

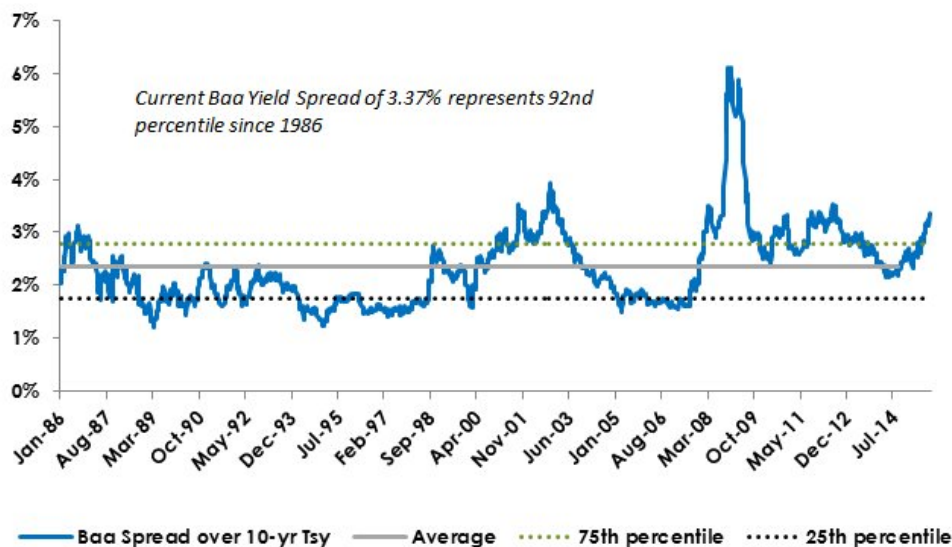
What Do the Fed and BBQ Have in Common?

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Rick Harper

Chief Investment Officer, Fixed Income and Model Portfolios

The phrase “low and slow” commonly refers to the proper method for cooking barbecue. Cooking over low heat for a long, long time is the pathway to BBQ bliss. These days it feels like the Fed is applying the same philosophy to normalizing rates—the terminal rate being lower and the process taking much longer. So what are fixed income investors to do while the Fed simmers? Search for yield. As long as weakness abroad is counterbalanced by improvement domestically, Treasury rates are likely to trade stepwise within ranges. Additionally, the credit cycle will be extended. Corporate credit spreads should provide value, and even though they may be less attractive on a valuation basis, residential and commercial mortgage-backed securities (MBS and CMBS) should supplement the income offered by Treasuries. Corporate credit spreads have recently been pushed higher by liquidity and growth concerns to attractive levels, in our view. As shown by the graph below, yield spreads over Treasuries have risen to levels typical for a recession; at quarter-end, current 10-year Baa spreads ranked in the 92nd percentile relative to their history since 1986. While this is a concern, we would argue that a recession is not imminent. The domestic economy as a whole has been more resilient, and global leaders are willing to initiate policies to reduce financial distress and volatility. **Baa rated Corporate Bonds over 10-Year Treasuries**



Past performance is not indicative of future results. You cannot invest directly in an index.

Source: Bloomberg, as of 9/30/15.

Credit ratings apply to the underlying holdings of the Index, not to the Index itself. Standard & Poor's, Moody's and Fitch study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings' financial condition and histories. The ratings displayed are based on the highest of each portfolio constituent as currently rated by Standard & Poor's, Moody's or Fitch. Long-term ratings are generally measured on a scale ranging from AAA (highest) to D (lowest), while short-term ratings are generally measured on a scale ranging from A-1 to C.

Given this view, the recent sell-off in corporates seems overdone; we expect this sector of the fixed income market to outperform. In particular, clipping Treasury coupons seems less attractive when some investment-grade corporates are currently offering over twice the income. But back to our low and slow analogy: The world is still a little fragile, and blindly grabbing yield could still be risky. A more prudent approach may be to add yield gradually. At each step, investors should consider if the increase in income potential is going to materially alter their portfolio's risk profile. The Barclays U.S. Aggregate Enhanced Yield Index (Agg Enhanced Yield) takes this very approach in altering the composition of the Barclays U.S. Aggregate Index (Aggregate). The index first decomposes the Aggregate into 20 different buckets stratified across sector, credit quality, and maturity. It then reassembles the pieces to maximize yield within specified tracking error limits and bands on relative duration and sector exposures. Through this approach, the portfolio remains 100% investment grade but enhances the income potential of the portfolio. In most environments, this methodology will lead to allocations that have more credit exposure than the composition of the Aggregate. The guardrails ensure that the approach to adding corporate risk is measured. For example, each major asset sector cannot exceed a variance of 20% to its weight in the Aggregate. Thus exposure to credit-sensitive bonds is capped at 50%, roughly 20% above its current weight in the Aggregate. As we show below, the Agg Enhanced Yield provides an 82 basis point pickup in yield compared to the Aggregate. The credit allocation increases to 50% (against the 30% currently in the Aggregate), while exposure to U.S. Treasuries is reduced. In our view, this shift in positioning makes intuitive sense in the current environment. **Index Statistics as of September 30, 2015**

	Yield to Worst	Duration	Corporate %	Government %	Securitized %
Barclays U.S. Aggregate Yield Enhanced Index	3.14%	6.56	50.2%	17.3%	32.5%
Barclays U.S. Aggregate Index	2.31%	5.60	24.0%	45.1%	30.9%
Difference	0.83%	0.96	26.2%	-27.8%	1.6%

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Sources: Barclays, WisdomTree, as of 9/30/15.

For the last seven years, we have bumped along in this low-rate environment. If concerns about global conditions keep the Fed lower and slower, increasing your corporate exposure with your core portfolio may tide you over until the BBQ is ready (so to speak.)

Important Risks Related to this Article

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.