

The WisdomTree Q2 2022 Fixed Income Positioning

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This article is relevant to financial professionals who are considering offering Model Portfolios to their clients. If you are an individual investor interested in WisdomTree ETF Model Portfolios, please inquire with your financial professional. Not all financial professionals have access to these Model Portfolios.

We recently reviewed the [fundamental construction and ongoing management of our “strategic building block” fixed income Model Portfolio](#). As a quick reminder:

1. Investment Objective: Deliver superior risk-adjusted total return and yield relative to its benchmark, the Bloomberg U.S. Aggregate Index (the “Agg”), which broadly tracks the performance of the U.S. investment-grade bond market and is composed of both government and investment-grade corporate bonds (including U.S. Treasuries and the debt of major industries including real estate, industrial companies, financial institutions and utilities).

2. Investment Strategic Framework: Establish defined risk parameters for key fixed income attributes—interest rate risk, credit risk, volatility risk, currency risk—to frame the investment approach in meeting the objective.

3. Investment Approach: The portfolio is actively managed with respect to duration, credit quality and security selection to achieve the desired objective through prudent investment management.

In our March Model Portfolio Investment Committee (MPIC) meeting, we voted to implement a small handful of changes to our fixed income Model Portfolios as we head into the second quarter of 2022. This blog post summarizes those changes and why we made them.

The WisdomTree Economic and Market Outlook for Q2 2022

Before we summarize our recent Model Portfolio changes, let's put them in the context of our broad market outlook. We recently published our [Economic and Market Outlook for Q2 2022](#). We expressed our opinion that interest rates, with periodic retracements, will move higher as we move through the year, prompted in part by a now-hawkish Fed that, recognizing it is “behind the curve” with respect to inflation, has embarked on what we believe will be an aggressive “rate hike cycle” regime.

A quick illustration of recent yield curve movement captures this point nicely.

Treasury Yield Curve



Sources: WisdomTree, Bloomberg and FactSet, as of 4/21/22. You cannot invest in an index, and past performance does not guarantee future results.

Another way of illustrating recent yield curve movement is by measuring the spread between short-term and long-term rates (i.e., measure the “shape” of the curve, not just its absolute levels). We will use the widely followed “10-Year minus 2-Year” spread. After briefly inverting for one day on March 29 (which always raises market concerns about an impending recession), this spread has since widened. This may be in response to Fed Vice Chair nominee Lael Brainard’s recent comments about the commencement of reducing the Fed’s balance sheet (i.e., “quantitative tightening”), which may have the effect of pressuring longer-term rates upward.



After widening earlier in Q1, credit spreads have since retreated to levels we've experienced for most of the past several years, suggesting that investors remain comfortable with the default risk on their fixed income holdings—a view we agree with.



As mentioned above, in our March Model Portfolio Investment Committee (MPIC) meeting, we voted to make a small handful of changes to our fixed income portfolios and allocations.

