THE IMPACT OF FED RATE HIKES ON CORE FIXED INCOME

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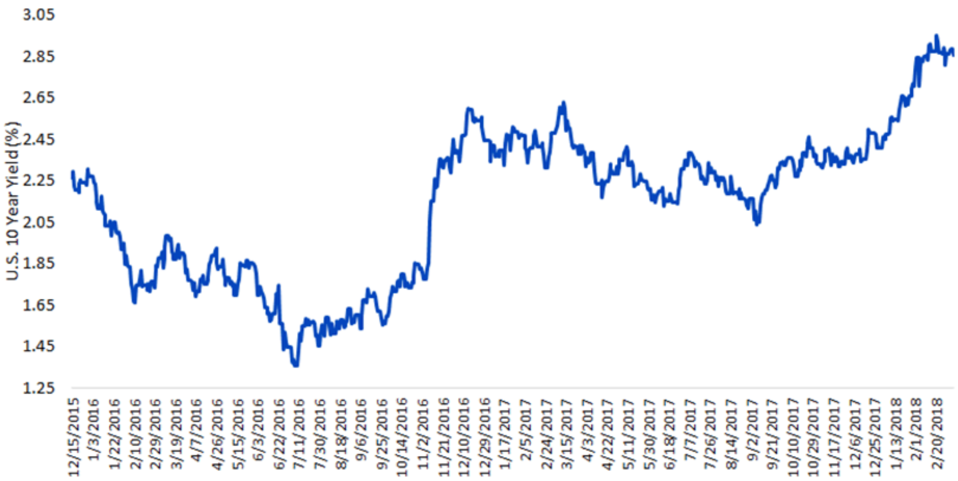
While fixed income strategists have called for rising rates in nearly every year since the financial crisis, 2018 has marked one of the worst starts for bond investors since 1996.[1] With 10-year rates up more than 45 basis points (bps), many investors are questioning what if any changes they should be making to their portfolios. Central to this decision is their view on inflation and Federal Reserve (Fed) policy. In this piece, we examine the impact on U.S. interest rates and fixed income returns since the Fed started tightening in December 2015.

Rising Rates Where?

Despite hiking the Federal Funds Rate five times, U.S. 10-year bond yields have spent much of their time lower than where they started. In our view, this has primarily been a function of the outlook for global growth along with inflation. With expectations for both forecasts to rise in 2018, longer-term bond yields around the world have started to take note.

U.S. 10-Year Yield, 12/15/15–3/6/18

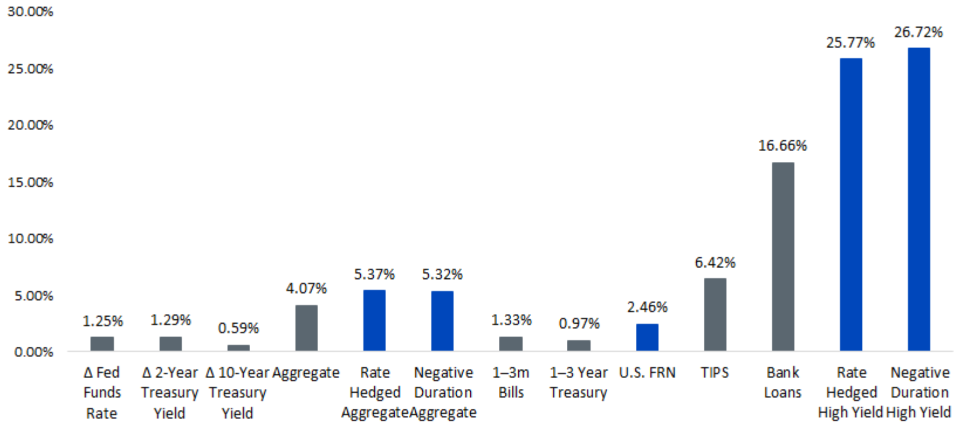


Source: Bloomberg, as of 3/6/18. Past performance is not indicative of future results.

With rates at their highest levels since 2014, the recent pause has many wondering if we're poised to retrace or move higher. While hardly a stretch, we're inclined to believe that we may have seen the cycle low in U.S. interest rates. As higher bond yields generally imply poor returns for fixed income, the gradual rise in rates (until recently) has meant that most investors have been able to avoid negative total returns. In the chart below, we highlight a variety of ways investors can reduce their exposure to rising rates.

