TELLTALE SIGNS OF GROWTH IN THE CURRENT CYCLE

Gaurav Sinha — Associate Director, Asset Allocation and Modern Alpha
06/08/2018

After nearly a decade of loose monetary policy, we entered a phase of monetary tightening in December 2015 when the Federal Reserve (Fed) hiked interest rates for the first time in about a decade. The world depends on greenbacks, which fuel trade everywhere from New York to New Delhi and from London to Macau. More than half of all global cross-border debt is issued in dollars, and they make up almost two-thirds of global central bank reserves[1]. When the U.S. Federal Reserve changes course, it's an event investors can't ignore.

Below I analyze the top five developed and top five developing economies and their growth profiles.

Debunking the "Fed Increases Rates Causing Stronger Dollar, Weaker EM Equities" Notion

For starters, I want to debunk this notion that the Fed hiking path will universally lead to a stronger dollar and that this has been bad news for emerging markets (EM). As the exhibit below shows, in the last four out of five cycles when the Fed hiked rates, EM actually rallied and outperformed the S&P 500, while the MSCI EAFE did so twice. ***The correlation between Fed hikes and weaker international equities is weak at best.***

	Rate Hike Cycle				
	Mar '88 - Feb'89	Feb '94 - Feb '95	June '99 - May '00	June '04 - June '06	Dec '15 - Current
MSCI EM Index	18.14%	-20.48%	5.75%	83.25%	56.10%
S&P 500 Index	15.44%	7.35%	4.66%	15.48%	35.35%
MSCI EAFE Index	12.55%	-5.78%	13.11%	45.28%	25.90%
U.S. Dollar	7.40%	-9.12%	5.73%	-4.10%	-8.78%
Increase in Fed Funds Rate (bps)	325	300	175	425	150

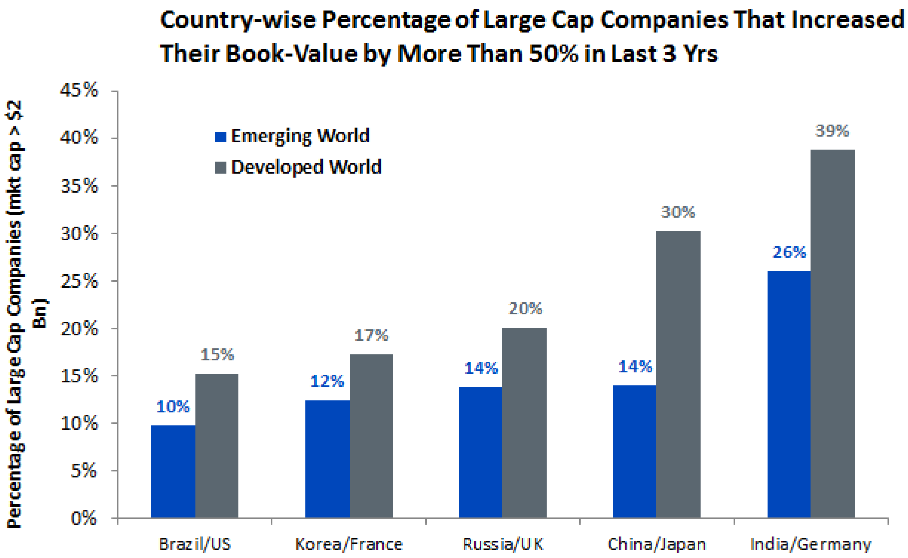
Source: Bloomberg, as of 3/31/18. Data measures performance beginning on the first day of the first calendar month following an increase in the Fed Funds Rate from the U.S. Federal Reserve and ending through the last month of the final increase of the rate hike cycle. Past performance is not indicative of future results. You cannot invest directly in an index.

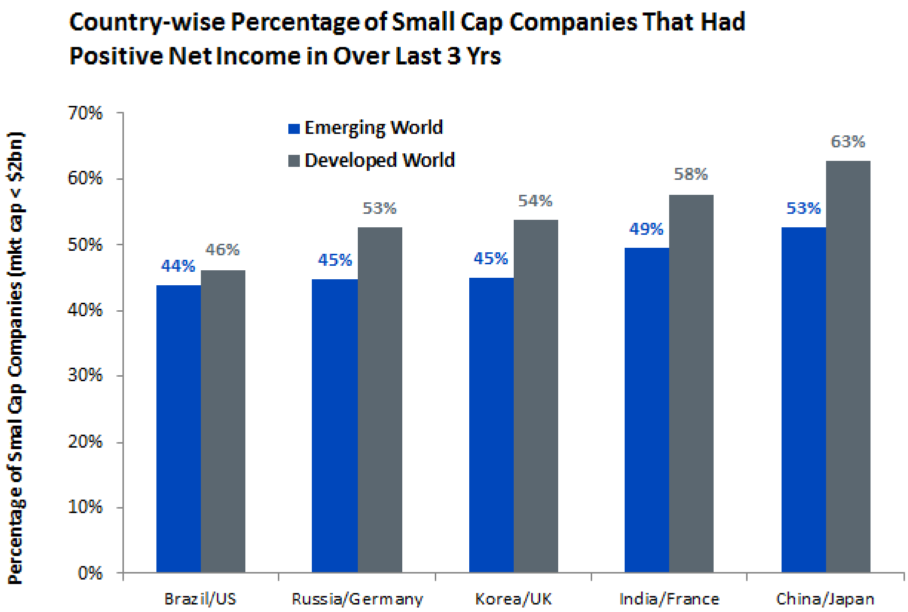
For definitions of terms in the chart, please visit our glossary.

