THE FED: NOT SO GREAT EXPECTATIONS

Wisdomtree EU
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The Federal Reserve (Fed) finally gave the financial markets 'lift-off' in mid-December, but ever since, the U.S. rate development has been 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 25 basis points, the U.S. 10-Year Treasury yield reached a high point of 2.31%, only to reverse course and penetrate the 2% threshold in recent weeks.

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. In the U.S., the economic news has been a bit more mixed, with a robust December jobs report having since 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.

Indeed, there is a clear disconnect between what the market is expecting and what policy makers are anticipating as the end result. The Fed Funds Futures arena, whilst not necessarily have the greatest track record in accurately predicting actual Fed rate moves, offers some interesting gauges of market sentiment and rate expectations this year. The December 16 futures contract, as shown in Chart 1, shows a clear shift in expectations since 'lift-off' occurred in mid-December, revealing also that investors never seem to have bought into the conventional wisdom of four additional rate hikes in the current calendar year. As of this writing, the pricing mechanism is geared towards only one additional rate hike in 2016, or a mid-point of roughly 55 basis points (bps) in the ½- to ¾-percent band.

With the Fed likely to slow the path to normalising interest rates, the landscape for U.S. Treasury yields is expected to be contained this year. In such an environment, fixed income investors would be prudent to consider alternative approaches to enhancing their yield.

Consider dividend yielding US equity baskets

Investors seeking an alternative to fixed income may increasingly find the dividend stream of quality companies a viable alternative. A broad basket of high dividend yielding stocks, weighted and rebalanced by the amount of dividends paid will not only offer investors a value-orientated strategy but also a significant yield premium over government bonds. As of the end of January, WisdomTree's US Equity Income and US SmallCap Dividend strategies offered a dividend yield in excess of 4.4%, representing a yield premium of over 250 bps compared to current 10Y US Treasury yield.

At a time when US rate expectations for 2016 remain uncertain, a US dividend strategy that emphasizes cash returns as the best signal for transparency and shareholder value may serve as a viable alternative to investors seeking yield.

Investors sharing this sentiment may consider the following UCITS ETFs (ticker in brackets):

+ WisdomTree US Equity Income UCITS ETF (DHS)
+ WisdomTree US SmallCap Dividend UCITS ETF (DESE)

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