

“Blue Wave”: The Other Side of the Trade

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Having spent a good portion of my career on a fixed income trading floor, I've always been appreciative of what “the other side of the trade” means. Put simply, a specific sentiment often moves “front and center,” and investors fail to factor in the possibility of an opposing viewpoint coming to fruition instead. Last week, I blogged about how the U.S. Treasury (UST) market seemed to be viewing a “blue wave” at the upcoming election as being potentially “pro-growth,” which could lead to higher UST 10-year yields, accordingly. But, for this blog post, I'm going to examine the possibility that a “blue wave” is not necessarily “growth-friendly” and how fixed income investors should plan for such an outcome.

In our Market Insights: Election Outcomes piece, we outlined [two possible outcomes from a “blue wave.”](#) They are somewhat polar opposites. In the scenario I want to focus on in this blog post, a “blue wave” results in a potentially higher tax, an increased regulatory environment and a less “business-friendly” setting, which could ultimately result in slower economic growth.

However, there are two other key considerations. As I wrote last week, one common thread among these two opposing scenarios is that [“deficit discipline” will go completely out the window.](#) In other words, it seems likely trillion-dollar deficits for the U.S. will become the norm. For the record, for fiscal year 2020, the U.S. recorded a \$3.1 trillion deficit. The other common thread will be continued easy monetary policy from the Federal Reserve (Fed). Chairman Powell & Co. have made it abundantly clear that rate hikes and/or balance sheet drawdowns will not be on the Fed's radar for possibly the next two years, at a minimum.

So how would the UST market view this scenario? More than likely, the broader UST market could initially be the beneficiary of a “risk-off” move (yields move lower), as investors weigh the prospects of higher taxes and increased regulation occurring against the backdrop of an already uncertain growth outlook. However, looking further down the road, the expanding budget deficit could curb enthusiasm for intermediate to longer-dated Treasuries. Another consideration for this part of the yield curve could be a rise in inflation expectations due to the Fed's “pedal to the metal” monetary policy approach.

Potential Fixed Income Solution

If the UST market does embrace “the other side of the trade,” investors should take a more “strategic” approach to fixed income asset allocation and be mindful of the current and prospective shape of the yield curve (relatively flat now, potentially steeper later). A core approach with a shorter duration to consider is the [WisdomTree Yield Enhanced U.S. Short-Term Aggregate Bond Fund \(SHAG\)](#). This strategy offers investors the following key attributes:

- The opportunity for enhanced yield in a historically low rate setting

- An investment-grade core solution that doesn't reach for yield with riskier assets or increased leverage
- A short-duration strategy to potentially mitigate the risks of higher intermediate and/or longer-dated yields

Unless otherwise stated, all data sourced is Bloomberg, as of October 16, 2020.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.