A Novel Way to Play the Reflation Trade

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I know it's only three weeks into the new year, but the unmistakable trend in bond land thus far has been the 'Reflation Trade.' Sure, we could all debate whether this theme will continue in 2021 (I believe it will), but more importantly, ask yourself this question: Should I position my fixed income portfolio for the possibility of further increases in Treasury (UST) yields? It really is more of a rhetorical question, don't you think?

As I've noted before, the fundamental and technical analyses still point toward the UST 10-Year yield rising from where it stands now. Yes, it broke through the 1% threshold rather easily and sooner than most expected, but that may just be the tip of the iceberg. I'm not calling for a 2% 10-Year yield (at least not now, anyway), but a move toward 1.50% does seem possible. The bond market appears to have quickly moved on from any potential economic soft patch that could be coming from the second wave of COVID-19, with last week's response to the weaker-than-expected jobs report being exhibit A. And if the economy bounces back sooner than anticipated due to the potential for another hefty fiscal stimulus package (do I hear $1.9 trillion?) to be enacted once the Biden administration takes hold, my recommendation would be consider a rate-hedge solution for your bond portfolio.

So, what type of interest rate hedge solution are we talking about here? Allow me to introduce a unique WisdomTree strategy on this front, specifically, the WisdomTree Interest Rate Hedged U.S. Aggregate Bond Fund (AGZD). This approach combines a long position in bonds representative of the well-known benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index (the Agg), with a short position in Treasury securities to target zero duration.

Why AGZD?

- Zero-duration aspect eliminates the potential for further rising rate risk
- Follows an investment-grade strategy to maintain a traditional credit risk profile
- Offers a 30-day SEC yield that is only marginally below the Agg but without the historically high duration of the Agg

When to Use AGZD?

While we haven't yet seen the 'whites of the eyes' of inflation, inflation expectations have moved visibly higher. Former Federal Reserve (Fed) Chair Greenspan once noted that actual inflation readings can be akin to looking in the rearview mirror. With that in mind, implementing our AGZD strategy now seems to be a prudent course of action because the UST 10-Year yield will not necessarily wait to see those whites of the eyes of inflation in order to move higher—the first three weeks of 2021 being exhibit B.

Important Risks Related to this Article

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