THREE STRATEGIES FOR AN EVOLVING BOND MARKET

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Over the last year and a half, fixed income investors have been faced with a variety of challenges. Coming out of a once-in-a-generation pandemic and unprecedented lockdown, next up was a surge in inflation to 40-year highs and the attendant Federal Reserve (Fed) response of hiking rates at a pace not seen since Chairman Volcker’s tenure. But alas, things were not done quite yet, as 2023 has brought with it the emergence of newfound banking woes and concerns that tighter credit conditions will ultimately push the U.S. economy into a widely anticipated recession.

THE LANDSCAPE

Arguably the worst annual performance in the bond market in 2022 has presented investors with the potential for opportunities in fixed income that haven’t been witnessed in a generation. The days of negative, or historically low, interest rates have now been replaced by what can be considered a return to normalcy for bond yields, as “income is now back in fixed income.”

I’ve written in some past publications that a generation of advisors and/or investors have never seen bond yields at their current levels. Even though the U.S. Treasury (UST) market has experienced a rally, the resultant yields are still at readings that have not been witnessed in roughly 15 years. The same can be said for the U.S. investment-grade (IG) corporate bond market, and outside of some of the risk-off periods that have occurred since 2007, the U.S. high-yield (HY) arena is also in a similar position.
Let’s provide some perspective on where U.S. fixed income yields are currently residing (as of this writing) compared to the past. In this analysis, I went back 35 years to 1988 and included the three arguably most monitored U.S. fixed income arenas: Treasuries, IG corporates and HY corporates. Then I broke this timeframe into three periods: 1988–2007, 2010–2021 and the most recent date available. The years 2008 and 2009 were excluded due to the unprecedented surge in corporate bond spreads/yields.

The above bar chart offers a clear look at how yield levels were prior to the great financial crisis (GFC), during the post-GFC world of negative/zero interest rates and where we are today. For Treasuries, the average yield pre-GFC came in at 5.15%, then plummeted to 1.52% and currently resides at 3.88%. For IG corporates, the breakdown is 6.90%, 3.21% and 5.32%, respectively. A similar outcome is noted in the HY space, with the respective yield levels being 10.12%, 6.43% and 8.97%.

While the current yield levels are not quite back to their 1988–2007 readings, they are visibly above their 2010–2021 postings. In my opinion, the post-GFC world of negative/zero interest rates skewed investors’ perceptions of where U.S. bond yields typically resided when monetary policy was not being impacted to fight off the harsh effects of a global financial or Great Recession crisis. Yes, it took that long (and a once-in-a-generation pandemic) before more traditional economic forces like inflation forced central banks—i.e., the Fed—to return interest rates to levels last seen some 15 years ago.
INCOME WITHOUT THE VOLATILITY

One of the major themes we have emphasized for investors is the continued prospects for elevated volatility within the money and bond markets. Even before the recent banking turmoil, the volatility quotient was on the high side of the spectrum and has since only experienced more elevation as a result of these negative developments. While one usually looks at equities or credit for signs of increasing volatility, this latest episode has been underscored by the historical movements in the UST market.

One closely watched gauge for volatility in the UST market is the MOVE Index. Based upon this measure, the level of volatility for Treasuries has skyrocketed to its highest reading since 2008 and is at one of its loftiest levels in the last 20 years. If the recent banking turmoil-related effects stabilize, some drop-off in UST volatility is expected to occur. However, an elevated quotient is still our base-case scenario, as we saw prior to the concerns that arose around U.S. regional and European banks, as uncertainty surrounding future Fed policy decisions remains a primary culprit. (see graph).

