MACROECONOMIC AND ASSET ALLOCATION OUTLOOK

As always, we suggest focusing on market signals pertaining to:

- Economic Outlook
- Inflation Outlook
- Fed Watch
- Earnings Outlook
- Fixed Income Outlook

While we always attempt to ignore what can be considered market noise, there are, have been and continue to be substantial “known unknowns” heading into 2021.

The continuing evolution of the COVID-19 pandemic and the corresponding federal, state and local level responses will continue to be an integral part of the investment landscape in 2021. While vaccine news provided an initial booster shot for the markets in November, concerns linger over spiking infection rates, hospitalizations, and deaths. A reemergence of economic shutdowns will most likely have a definitive impact on Q1 2021 economic growth and consumer sentiment. However, any adverse economic effects are not expected to rise anywhere near the record-setting declines that were witnessed in Q2 2020. In fact, our base case sees the recovery process resuming in Q2 2021 and potentially gaining momentum during the second half of the year.
Here are our views on the signals we currently observe.

**ECONOMIC OUTLOOK**

In a remarkable plot twist, the U.S. economy rebounded sooner than what most observers were expecting only a few months ago. After a record-setting plunge in Q2, real GDP\(^1\) soared right back—and then some—by posting a record-setting 33.1% annualized gain in Q3. As a result, real GDP is now ‘only’ 3.5% below where it stood at the end of 2019. Based on Street consensus, this shortfall could be made up by year-end. The second wave of COVID-19 does present some challenges, however. While Q4 appeared to show momentum, it would not be surprising to see softening in the new year.

Looking ahead, in the U.S., the Wall Street Journal Economic Forecasting Survey anticipates GDP growth of approximately 3.0%–3.5% through 2021 and into 2022 (and perhaps higher, depending on the outcome of the stimulus negotiations).

![GDP Growth Forecasted to Stabilize after Volatile 2020](chart)


The Conference Board’s Leading (LEI)\(^2,3\) and Coincident Economic Indexes\(^4\) continued to reveal improvement. The more noteworthy of these two series is arguably the LEI, as it provides a potential glimpse into future economic activity; it has risen six months in a row.

---

1. Gross domestic product (GDP): The total monetary or market value of all the finished goods and services produced within a country’s borders in a specific time period.
2. The Conference Board (CB) is a member-driven economic think tank. The CB aims to delve into the issues which companies regularly grapple with daily. These everyday concerns may include top-line growth in a shifting economic environment and corporate governance standards.
3. The Composite Index of Leading Indicators (LEI) is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months.
4. The Collection Effectiveness Index (CEI) is a calculation of a company’s ability to retrieve their A/R from their customers.
Economic Indicators Continue to Rebound

The Conference Board Leading Economic Index® (LEI) for the U.S. Increased in October

Source: The Conference Board, as of 11/19/20.

Economic growth outside the U.S. is expected to outpace U.S. growth in 2021 in many parts of the world, with some “COVID caveats”:

Economic Growth Expected to Resume in 2021

Source: International Monetary Fund (IMF), as of October 2020.
There appears to be a growing discrepancy between economic prospects in the U.S. relative to the eurozone. While the U.S. Purchasing Managers’ Index (PMI) registered a five-year high in November, the eurozone gauge posted its fourth straight monthly decline, and is sluggishly south of 50, indicating economic contraction.

Investment Implications: We believe a generally positive environment for “risk-on” assets, but with uncertainty caused by COVID-19.

The vaccines have started to be distributed and will continue to become readily available (and willingly taken) over the first half of 2021, with a significant upswing in economic activity on a coincident basis with inoculation. As each COVID-19 cohort receives the jab we believe many people will immediately book flights and hotels.

A rapid economic reopening is consistent with the market’s recent embrace of Small Cap Value stocks relative to “COVID leaders,” namely Large Cap Growth. We believe the new market leadership by Small Caps and Value in November has staying power that carries into 2021.

5 Eurozone: Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).
6 Purchasing Managers’ Index (PMI): An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction, while 50 indicates no change.
7 Risk-on: Refers to changes in investment activity in response to perceived risk. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.
8 Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more as a result of their expectations of future improvements in these fundamentals.
Additionally, the pandemic and the election laid bare the power of Big Tech on our society, with an almost universal view – from the left and the right – that it enables, enhances and empowers purveyors of fake news. A critical 2021 theme will be regulatory action in social media, search and e-commerce. Keep an eye on the EU’s Big Tech “hit list” in the near term, as regulators there are naming and shaming, with anti-trust the issue of the day.

INFLATION OUTLOOK

There are pockets of higher inflation⁹ in specific sectors or industries (food, automobiles, suburban home prices, etc.). But the current inflation picture remains largely benign. Unprecedented fiscal and monetary policy stimulus carries the potential for higher inflation over the next few years, though it could still fluctuate while on the upward trajectory.


