Fed Hikes: Hedge Your Rate Bets for 2017

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For the second year in a row, the Federal Reserve (Fed) has given the financial markets a rate hike in December. The natural question now is whether U.S. policy makers will follow this year's playbook for 2017, or will they blaze a new trail and potentially raise rates more than once per year? The Fed's new median forecast is for three rate hikes next year.

Certainly, the investment climate seems rather different than how it was 12 months ago, because the results of the U.S. presidential election have altered the dynamics of the financial markets. Within the fixed income arena specifically, the sell-off in the U.S. Treasury (UST) market after the election placed yields at levels investors haven't witnessed in well over a year. In fact, in the case of the UST Two-Year and Five-Year notes, yield levels reached their highest readings in the last five to six years.

The prospect for fiscal stimulus in the guise of tax cuts, infrastructure spending and regulatory relief has created an investment landscape where improved economic growth and the potential for higher inflation have dominated investor sentiment. As far as the current economic landscape is concerned, real gross domestic product (GDP) has improved from the first half of this year, while inflation gauges, such as the Consumer Price Index (CPI), have seen some elevation in recent months as the drag from lower energy prices gets removed from year-over-year comparisons, and wage trends have revealed signs of improvement as well.

The aforementioned economic conditions were key reasons for the Fed's latest tightening move. Where the voting members go from here is still subject to some uncertainty. Based on comments from a variety of Fed officials, they are not going to preemptively change their policy outlook based on the premise of upcoming fiscal stimulus. Rather, the Federal Open Market Committee (FOMC) seems to be entering more of a potential reactive phase to policy, with a tilt toward perhaps more rate hikes than Fed members currently envision if conditions warrant such action.



Source: Bloomberg as of 12/08/16. Past performance is not indicative of future results. You cannot invest directly in an index.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Please click here for the standardized performance of the WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund.

Given today's Fed outcome and the fixed income landscape being altered post-election, investors should examine their portfolios to ensure they are prepared for a potential volatile environment for the remainder of this year and into 2017. If fiscal stimulus, regulatory relief and additional Fed rate hikes are the base case for 2017, one should consider an approach to help mitigate potential interest rate risk.

The graph above clearly illustrates the importance of reviewing the need to help immunize a fixed income portfolio from potentially higher interest rates. Indeed, since the UST 10-Year yield reached its all-time low on July 8, investors who went unhedged and remained solely in a broad fixed income position as represented by the Bloomberg Barclays U.S. Aggregate Index (Agg) have witnessed a negative total return of more than 3%, as of this writing. In contrast, by dialing down rate exposure by using a zero duration strategy as represented by the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index, investors would have been able to reduce their risk of higher rates and see a positive total return of more than 6%, in the same time frame.

Conclusion

The WisdomTree BofA Merrill Lynch High Yield Bond Zero Duration Fund (HYZD), which tracks the BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index, and the WisdomTree Barclays U.S. Aggregate Bond Zero Duration Fund (AGZD) are two vehicles investors could utilize to achieve this goal. These Funds can be used to complement a "core" fixed income strategy or as "stand-alones" for this

approach.

Investors looking to mitigate potential interest rate exposure may also wish to examine the potential benefits of floating rate Treasury securities (FRNs). FRNs are based on a reference rate that is determined at the weekly Three-Month Treasury Bill auction. Given the potential for additional increases in the Federal Funds Rate in 2017, some potential “Fed protection” seems warranted. Against this backdrop, we feel that utilizing a floating rate product, such as the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR), investors may be better able to insulate their bond portfolio compared with a more traditional fixed income investment.

Unless otherwise noted, source is Bloomberg, as of 12/9/2016.

Important Risks Related to this Article

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