Certainly, another aspect of the UST market that has garnered a great deal of attention this year is the shape of the yield curve. Indeed, the “Volcker-esque” rate hike action from the Fed has created an environment where inverted yield curves appear to be the norm, not the exception. To be sure, as Powell & Co. have ramped up their rate hikes, 475 basis points (bps) in total up to this point, shorter-dated UST yields have outpaced the increases that have been witnessed among intermediate to longer-dated maturities. With the Fed guiding the bond market toward “some additional policy firming” being “appropriate,” odds favor this phenomenon continuing in the months ahead. In fact, based upon Powell’s March Federal Open Market Committee (FOMC) presser, even if the current rate hike cycle is coming to an end, Fed officials “just don’t see rate cuts this year.”
So, let’s take a look at where key Treasury yields stand as of this writing. The accompanying graph highlights the widely watched Treasury maturity spectrum, ranging from the 3-month t-bill out to the 30-year bond and, of course, the floating rate note (FRN). This way, investors can get an up-close look for themselves at the various yield disparities. As you can see, the UST FRN yield stands at 5.24%, the highest-yield Treasury security. The most interesting part of this analysis is that the UST FRN yield is visibly above the entire fixed coupon curve from 2 years on out to 30 years in maturity. In fact, some of the widest yield advantages are occurring versus the 5- to 10-year part of the curve, where the differential ranges anywhere from an eye-opening +170 bps to +180 bps. The spread is even +120 bps above the 2-Year note.

I keep going back to the shape of the Treasury yield curve and what investors are (or perhaps “are not” is a better way of looking at it) being compensated for. At current yield levels, UST fixed coupon securities remain vulnerable to any Fed and/or economic (inflation) data surprises. Even if the Fed does cut rates later this year, the starting point of a 5% terminal Fed Funds Rate is double the 2.50% target from the last rate hike cycle, providing a great deal of cushion in the process. You need to ask yourself: Why should I expose myself to heightened volatility and speculative rate risk when I can use UST FRNs to potentially avoid such outcomes and receive a higher yield than what Treasury fixed coupons are offering? The WisdomTree Floating Rate Treasury Fund (USFR) offers investors a means of investing in the UST FRN space.
AIMING FOR HIGH INCOME WITH A QUALITY SCREEN

Another potential opportunity that has presented itself within the fixed income arena is high yield. Heading into 2022, a definitive argument could have been made that HY fixed income was on the expensive side, with spread levels beginning last year at a narrow +300 bps. Since then, HY differentials have been on the rise, widening a hefty +200 bps in the process. As a result, the differential is slightly above the +500-bp threshold, which is almost 100 bps above the median level that has existed over the last eight years (see graph).

![Figure 4: High-Yield Credit Spreads—1/2/15–3/27/23](chart)

Sources: WisdomTree, FRED. High-yield credit spreads measured by ICE BofA US High Yield Index Option-Adjusted Spread.

As I mentioned earlier, the notable increase in yield levels is also an important consideration when trying to determine value in the HY arena. Less than two years ago, the yield to worst for U.S. HY dropped to as low as roughly 3.50%, but it has since surged by an incredible 540 bp, bringing the level, as of this writing, to within hailing distance of 9.00%. In contrast to the July 2021 low, yields at these current levels offer investors more “cushion” in the event of any potential widening in HY spreads.
Figure 5: Cumulative HY Defaults (Mar ’16–Feb ’23)

Sources: Bloomberg, ICE, WisdomTree, as of 2/28/23. High-Yield Corporate Market Cap is proxied by the Bloomberg U.S. Corporate High Yield Index after 3/31/20. Prior to this date, High-Yield Corporate Market Cap is proxied by the ICE BofA U.S. High Yield Index. High-Yield Corporate Market Cap was policed due to data availability. Past performance is not indicative of future results. You cannot invest directly in an index.

With recession and potential risk-off concerns remaining a prevalent part of the investment landscape discussion, an HY solution that recognizes this factor is an important consideration for investors. The WisdomTree U.S. High Yield Corporate Bond Fund (WFHY) employs a “screen for quality” approach that only focuses on public issuers and their attendant balance sheets. We found that eliminating the public issuer universe with “negative cash flow” can serve as an important quality screen and help to address the elevated credit risk apparent in the market cap-weighted approach, with the goal being to mitigate credit concerns—i.e., default risk—that can arise from risk-off periods (recessions). As the above graph highlights, the U.S. HY market cap default rate has been 13.8%, while for WFHY, it has been only 2.0% since inception.
WHAT TO WEAR TO THE DURATION PARTY

Certainly, one of the more widely asked questions has been, when should we add, or go longer, duration in our fixed income portfolios? Our mantra has been, “we’d rather be late than early to the duration party.” And given the recent rally in UST intermediate and longer-dated maturities, we believe there is still no urgency or, perhaps more importantly, incentive to be the first one there, especially given the aforementioned shape of the yield curve. It should be noted that, unlike the extremely volatile conditions I detailed earlier, our economic and rate outlook does expect to provide the landscape for a more “true” rally in duration later this year and perhaps into 2024.

