U.S. FIXED INCOME: WHAT'S "NEXIT" FOR THE BOND MARKET?

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Well, here we are. The "leave" Brexit vote has become a reality and the global markets essentially responded as expected. While the catalyst this time around is perhaps different, it does seem as if we have been down this road before. Thus, it is important to not get caught up in the headlines of the day but, rather, focus on what comes next once emotions have cooled. The U.S. Treasury (UST) market certainly delivered in terms of its response. As we discussed in our June 22 blog post "U.S. Treasuries: Brexit Meets Grexit" the 10-year yield dropped through some prior technical low points and made a run at the all-time nadir of 1.39% that occurred post-Grexit in July 2012. For the record, the intraday level got down to 1.40% before reversing course at one point by nearly 20 basis points (bps). This knee-jerk response was no doubt a result of heightened fears and anxieties as to what a "leave" vote could ultimately entail, reflecting uncertainties regarding the global economy, potential political fallout (which nation may be the next to leave?) and the health of the banking sector in the event of increased stress in the funding markets. It came as no surprise to see spreads increase in the U.S. corporate bond market, and we could see additional widening as the Brexit saga plays out in the near-term. However, early on, yield levels for both the investment grade and high yield sectors have remained anchored by the visible drop in UST rates. If anything good came from the financial and prior eurozone crises, they gave global central banks a playbook or blueprint as to what policies to implement to counteract potential disruptions in the financial markets, specifically the funding markets. Once again, we turn our attention to the arena where banks are funding themselves on a more short-term basis to see if there were any indications of stresses emerging. As of this writing, the early signs revealed only modest widening in LIBOR–OIS spreads (USD, EUR, GBP), but nothing that came even remotely close to the levels that existed during the eurozone crisis in 2011–2012. Along these lines, in its initial response to the result of the vote, the Bank of England pledged $345 billion for the financial system while the Federal Reserve (Fed) put out a press release stating that it was "prepared to provide dollar liquidity through its existing swap lines with central banks, as necessary, to address pressures in global funding markets."[1] Obviously, potential rate cuts, especially from the Bank of England, have entered into the discussion as well, but the Fed also was brought into the mix. Indeed, Federal Funds futures posted anywhere from a 10% to almost 25% implied probability that the FOMC would also go down this road. At this point, our base case does not envision the Fed reversing last December's rate hike. **Conclusion** There's little doubt the Brexit headlines, and the potential fallout, will affect the U.S. fixed income arena in the near future. However, as we saw with Grexit, the UST market doesn't stay constant. In fact, a year after hitting its all-time low in 2012, the 10-Year yield had risen 120 bps to 2.59% as the bond market was in the throes of the "taper tantrum." A year from now, the U.S. will have a new president and fiscal stimulus/tax reform could be on the radar screen (just a thought), and don't count out future jobs reports if they show a rebound from last month's data. We're already seeing ramifications for the U.S. economy being put into perspective, with economists projecting little impact on real GDP this year, followed by a modest reduction, of a couple of percentage points, in 2017. The Brexit process itself will take time to play out because, based upon Article 50 of the Treaty on European Union, the UK has two years to negotiate its secession. A core strategy for fixed income investors' portfolio is of paramount importance. The WisdomTree Barclays U.S. Aggregate Bond Enhanced Yield Fund (AGGY) offers fixed income investors a quality investment option with the potential to serve as the bedrock and ballast for both today's and tomorrow's income needs. ***Unless otherwise noted, data source is Bloomberg as of 6/27/2016.*** [1]Federal Reserve press release, 6/24/16.

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DEFINITIONS

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

10-year government bond yield : Yields on the 10 year government debt security.

Grexit : an abbreviation of "Greece exit" that mirrors the term Brexit. It refers to the possibility that Greece will withdraw from the European Union.

Basis point : 1/100th of 1 percent.

Eurozone (EZ) : 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).

London Interbank Offered Rate (LIBOR) : the average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.

Overnight Index Swap (OIS) : an interest rate swap that consists of both a fixed and a floating rate component. The floating rate part uses an overnight rate index, in the case of the U.S. dollar the Federal Funds Rate, while the fixed portion is set at an agreed-upon rate between the two parties.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Article 50 : States the rules and procedures regarding a member of the EU intending to withdraw from the EU.