UNCERTAINTY IS THE NEW CERTAINTY. HOW WILL INVESTORS RIDE THE WAVE?

Wisdomtree EU
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While we are now past the initial stage of broad based lockdown measures imposed by governments globally, the opening of economies has led to a resurgence in Covid-19 cases is the US, Euro Area and Asia. As governments try to mitigate the renewed health risk concerns, we are seeing more regional lockdowns imposed as opposed to the broader based measures enforced earlier this year with the aim to lessen the degree of contraction in the economy and push the recovery forward. Notably, the spike in new daily Covid-19 cases in the US particularly in Florida and California have surpassed the heightened levels reached by New York during the peak of the crisis in March of this year[1]. In Spain, the last week of July has led to a sharp regional spike in new confirmed Covid-19 cases, although generally still below the March peak levels. Region spikes such as those occurring in the region of Aragon are creating doubts over the speed of the economic recovery in Spain given its heavy dependency on tourism. Other economies face a similar concern as containing the virus appears more challenging than initially anticipated.

Until a vaccine is approved for broad use or a sustainable treatment path is achieved, uncertainty around the future path of the global economic recovery will likely weigh heavily on markets and drive central bank behaviour for the rest of the year. In this blog, we aim to review some of the risks investors may inherently hold within their bond portfolios and consider examples of strategies that have historically helped investors navigate uncertain equity market behaviour.

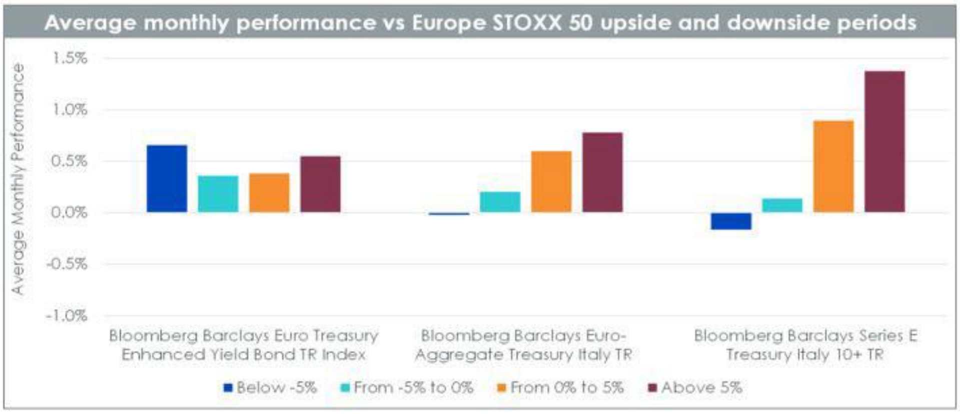
What are you holding in your government bond fixed income portfolios?

As European government bond yields remain low, some investor portfolios, particularly in Italy, may hold large allocations to Italian government bonds (BTPs) given that BTPs generally provide a yield enhancement over many other European Sovereign debt.

While this can be one way to enhance portfolio yield, we note that allocating 100 percent of the government bond portfolio bucket to one Sovereign can hold inherent risks such as those associated with a lack of diversification. The below three figures provide some interesting insight for investors who hold large allocations in Italian government bonds meanwhile are also concerned about future equity market volatility due to the high level of uncertainty around the path of the economic recovery.

Figure 1 below considers three different indices: one reflecting a European government bond index that is optimised with the aim to maximise the yield by adjusting weights across the yield curve and within sectors subject to tracking error, exposure, eligibility, and turnover constraints. The second index is a broad maturity Italian government bond index and the third index is an Italian government bond index with maturities of 10+ years. The left has axis of the chart highlights the average monthly performance of these three indices under four different equity market scenarios such as when equity markets are down by - 5% or more, down by -5% to 0%, up by 0 to 5% and finally up by 5% or higher on average. One can note that while long dated Italian government bonds offer higher average monthly performance when equity markets are up, the index was also on average in negative territory when equity markets were down by -5% or more. The broad maturity Italian BTP index had modestly less outperformance when equity markets were on average in positive territory and the Bloomberg Barclays Euro Treasury Enhanced Yield index on average had a more balanced historical return profile under the four different equity market scenarios.

Figure 1: A balanced risk profile for uncertain times



Source: Bloomberg. Period from January 2002 to June 2020. Based on monthly returns in EUR. Legend illustrates average monthly performance of the Europe STOXX 50 under four different performance ranges as noted.