Figure 6: U.S. Treasury Yield Curve

For investors who are looking to add duration to their bond holdings, we would recommend a more deliberative approach. In my opinion, one way to pursue such a goal would be “getting back to the core”—incrementally reducing any under-weights that exist in one’s core fixed position.

When looking at investing for core fixed income, one of the options many investors choose is the Bloomberg U.S. Aggregate Index, or the Agg. However, what investors don’t realize is that the Treasuries component alone represents more than 40% of the overall Index. As a result, there can be some yield sacrifice involved with this approach. The WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY) uses a rules-based strategy that reallocates the subcomponents of the Agg, seeking to enhance yield while maintaining a similar risk profile. Utilizing this approach, the average yield to maturity for AGGY is more than 30 bps above the Agg’s yield to worst and has a modestly shorter duration profile at a little over 6.0 years, as of this writing.
CONCLUSION

With the U.S. bond market expected to continue evolving to a variety of different factors in the year ahead, we feel there are three high-conviction themes/ideas for fixed income investors to consider:

+ Income without the volatility: **WisdomTree Floating Rate Treasury Fund (USFR)**
+ Quality screened income in a core-plus approach: **WisdomTree U.S. High Yield Corporate Bond Fund (WFHY)**
+ Getting back to the core: **WisdomTree Yield Enhanced U.S. Aggregate Bond Fund (AGGY)**

Glossary

**Basis point (bp):** 1/100th of 1 percent. **Bloomberg U.S. Aggregate Index ("Agg"):** A broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance. **Bloomberg U.S. Aggregate Corporate Index:** Measures the investment grade, fixed-rate, taxable corporate bond market. **Bloomberg U.S. Aggregate Treasury Index:** Measures the Treasury component of the Bloomberg U.S. Aggregate Index. **Bloomberg U.S. Corporate High Yield Index:** Measures the high yield component of the Bloomberg U.S. Aggregate Index. **Bond yield:** Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value. **Corporate bond:** A debt security issued by a corporation. **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. **Federal Open Market Committee (FOMC):** The branch of the Federal Reserve Board that determines the direction of monetary policy. **Federal Reserve (Fed):** The Federal Reserve System is the central banking system of the United States. **Floating rate note (FRN):** A debt instrument with a variable interest rate. **High yield (HY):** Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities. **ICE BofA U.S. High Yield Index:** Tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. **Inflation:** Characterized by rising price levels. **Investment grade (IG):** A rating that signifies a municipal or corporate bond presents a relatively low risk of default. **Market cap = share prices x number of shares outstanding.** Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap. **MOVE Index:** Measures Treasury rate volatility through options pricing. **Recession:** Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment. **Spread:** Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely. **Terminal Fed Funds Rate:** The peak spot where the benchmark interest rate—the federal funds rate—will come to rest before the central bank begins trimming it back. **U.S. corporate bond:** A type of debt security that is issued by a firm and sold to investors. The company gets the capital it needs, and in return, the investor is paid a pre-established number of interest payments at either a fixed or variable interest rate. **U.S. Treasury (UST):** UST is the abbreviation for the United States Treasury, the federal government division that manages U.S. finances. UST is commonly used to reference debt that is issued by the United States. **Volatility Quotient:** The risk measurement of a security. **Volcker-esque:** Refers to the years that Paul Volcker Jr., an American economist, served as the 12th chairman of the Federal Reserve, from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with ending the high levels of inflation seen in the U.S. throughout the 1970s and early 1980s. **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. **Yield:** The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value. **Yield-to-Worst:** The rate of return generated assuming a bond is redeemed by the issuer on the least desirable date for the investor.
IMPORTANT INFORMATION

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AGGY: Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. 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. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. USFR: Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new, and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. WFHY: Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. 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. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments.

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