U.S. RATES: A CASE OF ONE STEP FORWARD, TWO STEPS BACK

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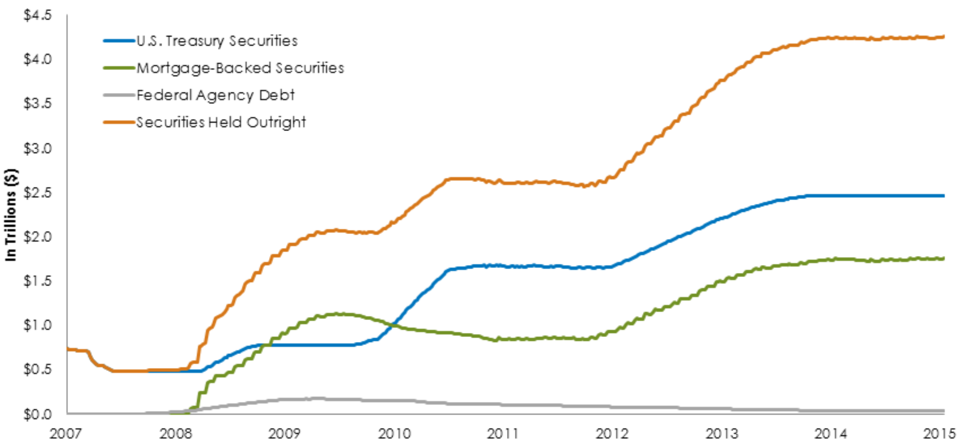
The Federal Reserve (Fed) finally gave the financial markets 'liftoff' in mid-December, but ever since, the U.S. rate development is a case of "one step forward, two steps back." Indeed, in the aftermath of the Fed's decision to raise the Federal Funds target by a quarter-point, the U.S. 10-Year Treasury (UST) yield reached a high point of 2.31%, only to reverse course and penetrate the 2% threshold in recent weeks. There is little doubt that the UST market's focus early in the new year has been on other financial arenas. The visible drop in crude oil and attendant decline in equity valuations have once again spurred safe-haven buying, a scene we've seen played out many times over the last few years. Slowing global growth concerns have also come into play, led by worries about China's economy, while global rates and monetary policy in the developed world also remain active considerations. Here in the U.S., the economic news has been a bit more mixed, as a robust jobs report has been offset by softer readings for manufacturing. Thus, real gross domestic product (GDP) for 2016 is not expected to be too far off the +2.2% average since the end of the Great Recession in mid-2009. What about the Fed? Consensus wisdom coming into 2016 has centered around the notion that policy makers would announce four additional rate hikes this calendar year (March, June, September, December), a view basically confirmed by Fed officials themselves. With the first Federal Open Market Committee (FOMC) meeting of the year now behind us, the Fed is left with seven future gatherings in which to effectuate these possible tightening moves. Given the newfound uncertainty at the beginning of the year, it seems difficult to envision four hikes will be in the offing; perhaps two, maybe three seem a better likelihood at this point. Within the UST arena, recent history has shown that one month's rate movement is not necessarily a harbinger of what lies ahead. Our current rate outlook anticipates a gradual low-trajectory rise in UST yields from here, with a range-bound seesaw type of pattern along the way. One of the key reasons we believe any increase will be tempered actually lies with the Fed and is due to not only the scaled-back rate hike expectations but also to balance sheet considerations. **Federal Reserve Securities Held Outright-Breakdown**



Source: Federal Reserve, as of 1/13/2016.

Phase 2 of the Fed's "normalization" playbook involves its holdings of securities—Treasuries, federal agencies and mortgage-backed securities (MBS). As of this writing, its System Open Market Account, or SOMA, totaled $4.25 trillion, with Treasuries standing at $2.46 trillion or 58% of that amount. It has been reported that, for the first time, the Fed will have a sizeable amount of Treasuries (the figure has been placed at roughly $215 billion) rolling off the books in 2016. Recent Fed commentary has reiterated its intention to reinvest any maturing holdings until the normalization of rates is well under way. As a result, the UST market should continue to receive support from the Fed this year to offset potential selling pressure from global central banks. When combined with the aforementioned forces, any rise in rates from current levels appears to be capped. Against this backdrop, WisdomTree feels fixed income investors would be prudent to enhance their yield. Rather than focusing on the Barclays U.S. Aggregate Index (Agg), an alternate approach to achieve this goal could be the Barclays U.S. Aggregate Enhanced Yield Index strategy. That Index looks to enhance yields vis-à-vis the Agg by re-weighting its components to enhance income while broadly retaining its risk characteristics. While investors have in recent years stretched for yield in more speculative credits, they might have overlooked the potential to get more income out of their core fixed income by looking inside the Agg itself.

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DEFINITIONS

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

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

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Federal Agencies : Special government organizations set up for a specific purpose such as the management of resources, financial oversight of industries or national security issues.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

System Open Market Account (SOMA) : An account that is managed by the Federal Reserve Bank, containing assets acquired through operations in the open market. The assets in SOMA serve as a management tool for the Federal Reserve's assets, a store of liquidity to be used in an emergency event where the need for liquidity arises, and as collateral for the liabilities on the Federal Reserve's balance sheet such as U.S. dollars in circulation.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Bloomberg Barclays U.S. Aggregate Enhanced Yield Index : a constrained, rules-based approach that reweights the sector, maturity, and credit quality of the Barclays U.S. Aggregate Index across various sub-components in order to enhance yield.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.