Historically, investors could reduce legacy fixed income positions and increase exposure to cash, shorter-duration fixed income or floating rate strategies. As we highlighted back in 2013, traditional approaches to rising rates often involve trade-offs. Below, we contrast these traditional approaches with the Indexes in WisdomTree's rising rates suite.

Impacts of Fed Rate Hikes on Fixed Income Returns, 12/15/15–3/6/18



Source: Bloomberg, as of 3/6/18. Past performance is not indicative of future results. You cannot invest directly in an index. Aggregate, rate-hedged aggregate, negative duration aggregate, 3m bills, 1-3 year Treasury, U.S. FRN, TIPS, bank loans, rate-hedged high yield and negative duration high yield are proxied by the Bloomberg Barclays U.S. Aggregate Index; Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration; Bloomberg Barclays Rate Hedged U.S. Aggregate Bond Index, Negative Five Duration; Bloomberg Barclays 1–3 Month Treasury Bill Index; ICE U.S. Treasury 1-3 Year Index, Bloomberg U.S. Treasury Floating Rate Index; Bloomberg Barclays U.S. Treasury Inflation Protected Securities Index; S&P/LSTA U.S. Leveraged Loan 100 Index; BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index; BofA Merrill Lynch 0-5 Year US High Yield Constrained, Negative Seven Duration Index.

For definitions of terms in the chart, please visit out glossary.

Short-Maturity Strategies

While many investors have sought to invest in short-maturity fixed income as a way to reduce exposure to rising rates, an approach that we really believe in is focused on investing in floating rate notes from the U.S. Treasury. In this strategy, investors have zero exposure to corporate credit risk, but are able to see the coupon rate of their investments rise along with short-term bill yields. This approach has doubled returns of 1- to 3-month Treasury bills as short rates rose. Given that floating rate notes have a duration equal to the frequency of their reset,[2] they have not experienced the negative total returns experienced by 1- to 3-year maturity Treasuries. At current levels, it's possible that investors begin to experience negative holding period returns as soon as the beginning of April. Just because an investment has low interest rate risk doesn't necessarily mean that it can't underperform as short rates rise. In our view, this is one of our favorite ways to play a slightly more hawkish Fed.

Aggregate Strategies

In WisdomTree's approaches to the Agg, we worked with Bloomberg Barclays to construct a strategy that maintains exposure to the same core bonds in their portfolio, but seeks to reduce exposure to interest rate risk by selling offsetting positions in Treasury futures contracts to hedge risk. Since the Fed started tightening, hedging has led to an additional 1.37% in returns, net of the cost of hedging. For more aggressive investors who are seeking to profit from rising rates, our negative duration approach "overhedges" the bond portfolio to achieve a target duration of -5 years. Since this approach exposes investors to a flattening yield curve, gains from negative duration have been partially offset by losses as short-term rates rose faster than long-term rates despite recent outperformance.

High Income, Low Duration

One approach that has gained a significant amount of assets over the last several years has been bank loan strategies. While the headline of high income, low-interest-rate risk seems great, performance has meaningfully lagged WisdomTree's approaches to high yield. Similar to our thinking with aggregate strategies, if investors can maintain exposure to bonds, but then hedge or "overhedge" their portfolios, they're able to maintain a consistent approach to fixed income while reducing interest rate risk. While rate-hedged high-yield strategies have been more volatile, they've meaningfully outperformed by more than 900 bps in three years because of sector differences and a lack of LIBOR floors. Similarly, the negative duration approach has outperformed a hedged approach but has seen its return advantage reduced by a flattening yield curve.

In sum, we believe we've created some of the most effective tools for navigating rising rates in the ETF industry. By packing institutional-caliber strategies in a fully transparent approach, we've provided investors with new tools to help navigate an increasingly treacherous fixed income environment.

[1]Based on total returns of the Bloomberg Barclays U.S. Aggregate Bond Index.

[2]In this case, one week.

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

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You cannot invest directly in an index.

DEFINITIONS

Basis point : 1/100th of 1 percent.

Inflation : Characterized by rising price levels.

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

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

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.

10-year government bond yield : Yields on the 10 year government debt security.

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.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

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.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Short-term treasury bills : a debt obligation of the U.S. government with an original maturity of less than one year.

1-3 month U.S. Treasury Bill : A short-term debt obligation backed by the U.S. government with a maturity of less than 3 months.

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

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.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Curve-flatten : a relative-value position that benefits if the spread between short and long maturity securities declines.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

London Interbank Offered Rate (LIBOR) : the average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.