# EURO DEPRECIATION: THE KEY TO UNLOCKING THE VALUE IN EUROPEAN EXPORTERS

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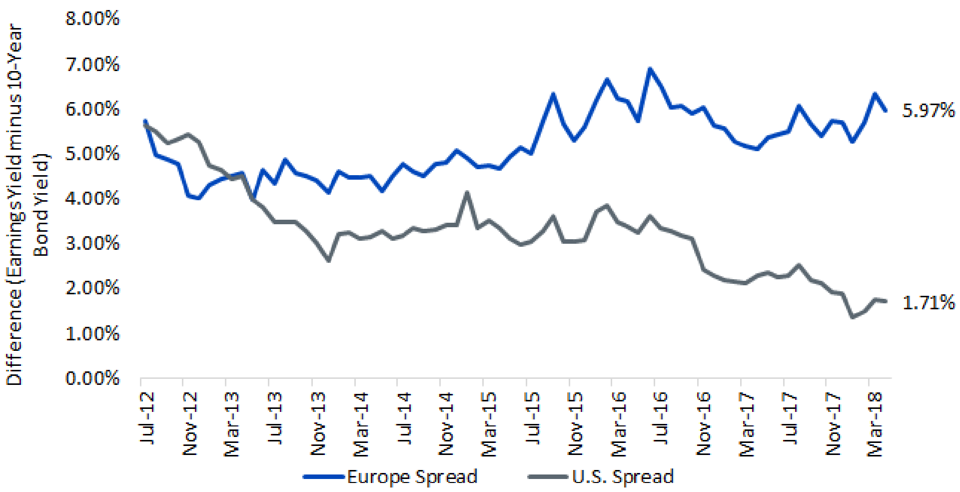
One of the biggest surprises of 2017 was the fact that the euro exchange rate measured against the U.S. dollar appreciated 14%—only about 7% behind the performance of the S&P 500 Index over the same period.[1]

**The Consequence: European Equities Look Quite Attractive (7/31/12–4/30/2018)**




Source: Bloomberg, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index. Period is based on data availability for the WisdomTree Europe Hedged Equity Index. Europe Spread: WisdomTree Europe Hedged Equity Index earnings yield minus 10-year German bund interest rate. U.S. Spread: S&P 500 Index minus 10-Year Treasury note interest rate.

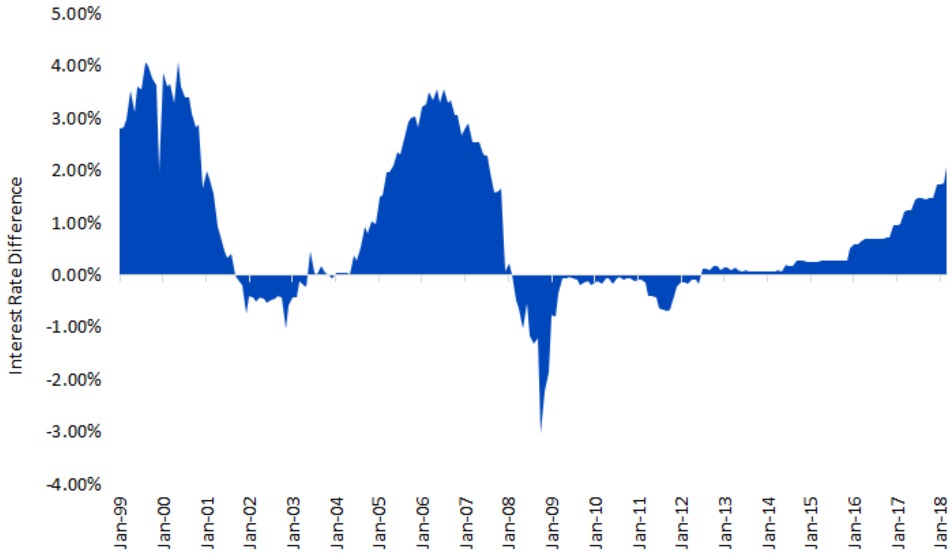
- This spread illustrates one consequence of a central bank policy divergence, as the 10-year German bund was around .60%, approximately one-fifth of the 2.95% where we saw the U.S. 10-Year. Yes, the current earnings yield of the WisdomTree Europe Hedged Equity Index is about 190 basis points higher than that of the S&P 500 Index, but an even greater reason for the difference in spread is the very low position of German interest rates.
- Our European equity Index is focused on export-oriented companies that derive more than 50% of their revenues from outside of Europe. The euro's performance is important, therefore, in that a weaker euro creates a stronger fundamental backdrop for the earnings of these companies.

