

Testing WisdomTree's US Quality Dividend Growth Index in different macro scenarios

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Given WisdomTree's focus on dividend-weighted strategies, clients frequently ask us how we would navigate a rising interest rate environment. Recently, the US 10-year Treasury Note rose above 3% for the first time in over four years. While it's difficult to say with certainty whether we'll see 3.5% or 2.5% next, we think it's important to analyse our quality dividend growth strategy on a historical basis, to better understand how the strategy has performed during periods of rising and falling interest rates.

Interest rate scenarios

Figure 1: Testing WisdomTree's US Quality Dividend Growth Index in rising vs. falling interest rate environments

WisdomTree U.S. Quality Dividend Growth Index Returns in Interest Rate Regimes*			
Fund	Falling Rates	Rising Rates	Full Period
WisdomTree U.S. Quality Dividend Growth Index	-0.03%	23.21%	10.65%
S&P 500 Index	-3.25%	22.46%	8.48%

* Average Annual Returns (31 December 2003 to 29 March 2018)

Source: Factset. Past performance is not indicative of future results. You cannot invest directly in an Index. Data is calculated on a monthly basis and months are classified as rising or falling interest rate months based on the trend in the 50-day simple moving average for the US 10-Year Treasury Note. The trend in the 50-day and 100-day centred moving averages are used to confirm the classification.

- Rising Rates:** It is important to set the baseline and first consider some of the factors that tend to drive the US 10-year rate higher. One such factor is improving or increasing economic growth expectations. Another is rising inflation. Both rising growth and increasing inflation are more likely to be associated with rising equity markets than falling equity markets, as rising growth usually translates to higher revenues and earnings for companies. This explains why the ‘Rising Rates’ average annual return figures are so much higher than the ‘Falling Rates’ average annual return figures. While the WisdomTree US Quality Dividend Growth Index outperformed the S&P 500 Index in this particular case due to its dividend focus, we wouldn’t necessarily expect it to generate the bulk of its outperformance in strong, upward-trending equity markets. A strategy focused solely on dividend payers, in our view, should have potential to exhibit a high correlation to a market benchmark such as the S&P 500 Index, however, we would expect greater relative outperformance in tougher, downward trending or more volatile markets.
- Falling Rates:** Of course, falling rates reflect the opposite baseline scenarios—declining growth expectations and decreasing inflation. Typically, these translate to lower revenues and earnings for companies. These scenarios, at least with regard to the US and the liquidity of US Treasuries, are often associated with ‘risk-off’ or ‘safe-haven’ flows and can result in lower or even negative returns across equity markets. During this particular historical analysis, the WisdomTree US Quality Dividend Growth Index delivered more than 3% average annual outperformance. This is where we would expect outperformance to occur, due to the fact that we focus on the quality factor premium which has delivered more historical outperformance during down markets.

US Dollar scenarios

We shouldn’t end our analysis at interest rates though, as the US dollar is another important factor to consider. Of course, interest rates can have an influence on how the dollar performs against foreign currencies, so interest rates and the dollar are not truly independent.

Figure 2: Testing WisdomTree’s US Quality Dividend Growth Index in strong dollar vs. weak dollar scenarios

WisdomTree U.S. Quality Dividend Growth Index Returns in USD Regimes*			
Fund	Strong Dollar	Weak Dollar	Full Period
WisdomTree U.S. Quality Dividend Growth Index	5.60%	13.26%	10.65%
S&P 500 Index	2.76%	11.45%	8.48%

* Average Annual Returns (31 December 2003 to 29 March 2018)

Source: Factset. Past performance is not indicative of future results. You cannot invest directly in an Index. Data is calculated on a monthly basis and months are classified as rising or falling US dollar months based on the trend in the 50-day simple moving average for the US Dollar Index, frequently referenced as ‘DXY.’ The trend in the 50-day and 100-day centred moving averages are used to confirm the classification.

- **Weak Dollar:** Both the WisdomTree US Quality Dividend Growth and S&P 500 Indexes focus predominantly on large-cap US companies, many of which have multinational revenue streams. US exporters tend to see a boost in demand for the goods and services they offer when the dollar depreciates in value, and this can create a stronger return environment for equities. It is difficult to provide more insight beyond that. The WisdomTree strategy outperformed, but there is nothing specific in the methodology that would lead us to expect it to continue outperforming the S&P 500 Index during future weak dollar scenarios.
- **Strong Dollar:** A strengthening US dollar can be a result of 'safe-haven' investor flows when riskier assets such as equities are volatile. As with the falling interest rate environment, the WisdomTree US Quality Dividend Growth Index outperformed the S&P 500 Index during stronger dollar periods. This makes sense, and emphasises the potential for the strategy to outperform during tougher market environments.

Strong vs. weak equity markets

We've looked at how falling rates or a stronger dollar might impact our US Quality Dividend Growth Index. Next, let's take a more direct look at how the Index performed during weaker and stronger periods for equity markets. From the findings above, our intuition tells us that a greater degree of outperformance should be generated during tougher market periods, rather than stronger market periods.

Figure 3: Testing WisdomTree's US Quality Dividend Growth Index in strong upward-trending equity markets & weak downward-trending equity markets

WisdomTree U.S. Quality Dividend Growth Index Returns in U.S. Equity Regimes*			
Fund	Weak Equity Market	Strong Equity Market	Full Period
WisdomTree U.S. Quality Dividend Growth Index	-13.90%	28.55%	10.65%
S&P 500 Index	-18.60%	28.80%	8.48%

* Average Annual Returns (31 December 2003 to 29 March 2018)

Source: Factset. Past performance is not indicative of future results. You cannot invest directly in an Index.

Data is calculated on a monthly basis and months are classified as weak equity market or strong equity market months based on the trend in the 50-day simple moving average for the S&P 500 Price Index, frequently referenced as 'SPX.' The trend in the 50-day and 100-day centred moving averages are used to confirm the classification.

In this case, the data speaks for itself. The WisdomTree US Quality Dividend Growth Index significantly outperformed the S&P 500 during weaker market periods, in line with the results of the interest rates and dollar analyses.

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