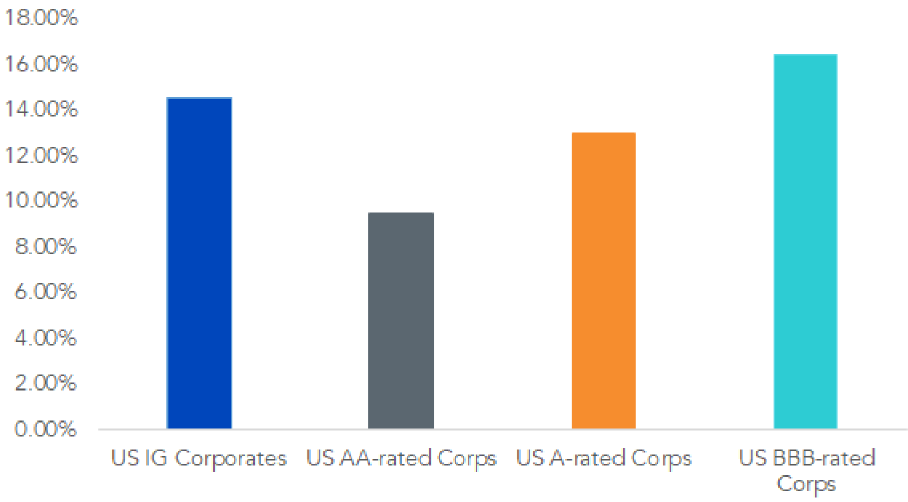
An overarching theme when investing in U.S. corporate bonds the last few years has been the discussion surrounding the credit makeup of the investment grade (IG) universe. Specifically, the share of the BBB-rated sector within this universe has risen considerably since the end of the Great Recession in 2009. As a result, there have been numerous articles written on the topic, and of course the usual hype surrounding a "what if" scenario. In other words, what happens if the BBB sector stumbles? While we are certainly mindful of this new IG landscape and monitoring it carefully, we are not ready to ring any alarm bells at this time.

As we all know, past performance does not predict future results, but calendar year (CY) 2019 offered an interesting glimpse into the U.S. IG market. Total return for a variety of fixed income asset classes last year was a very positive experience, but for broader IG corps, it was a "double-digit" performance in plus territory. Guess which sector rose to the top? You guessed it, BBBs (+16.4%).

Figure 1: 2019 Total Returns



Source: Bloomberg as of 1/15/2020. 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. U.S. IG Corporates: Bloomberg Barclays U.S. Corporate Total Return Value Unhedged Index. U.S. AA-rated Corps: Bloomberg Barclays U.S. Agg AA Total Return Value Unhedged Index. U.S. A-rated Corps: Bloomberg Barclays U..S Agg A Total Return Value Unhedged Index. U.S. BBB-rated Corps: Bloomberg Barclays U.S. Agg Baa Total Return Value Unhedged Index.

Admittedly, we do not expect the 2020 performance to be this robust, but some modest positive readings would be our base case. For IG corps, there are some potential warning signs to watch from a balance sheet perspective (interest coverage and cash/debt ratios). However, on the supportive side of the equation, the Federal Reserve (Fed) has definitely provided a friendlier glide path with monetary policy, and economic data, such as the recent jobs report, continues to suggest a +2% type of growth trajectory, with no recession on the immediate horizon. Last, but not least, on the short list, as the recent signing of the U.S./China Phase 1 trade deal underscores, trade tensions have been de-escalated (for now), as compared to last year.

We believe these key macro factors should be supportive for BBB-rated credits in general. In addition, BBB corporates typically have a stronger incentive toward balance sheet discipline in order to maintain their investment grade credit rating to avoid becoming a "fallen angel" (an issue that gets downgraded from IG to high yield).

Obviously, investors have been wondering about recent downgrade trends in the U.S. IG space. We thought it would be useful to provide some insights on this topic, as it relates to our own yield-enhanced core strategy as well, the WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY), which overweights credit as compared to the Bloomberg Barclays U.S. Aggregate Index (Agg) but cannot deviate beyond 20% of the weights in the Agg.

Figure 2

Cumulative Percent Falling to Junk
9/30/16–9/30/19

Time Horizon	AGGY	Bloomberg Barclays U.S. Agg Enhanced Yield Index	Bloomberg Barclays U.S. Agg Index	ICE BAML U.S. Corporate Bond Index
1 Year	0.21%	0.30%	0.10%	0.44%
2 Year	0.75%	0.71%	0.28%	1.16%
3 Year	1.04%	1.06%	0.43%	1.58%

Sources: Bloomberg, Mellon Corp, ICE BofA.

In figure 2, we measured the percent of AGGY falling to junk over the past three years and compared it to the Agg, the Enhanced Yield Index, and a broad-based corporate index. Our analysis suggests that AGGY's credit overweight has not resulted in a significant increase in downgrades to junk and was visibly less than that of broad U.S. corporates.

- **Marginal Increase in Downgrades to Junk:** Over the three-year period stretching from 9/30/2016 to 9/30/2019, AGGY had only 0.61% more downgrades to junk compared to the U.S. Agg (1.04% in AGGY vs. 0.43% in the U.S. Agg; both figures are cumulative). The one-year horizon only saw a 0.11% difference vs. the Agg (0.21% vs. 0.10%).
- **U.S. Corporates Had More Than 1.5x More Downgrades to Junk:** Over the same three-year time, an investor broadly buying U.S. corporate bonds would have had 1.58% of their portfolio falling to junk (more than 1.5x vs. AGGY).

Conclusion

To reiterate, we are very mindful of the current U.S. IG corporates landscape, but playing to investors' anxieties is normally what makes headlines. However, sometimes facts get in the way.

Unless otherwise stated, all data sourced is Bloomberg as of January 17, 2020.

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DEFINITIONS

Corporate Bonds : a debt security issued by a corporation.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

BBB- : Standard & Poor's credit rating that implies the borrower has adequate capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating represents the lowest level of investment-grade.

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 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.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Junk Bond : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of 'BB' or lower by Standard & Poor's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.