Fast Economies Lead to Faster Corporate Growth

Now, let's focus more locally and check for countries that have outperformed. In the exhibits below, I look at companies, both large and small caps, in the top five developed and developing economies to focus on where maximum growth happened.

I evaluated the proportion of large-cap companies (market cap greater than $2 billion) that showed strong growth by increasing book value by more than 50% over the last three years. Similarly, I also looked for the proportion of small-cap companies (less than $2 billion market cap) that made positive cash flows and generated profits, again over the last three years.





Sources: FactSet, WisdomTree, as of 4/30/18. Past performance is not indicative of future results.

Here are two quick observations:

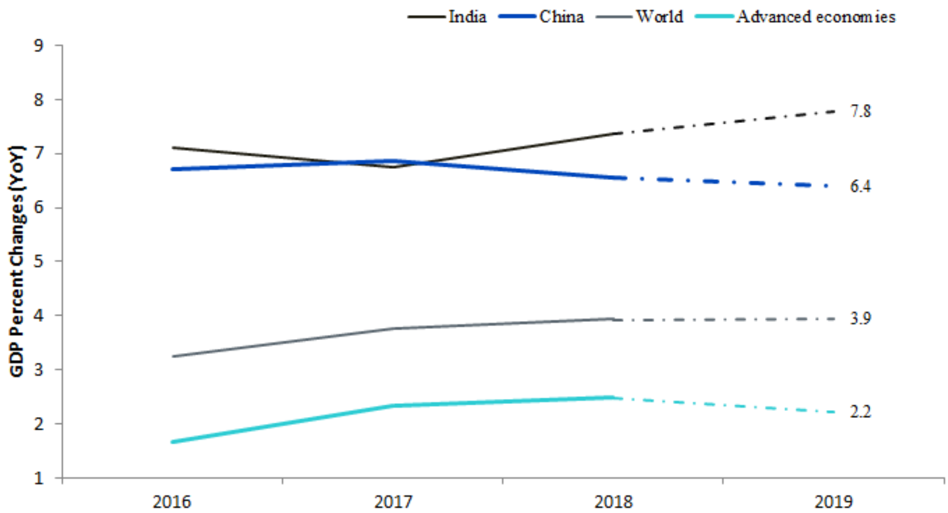
1. EM—Indian and Chinese companies consistently fared better across large/small caps.
2. Developed world—Companies in export-oriented countries such as Japan, France and Germany fared better.

Next, let's look at what, in my opinion, helped these companies.

Economic Growth Feeding Corporate Growth

To explore why certain countries did better than others, I show a rather simple chart of economic growth trends projected by the IMF.

Gross Domestic Product (GDP) Growth Rates (Past and Projected)



Source: IMF, as of 4/30/18. Past performance is not indicative of future results.

When I juxtapose this chart with corporate growth above, there are two primary takeaways:

- Countries like **India** and **China**, whose growth was nearly twice as fast as global growth, provided massive support for their large-cap companies to piggyback on and grow alongside. As their economies picked up, rewards percolated to all segments of society, and small-cap companies, which are typically tied more strongly to local consumption, benefitted and made more profits.
- For advanced economies, 2016 and 2017 were years when growth picked up pace, and this helped companies in countries running fiscal surpluses as they exported more goods to satisfy global demand. This led Japanese and German firms to grow and make profits as well.

Conclusion and Key Risks

There are a few conclusions here:

- ***Strategic investors should consider over-weighting countries that are growing fast (i.e., India and China). As fast economic growth is a strong tailwind to large-cap companies and as benefits of economic expansion percolate downward, small caps get a boost as well.***
- ***Over-weighting export-oriented countries, especially Japan and Germany, could be a great way to play on global growth. Continued growth in global demand is likely going to be favorable to corporate earnings in these countries.***

This is not to say there are no risks. The top risks I see:

- As institutions in EM are fragile, any change in sentiments can temporarily send EM equities on a downward trend. ***In my opinion, investors can mitigate such a risk by staying focused on fundamentally attractive and profitable companies.*** For instance, the WisdomTree India Earnings Fund (EPI), by **ONLY** selecting profitable companies and then weighting them by trailing 12-month profits, is, in our view, a smart way to invest in profitable companies with less expensive valuations. Similarly, the WisdomTree China ex-State-Owned Enterprises Fund (CXSE) is a strategy to invest with non-state-owned companies, thus gravitating to more companies in China that have more robust growth profiles.

- A rising dollar or rotation to safe-haven assets due to escalation in geopolitics can also put downward pressure on currencies, dragging equities down too. One way to partially hedge this risk is by removing currency exposure that comes with investing internationally. ***Because of the cheaper cost to hedge, hedging currency risk can be easier for developed countries and makes even more sense for export-oriented countries with trade surpluses, such as Japan and Germany.*** Investors should consider currency-hedged strategies from WisdomTree, which provide a great way to invest internationally while mitigating currency risk.

[1]Source: Bank of International Settlement, Economist as of 05/31/2018

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Funds focus their investments in China and India thereby increasing the impact of events and developments associated with the region which can adversely affect performance. Investments in emerging or offshore markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. The Fund's exposure to certain sectors may increases its vulnerability to any single economic or regulatory development related to such sector. As the Funds can have a high concentration in some issuers and can be adversely impacted by changes affecting those issuers. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

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.

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

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.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

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

Trailing 12-month earnings : is the sum of a company's earnings for the previous 12 month.

Ex-SOEs : ex-state owned enterprises or companies that are neither wholly or partially owned and operated by a government.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.