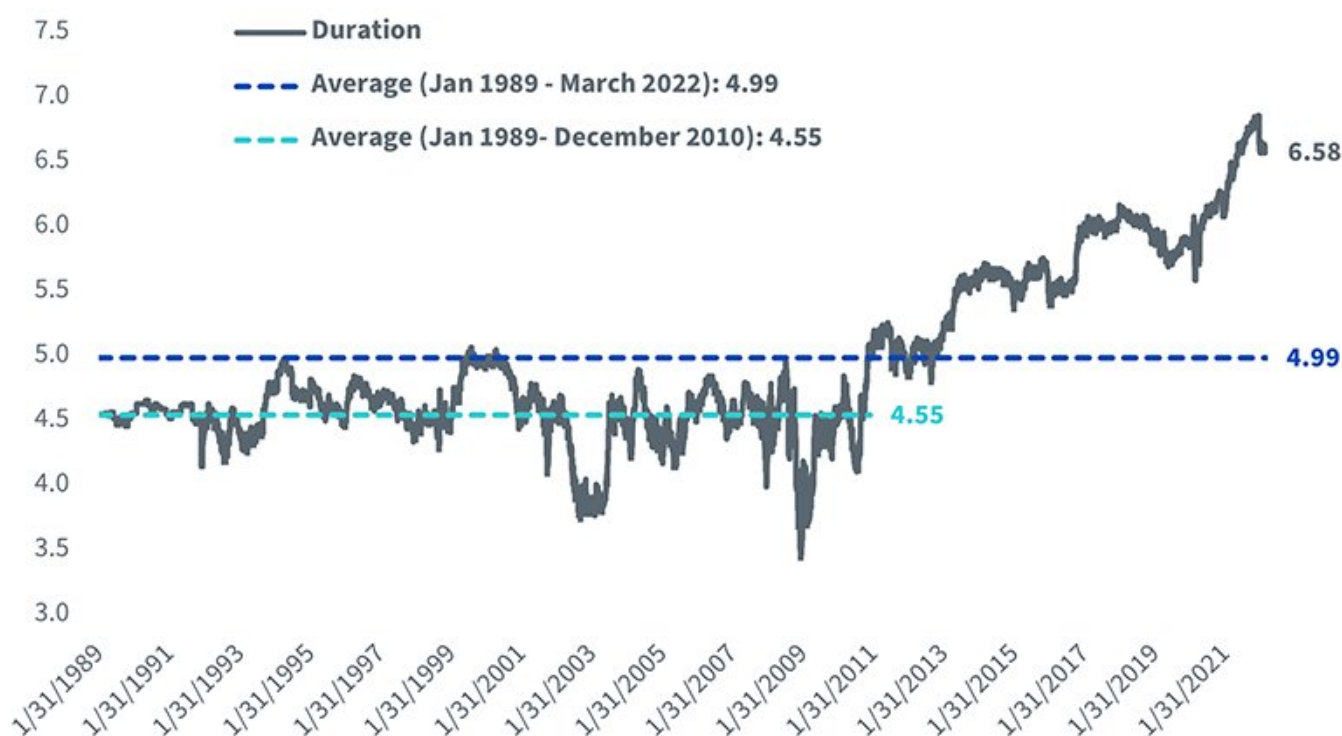
The net result is that we are short duration and over-weight in quality credit relative to the Agg. Typically, as mortgage rates rise, prepayments fall, thereby extending the inherent duration of mortgage-backed securities. We also maintain an under-weight allocation in that space.

1. History suggests “we have only just begun”: Rates rose into past rate hike regimes. We examined the evolution of Treasury yields and core bond performance in each of the five previous “rate hike regimes” (beginning in 1988, 1994, 1999, 2004 and 2015, respectively). In each case, yields on 10-Year Treasuries only peaked after the Federal Reserve had delivered a significant amount of tightening. For example, the 1988 and 1994 cycles each saw the Fed hike rates 175 bps before the 10-Year Treasury yield peaked. The extended 2004 and 2015 cycles saw even more tightening before the Treasury yield plateaued. With only

25 bps of hikes to date, we believe we may still be in the “early innings” of the current ultimate interest rate rise. To us, there does not seem to be any justification for taking excessive duration risk.

2. Extended interest rate risk within core benchmarks: The potential interest rate risk in the Bloomberg U.S. Aggregate has grown exponentially in recent years. For the formative years of our careers, the duration of the “Agg” generally fluctuated between four and five years, feeding common investor perceptions about core bond risks. Zero interest rate policy changed all that. Since 2013, the Agg’s duration has marched steadily higher. Its current level of 6.58 years ranks in the 97th percentile of durations since 1989 and seems disconnected from our past perception of the core bond risk profile.