### Interest Rates Matter

Central bank policy divergence has been one of those "big themes" often discussed among market participants around the world, and along those lines, many would then cite the policy rates first because these are what the central banks directly influence.

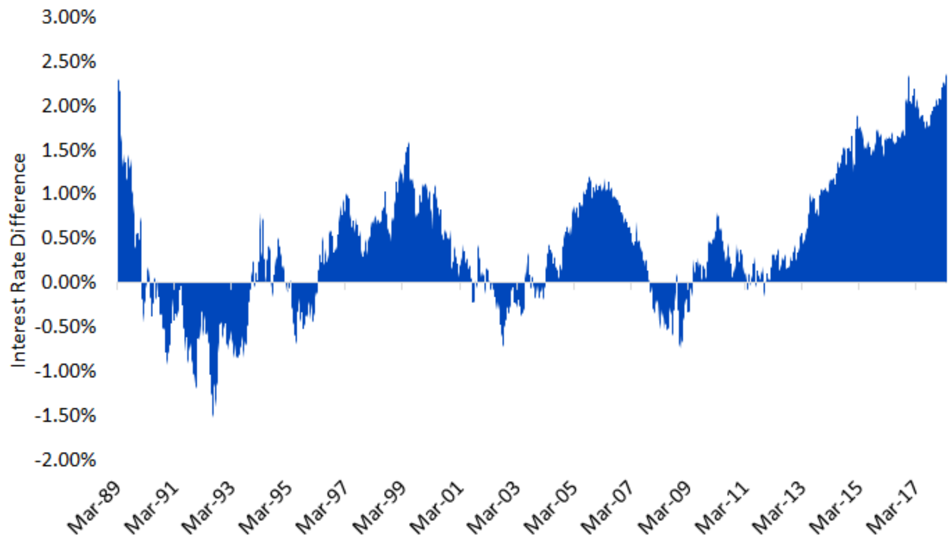
However, it is also important to look further out on the interest rate curve. Ten-year government bond interest rate differences between Germany and the U.S. indicate a broader spectrum of differences beyond central bank policy and could indicate both growth and inflation differentials.

**Difference in Central Bank Policy Rates: U.S. Federal Reserve Minus European Central Bank (ECB)**




Source: Bloomberg, with period based on available data from the ECB policy rate, 1/31/1999 to 3/31/2018. U.S. Federal Reserve is the U.S. Federal Funds Effective Rate. ECB rate is the ECB Deposit Facility Announcement rate.

**Difference in U.S. 10-Year Treasury Interest Rate Minus 10-Year German Bund Interest Rate**




Source: Bloomberg, with period based on available data for the German 10-year bund, 3/31/1989 to 3/31/2018.

- **Policy Rates:** It is very clear that the U.S. central bank has tended toward a higher policy rate than the ECB over the vast majority of the period that we can analyze. The difference peaked—meaning the Fed policy reached its highest level in a relative sense—in 2000 and in 2006. The critical question is whether we are traveling toward a third peak, being currently at about a 2% difference, around half of the historical maximum in the 4% range.

- **10-Year Government Bonds:** Going back to 1989, the U.S. 10-Year had an approximate 2.3% to 2.4% yield advantage over the 10-year German bund. Markets had to wait until the current period for this level of difference was reattained—a period of nearly 30 years. This means a couple of things: 1) the U.S. has much higher growth/inflation expectations than the eurozone over the next 10 years, and 2) European investors have an opportunity to pick up a historically large spread when investing in U.S. government debt.

