WILL THE BOND MARKET TAKE A TURKISH BATH?

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Just when the focus was shifting to robust U.S. growth numbers and higher inflation readings, global events, once again, interjected themselves into the bond market equation. This time around the headlines centered on developments in Turkey and what potential ramifications they could have on the broader investment landscape. Specifically, as it relates to fixed income, should investors revisit their views on U.S. rates and, by extension, their portfolio positioning?

While Turkey may have been the catalyst for the most recent flight-to-quality trade, financial market reactions were a reminder that the global backdrop for investors has been shifting. Indeed, tariffs and concerns over trade wars have certainly entered the mix, as have elevated anxieties about emerging markets (EM) in general. Besides Turkey, countries such as Argentina, South Africa and even Russia have been making their way into the collective investor mind-set, and doubts are creeping in regarding growth prospects for China.

Perhaps the most important aspect of change has been the shift in financial conditions. To be sure, the global central bank backdrop is no longer a "pedal to the metal" policy, but in the developed world, the approach has been on beginning the process of normalization. Without a doubt, the Federal Reserve (Fed) has been the leader on this front, but other central banks in the developed world have begun jumping in as well. The Bank of Canada and the Bank of England have both raised rates this year, while the European Central Bank is expected to continue paring down its quantitative easing program and ultimately ending new asset purchases by year-end.

Another important factor is the specter of continued U.S. Treasury (UST) supply increases. With U.S. budget deficits on an ascending trajectory, investors will be faced with an environment of more Treasury securities coming to market at a time when the Fed is reducing its reinvestments, and global investors in general may be commanding some concessions at future auctions.

Conclusion

So, what's a fixed income investor to do? WisdomTree offers three fixed income solutions for the landscapes laid out here.

- First, if you fall into the camp that believes "Turkey contagion" and trade wars will be the primary forces looming, then odds would favor that UST yields have already peaked and may be set for a more sustained move to lower readings. Against this backdrop, investors should consider the WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY).
- The other view would be that recent increases in trade tariffs and EM turmoil will not serve as meaningful impediments to the domestic growth and inflation outlooks. In this case, the Fed would continue on its policy normalization path and maintain its gradual path of future rate increases. This scenario would highlight the need for further rate-hedging solutions, with investors considering the WisdomTree Floating Rate Treasury Fund (USFR) for their portfolios.

- On a final note, perhaps the most opportune approach would be to implement the barbell strategy I discussed in last week's blog post, "The Barbell Approach: A Time-Tested Fixed Income Strategy." This strategy offers investors a solution that takes both sides of the rate trade into consideration.

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DEFINITIONS

Inflation : Characterized by rising price levels.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Normalization : The process by which a policy or action returns to its historically normal levels.

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 : 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.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.