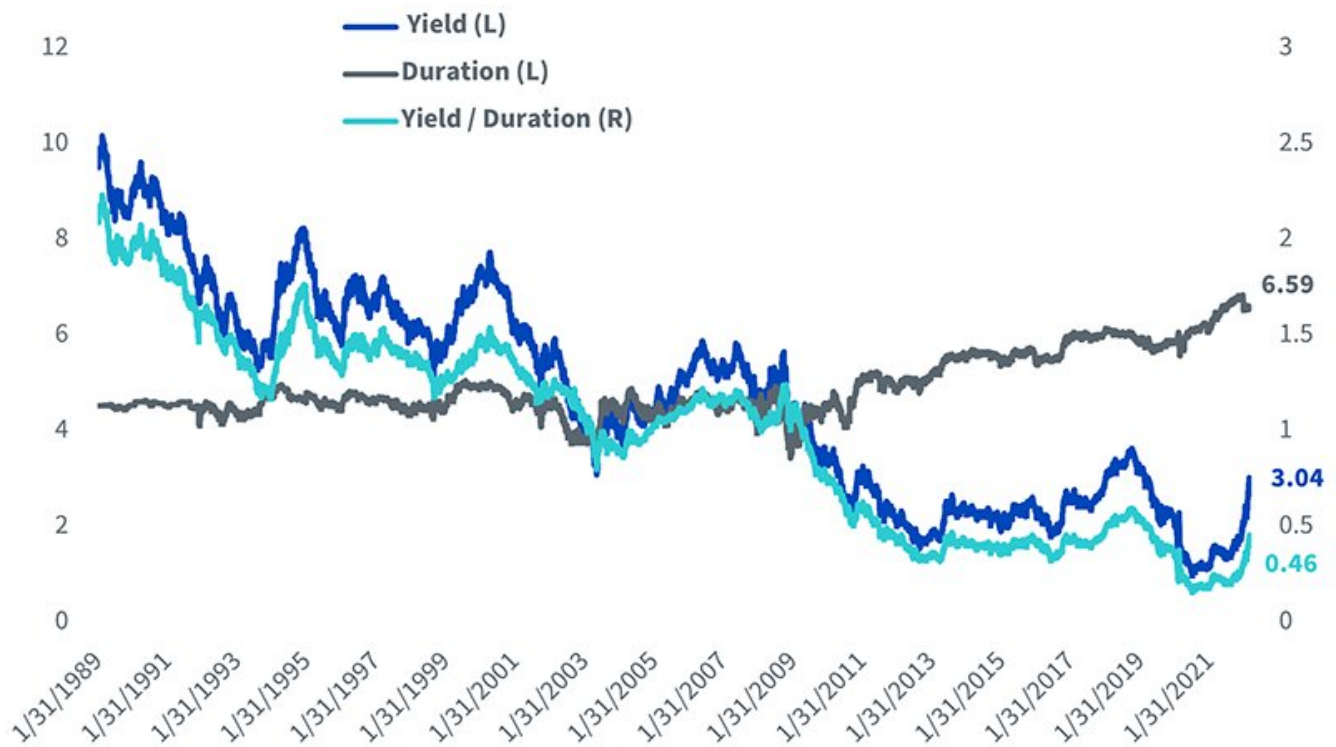
U.S. Aggregate Duration Characteristics



Sources: WisdomTree, Bloomberg, March 2022. U.S. Aggregate: Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage- and asset-backed securities.

3. More risk, less compensation: Elevated interest rate risk levels are further complicated by the steady fall in compensation or income to offset this risk. Yields have fallen, and durations have risen, triggering a long-term decline in the “unit of return for unit of duration risk” ratio. You simply are not being as compensated for taking duration risk as you used to be.

U.S. Aggregate Yield and Duration Characteristics



Sources: WisdomTree, Bloomberg, March 2022.

The combination of aggressive Fed tightening cycle, heightened interest rate risk and limited coupon protection suggests caution is still warranted.

At the same time, one positive aspect of the recent low interest rate environment is that corporations were able to restructure their balance sheets and issue lower-cost debt. Regardless of economic uncertainty, most corporate balance sheets are in decent shape, and we view the overall default risk as low by historical standards. This is why we remain comfortable being over-weight in quality credit.

Conclusions

We tend to be strategic investors at WisdomTree and build and manage our Model Portfolios to seek to perform consistently and as expected over full market cycles. That said, we will make dynamic changes as market conditions change—something that certainly happened in Q1 2022.

Our fixed income Model Portfolios [have performed well and have beaten their benchmark](#) (the Bloomberg Agg) on a total return basis over almost every period since inception in 2013.

With our recent reallocations to further shorten duration and remain over-weight in quality credit, we believe we are well-positioned for the market conditions we expect to see over the remainder of 2022 and beyond.

You can learn more about all our Model Portfolios, including full transparency into allocations, individual securities, fees, yield and performance, at our [Model Adoption Center](#).

We invite you to take a look.

Important Risks Related to this Article

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