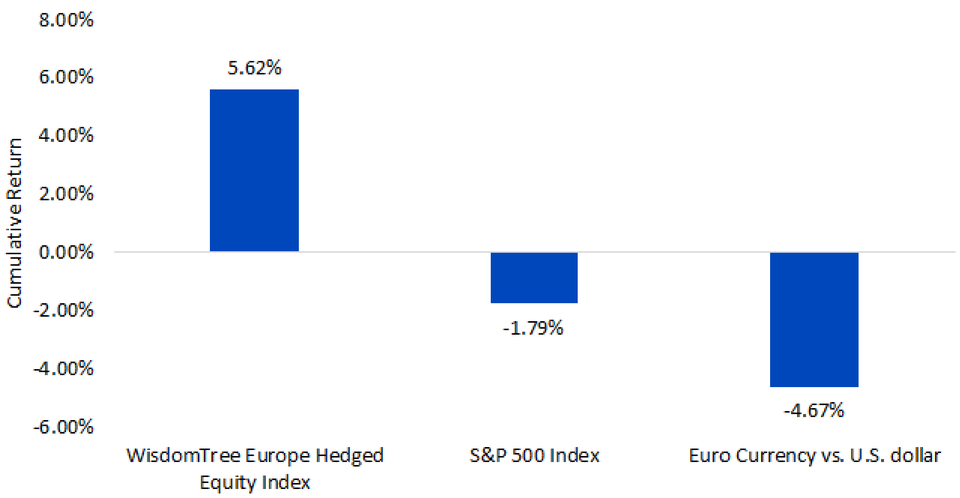
*Bottom line: These spreads favor a stronger U.S. dollar and a weaker euro. Now, we're careful to say "favor" because other factors clearly influence the picture. The market has known about these developments for some time and the euro is still trading at around €1.19 to the U.S. dollar, as of this writing.*

**2018: Will the ECB Begin Tapering?**

The April 26, 2018, ECB press conference went as expected—not much in the way of new information, and policy will be assessed flexibly on an ongoing basis. As of now, we know that the asset purchase plan will continue at a rate of €30 billion per month through September this year. Data may lead this to be extended, but as yet we do not have that new information—we just know that indicators such as the Citi Economic Surprise Index haven't been at their most positive thus far in 2018. Extending the time frame for easing—contingent, of course, on economic data—may come to light in June. If we can assume this is not currently priced into the euro, then it may be a catalyst for euro weakness.

**U.S. 10-Year Broke 3%—A Short-Term Case Study of Euro Weakness & Equity Prices**

**Recent Euro Depreciation (2/15/18–5/7/18)**




Source: Bloomberg.

- February 15, 2018, was a near-term peak in the euro, when it traded above 1.25. As of this writing, it is trading around 1.19, implying approximate depreciation of 4.7%. This represents an important example of what can happen to European exporters—shown through the WisdomTree Europe Hedged Equity Index—when the euro weakens: outperforming the S&P 500 Index over this period by about 7.4% cumulatively.

**Conclusion: A Weaker Euro Could Unlock Valuation Potential of European Exporters**

We've seen the U.S. 10-Year break through 3% for the first time since early 2014, and we've written about the appointment of Larry Kudlow to the Council of Economic advisors and possible "King Dollar" policy. We had a glimpse of this over the past few weeks, and now we will have to examine the staying power of this trend.

[1]Source: Bloomberg, with 2017 performance measured from 12/31/16 to 12/31/17.

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## DEFINITIONS

**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.

**German bunds** : A debt security issued by Germany's federal government, which is the German equivalent of a U.S. Treasury bond.

**10- Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.

**Basis point** : 1/100th of 1 percent.

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

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

**Inflation** : Characterized by rising price levels.

**Citi Economic Surprise Index** : An indicator of how actual economic data compares to analyst expectations. A downward trend means actual data has been trending below expectations, and an upward trend means actual data has been trending above expectations.