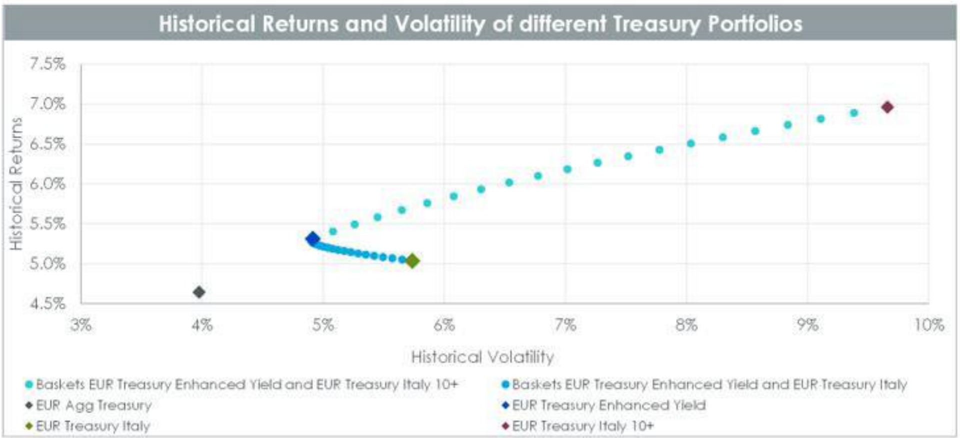
You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

+ EUR Treasury Enhanced Yield Bond index has historically performed positively in the 4 regimes

+ Italian Treasuries (BTPs) historically have not done so well in crisis

In Figure 2, the analysis illustrates a combination of portfolios that could be achieved by combining the exposure of Italian BTPs 10+ year considering the Bloomberg Barclays Series E Treasury Italy 10 + index and the Bloomberg Barclays Euro Treasury Enhanced Yield Bond index. These illustrative portfolios are shown in light blue dots plotted against historical returns versus historical volatility. The below analysis provides an interesting example of how portfolio volatility could potentially be reduced meanwhile maintaining some long-term historical performance by combining long dated Italian Treasuries with a more diversified European Sovereign index such as the Bloomberg Barclays Euro Treasury Enhanced Yield Bond index.

Figure 2: Mixing EUR Treasury Enhanced Yield and BTPs



Source: Bloomberg, WisdomTree. Period from January 2002 to June 2020. Based on monthly returns in EUR and **includes backtested data**. All indices are total return. Indices represented include **EUR Agg Treasury** represented by ticker: LEATTREU, **Euro Treasury Enhanced Yield** represented by ticker: I33855EU, **EUR Treasury Italy** represented by ticker: LTITTREU, **EUR Treasury Italy 10+** represented by ticker: BEITG5.

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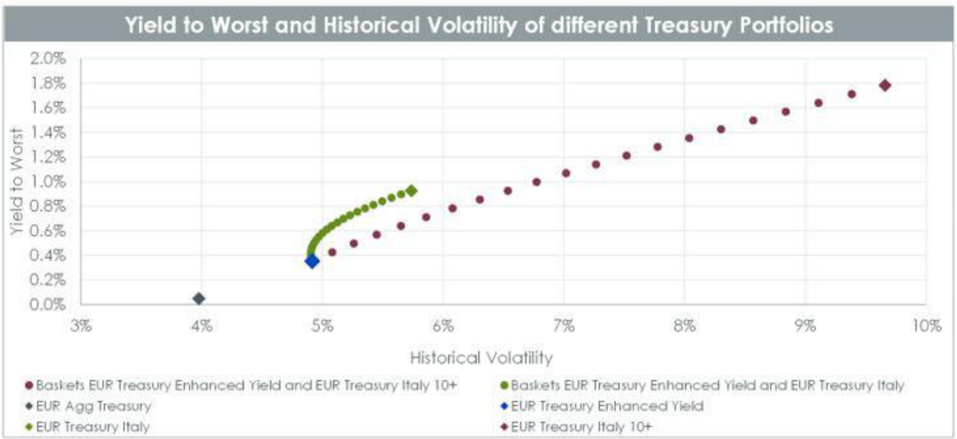
+ Reducing the Historical Volatility of the portfolio, using EUR Treasury Enhanced Yield Bond index

+ While maintaining some long-term historical performance

In Figure 3, the below analysis provides a similar example of portfolio combinations but instead plots them against the yield to worst versus historical volatility. Considering the below examples, there appears to be a number of ways for portfolios to be constructed that could potentially help an investor reduce volatility meanwhile maintaining yield.

Figure 3: Mixing EUR Treasury Enhanced Yield and BTPs



Source: Bloomberg, WisdomTree. Period from January 2002 to June 2020. Based on monthly returns in EUR and **includes backtested data**. All indices are total return. Indices represented include **EUR Agg Treasury** represented by ticker: LEATTREU, **Euro Treasury Enhanced Yield** represented by ticker: I33855EU, **EUR Treasury Italy** represented by ticker: LTITTREU, **EUR Treasury Italy 10+** represented by ticker: BEITG5.

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+ Reducing the Historical Volatility of the portfolio, using EUR Treasury Enhanced Yield

+ While maintaining some yield

Given the market uncertainty that lies ahead, historical data appears to provide some interesting insight into different strategies that investors can consider when positioning portfolios for an unpredictable 2020.

[1] As reported on 30 July 2020 in the Centers for Disease Control and prevention government website https://www.cdc.gov/coronavirus/2019-ncov/cases-updates/cases-in-us.html

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