The Federal Reserve has indicated that it will allow inflation to “run hot” (when it eventually reappears) rather than stifle an economic expansion through increasing rates, leading to a turnaround in inflation expectations from their springtime lows.

⁹ Inflation: Characterized by rising price levels.
Source: St. Louis Fed, as of 11/20/20. Breakeven inflation rates refer to the market’s forecast of inflation. They are calculated as the difference between the yield on a nominal bond and the yield on an inflation-linked bond of the same maturity, with the difference indicating what the market expects inflation rate to be at that point in the future.

We believe two other key factors could nudge inflation higher:

1) We may see some higher-than-expected pressure on input prices\textsuperscript{10}, largely due to China’s recovery.

2) We think the U.S. dollar has downside risk\textsuperscript{11}, elevating the potential for import inflation.

WisdomTree Senior Investment Strategy Advisor and Wharton Professor Jeremy Siegel expects to see higher inflation levels of 4%–5% over the coming two to three years as the economic reopening accelerates and added money in the system puts pressure on prices. We’ll be watching for signs of this breakout.

*Investment implications: We believe a generally benign inflation environment, at least in 2021, should generate a positive environment for risk-on assets. While this is our “reasonable outcome” scenario, the primary risk is an upside surprise to inflation, as opposed to a downside shock (deflation\textsuperscript{12}).*

\textsuperscript{10} Input prices: Costs of resources used to produce a good or service.

\textsuperscript{11} Downside risk: An estimation of a security’s potential to suffer a decline in value if the market conditions change, or the amount of loss that could be sustained as a result of the decline.

\textsuperscript{12} Deflation: The opposite of inflation, characterized by falling price levels.
FED WATCH

The Federal Reserve has adopted a new policy framework that centers around average inflation targeting, rather than maintaining a 2% target. Based upon this approach, policymakers are willing to let the economy run hot, letting inflation overshoot the target for some time before reacting accordingly. This policy could create market confusion when it finally needs to be implemented. But with the Fed seemingly committed to a zero-interest-rate policy for several years, we believe rate hikes are not likely to be a 2021 story.

The Fed will likely continue to add to its balance sheet, despite the Treasury’s recent announcement that some COVID-19-related extraordinary credit facilities will be closed. Additional purchases of Treasuries and MBS seems to be the course of action at the moment, adding to the record amount currently on its balance sheet.

Investment implications: We believe the Fed’s accommodative positioning is generally positive for risk assets. Likewise, there are no major central banks that are targeting a tightening regime any time soon.

Mortgage-backed security (MBS): An investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them.
EXPECTED EARNINGS GROWTH RATES

In the U.S., the consensus is for steady improvement in earnings through 2021:


Sources: LPL Research, FactSet, and The Daily Shot, as of 11/13/20. Earnings per share (EPS): Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.
As with economic growth, earnings growth outside the U.S. is expected to outpace the U.S. This is at least partially because the U.S. recovered faster in 2020, whereas regions such as developed Europe witnessed more fits and starts:

**Investment implications: We believe that this is a generally positive earnings environment for risk on assets.**

**FIXED INCOME OUTLOOK**

The U.S. 10-year Treasury yield\(^{14}\) visibly increased since reaching its 2020 low of 0.51% on August 4, at one point in November changing hands within a hair of 1%. As a result, the yield curve\(^{15}\) steepened the most in three years. Budget deficits with a trillion-dollar baseline are here for the foreseeable future. But we think Treasuries will take their cue more from the fundamental side of the equation. We anticipate the economy meeting and then exceeding pre-pandemic levels in 2021, though we do have our eye on an inflation regime change from fiscal largesse and a Fed Funds Rate pinned at zero. Our outlook still calls for a ‘lower for longer’ rate setting, but Treasury yields\(^{16}\) could grind higher in 2021, leading to further curve steepening.

---

\(^{14}\) 10-Year Treasury: A debt obligation of the U.S. government with an original maturity of 10 years.

\(^{15}\) Yield curve: Graphical depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

\(^{16}\) Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.
Within the U.S. corporate bond market, investors have witnessed a dramatic shift from the depths of the March sell-off. Investment-grade\(^\text{17}\) and high-yield\(^\text{18}\) spreads\(^\text{19}\) have recouped 97% and 91% of the widening that was witnessed at the time. In our base case, we believe elevated downgrades and defaults are already priced in, enabling further spread compression as wounds heal in 2021.

