FIXED INCOME INVESTORS HAVE A PROBLEM

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01 Apr 2019

It’s true—fixed income investors have a problem, particularly those that invest in Eurozone government bonds. If one looks at a plot of the yield to maturity of these assets, there is a clear downward trend. This makes sense, as in many countries within the Eurozone one has to extend maturity to the 7 to 10-year tenor in order to simply receive a positive yield.

The problem is that the measure of duration of these assets has been increasing. This means that the level of interest rate risk has been climbing.

Simply put: Today’s investor in Eurozone government fixed income must take more risk to receive less income—not a favourable trade-off in our view.

The Eurozone rates backdrop

Many would have expected that, when the European Central Bank (ECB) stopped buying 30 billion Euros of government bonds per month in December of 2018, this would have placed upward pressure on rates.

The problem comes down to growth.

When one looks across the Eurozone today, from an economic growth perspective, Germany—frequently termed the engine of growth for the region—just barely avoided a technical recession, defined by two consecutive quarters of negative Gross Domestic Product (GDP) growth. Italy is in a technical recession by this same definition. The Purchasing Managers Index (PMI) statistics across the region have been trending downwards, with some markets observing levels that are indicative of economic contraction.

If we think about interest rates at the 10-year tenor, they should reflect expectations of future growth and future inflation. With the growth outlook so poor, we believe that this is a primary driver for the low interest rate picture that we currently see.

Possible actions to be taken in fixed income

Absent any fiscal actions at all, it is difficult for one to place a finger on any immediate catalyst to solve Eurozone’s growth issue.

In the meantime, fixed income investors still need income. Three avenues remain open to them:

- Increase duration: It is still the case that longer maturity assets tend to yield more than shorter maturity assets, therefore indicating that for greater income, one must extend further and further along the maturity spectrum. If interest rates rise, the risk to this practice is that there can be a greater negative impact on total return.
- Decrease credit quality: It is also still the case that lower quality corporate credit yields more than higher quality government credit. Investors with the flexibility to do so might find a benefit to take the greater current compensation for taking more of this risk.
- Focus abroad: Investors able to do so have also communicated to us that they have looked outside of the Eurozone into things like emerging market government bonds. There are unique risks in this space—such as currency movements—but currently the yields are quite high.

What is Enhanced Yield?

For those investors that must retain a percentage of their exposure in Eurozone government debt, WisdomTree has developed a pragmatic approach to attempt to squeeze more income out of these assets for minimal tracking risk against the established benchmark. Only government bonds are used and the approach tilts away from the lower, frequently more negative yielding assets and towards the positive yielding assets, subject to constraints. Big picture:

- Longer Duration
- More Italy
- Less Germany

This may present one way to try to tackle the problem faced by investors in Eurozone government bonds today.

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