\(^\text{17}\) Investment-grade: A rating given to a municipal or corporate bond. It is a relatively favorable rating, given by either Moody’s or Standard & Poor’s, indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

\(^\text{18}\) High-yield: Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

\(^\text{19}\) Spread: The difference between the yield on two investment instruments. Widening means that the yield differential is increasing as a result of selling pressure, while narrowing indicates that the differential has reduced as a result of buying pressure.
Spreads Have Steadily Recovered from Peak Widening in 2020

Source: WisdomTree, Federal Reserve Bank of St. Louis, as of 11/30/2020. Data series represent the spreads for the U.S. investment-grade corporate bond market (teal) and the U.S. high-yield corporate bond market (blue).

**Investment implications:** We maintain our position of being underweight duration and overweight credit, with a focus on quality security selection, especially in high yield.

**SUMMARY AND ASSET ALLOCATION IMPLICATIONS**

When focusing on what we believe are the primary market indicators, we conclude 2021 will enjoy a generally positive economic and market environment.

Given our cautiously optimistic view of the market environment throughout 2021, we believe the following themes will be prevalent and there are actionable ideas to capitalize on them should you agree with our position.

**Quality & Income:** Due to the sheer speed of the market’s snapback, it is imperative to consider Quality & Income as U.S. & global markets continue to deal with pandemic uncertainty. A focus on valuation in addition to fundamental profitability metrics make sense in two of the asset allocator’s largest asset classes, U.S. and developed market equities. And with interest rates at historical lows, investors will be tasked with looking for fixed income allocations without moving too far out in duration or sacrificing credit quality.

*Actionable investing ideas:* DGRW, DLN, IHDG, IQDG, AGGY, WFHY

---

12.50% | 0.00% | 5.00% | 10.00% | 15.00% | 20.00% | 25.00% | 30.00% | 35.00%
---
12/31/19 | 01/31/20 | 02/29/20 | 03/31/20 | 04/30/20 | 05/31/20 | 06/30/20 | 07/31/20 | 08/31/20 | 09/30/20 | 10/31/20 | 11/30/20
---
12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50% | 12.50%
---
4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33% | 4.33%
---
1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12% | 1.12%

*Primary market:* The primary market is where securities are created or redeemed.
Cyclical Rotation: After a 14+ year run that witnessed growth stocks consistently beat Value stocks, and the resultant historically large valuation gap that has opened up between the two, a rotation may finally be upon us. With the arrival of several vaccines, Value, which was hit hardest during the COVID crisis, has the most to gain from reopening and the return to normal.

**Actionable investing ideas:** DON, DES, DGRS, EES

Emerging Markets: With the global economy on trend to improve during Q1 2021, accommodative central bank policies in both the developed and emerging world, and the potential for a softer U.S. dollar, we are seeing a favorable environment for local currency sovereign emerging markets debt. Additionally, pressure on corporations that have close ties to the Chinese Communist Party and the Kremlin is a prime catalyst for engagement with emerging equity mandates that exclude state-owned enterprises.

**Actionable investing ideas:** XSOE, CXSE, ELD

Disruptive Growth: The COVID-19 pandemic has compressed a decade-long trend into the span of a few months in which we’ve seen cloud computing and tech-oriented growth leadership maintain notable performance. Those looking for thematic growth potential could consider our offerings.

**Actionable investing ideas:** WCLD, PLAT

Reflation Trade: For those who wish to play off the potential for renewed inflation against concerns of elevated equity valuations, a long-awaited bull market in commodities may be in tow. While we expect the Fed to keep rates at or near zero, intermediate-to-long-dated Treasury yields could grind higher, steepening the yield curve in response to unprecedented monetary and fiscal stimulus.

**Actionable investing ideas:** AGZD, HYZD, USFR, GCC

From an asset allocation perspective, our current portfolio positionings are:

1. **Overweight stocks relative to bonds**
2. **Overweight U.S. equities relative to global equities, with emerging markets favored over non-U.S. developed markets**
3. **Portfolio tilts toward small cap, value and quality**
4. **Within rates and credit, we remain underweight duration and overweight credit risk**, though we have an explicit focus on security selection

21 Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets and operating profitability as well as others. This term is also related to the quality factor, which associates these stock characteristics with excess returns vs. the market over time.

22 Duration: A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

23 Credit risk: The risk that a borrower will not meet their contractual obligations in conjunction with an investment.
Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473 or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging or offshore markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Funds focusing their investments on certain sectors and/or regions and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. 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. Please read each Funds’ prospectus for specific details regarding the Fund’s risk profile. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

This material contains the opinions of the authors, which are subject to change, and should not be considered or interpreted as a recommendation to participate in any particular trading strategy or deemed to be an offer or sale of any investment product, and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, nor its affiliates, provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise, the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

Kevin Flanagan, Jeremy Schwartz, Scott Welch and Jeff Weniger are Registered Representatives of Foreside Funds Services, LLC.