UNTIL DRAGHI ACTS, INVESTORS SHOULD CONSIDER INCREASING EXPOSURE TO EUROPEAN BONDS

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In perhaps one of the most memorable events of the eurozone crisis, European Central Bank (ECB) president Mario Draghi's comment that he would do "whatever it takes to preserve the euro" marked the inflection point of the highly uncertain future for the European Monetary Union (EMU).[1] Since that time, positive economic growth has returned to a majority of the European economies, bond yields for peripheral borrowers (such as Italy, Ireland, Portugal and Spain) have declined dramatically, and equity investors have largely started to talk about how to position for the European recovery. However, all is not well in the eurozone. In an inflation report released by Eurostat on March 31, markets took note that prices across the eurozone increased by only 0.50% compared to the same period last year. This marked the sixth consecutive month that inflation has been below 1%, well short of the ECB's 2% target. In the "Goldilocks" world of modern central bankers, risks can occur not only when inflation is too hot, but when it is too cold as well. In our view, one way for investors to play a potential "Japanification" (decades of deflation and subdued economic growth) of Europe is by investing in euro-denominated debt. **Setting the Stage: What Is Causing Europe's Weak Inflation?** Although prices did rise by a small amount, there is a very real concern about the impact of a stubbornly strong euro. A recent report from the ECB estimates that a strong euro has had the effect of containing prices by 0.40% to 0.50%. While the common currency may help reduce trade frictions among eurozone members, a strong euro can also make Europe's exports comparatively more expensive than those of its non-European Union trading partners. With the U.S. and China among the largest economies in the world, this has the impact of constraining economic growth, most notably through exports to Europe's largest trading partners. **Falling Prices of Goods, Rising Prices of Bonds** Whereas inflation tends to decrease the returns of fixed income investors, periods of deflation may actually boost bond returns. During periods of deflation, consumption remains constrained in anticipation of falling prices in the future, resulting in slowing economic growth. This is precisely the vicious cycle that saw Japan's economy stagnate for the last 20 years as consumers were turned into savers and bond investors. Falling prices may be a disincentive for consumption but they can also boost the prices of bonds as investors look for suitable places to park their cash. **What Can Draghi Do to Correct This Problem?** In our view, until Draghi announces a European round of quantitative easing (QE), soft inflation figures may continue to hinder the European recovery. While he has so far sought to avoid unleashing this program, markets may force his hand. With increased stimulus expected from the Bank of Japan in the coming weeks, Draghi may need to announce a plan soon in order to restore inflationary expectations in Europe. However, we acknowledge that building a consensus in Europe is far more difficult than within the Federal Reserve or the Bank of England. In our view, this could result in delays before a decision on QE is finally implemented. In anticipation of this change in ECB policy, we believe that buying bonds in front of any action by the ECB could result in an opportunity to sell them back at higher prices. **What EU QE Will Look Like Is Still Largely Unknown** While several options (including asset-backed securities purchases, government bond purchases and negative deposit rates) have been discussed publicly, what form additional stimulus takes is still unknown. However, when thinking about the potential impacts on markets of any ECB quantitative easing programs, investors should be conscious of not only the direct impact on falling bond yields but the impact on the currency as well. Given that a primary cause for European deflation is a strong euro, an aggressive quantitative easing announcement would likely be met by knee-jerk selling of the euro. For U.S.-based investors, should the euro depreciate against the dollar, unhedged positions in short-duration European debt would likely experience losses on a total return basis, as the income potential and capital gains would not be sufficient to offset losses from the currency. In our view, investors should increase allocations to intermediate-term euro-denominated debt as a contrarian play on the euro. In this scenario, investors have the potential to be compensated with higher amounts of income for assuming greater interest rate risk.

Given that investors have a greater sensitivity to changes in rates, these positions would also stand to appreciate by a greater amount than deposits, should intermediate-term bond yields fall. **Conclusion** While we believe that European policy makers will ultimately engineer a rebound in inflation and a depreciation of the euro against the U.S. dollar in the long run, investors should consider increasing allocations to euro-denominated debt as a way to opportunistically trade on Draghi's reluctance. As the only pure-play euro bond exchange-traded fund (ETF), the WisdomTree Euro Debt Fund (EU) may be attractively positioned to continue to benefit from the ongoing deflationary tendencies in the eurozone.

[1]Source: Bloomberg, 7/26/12.

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DEFINITIONS

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

European Monetary Union : 18 countries in Europe that use the Euro currenc.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

Inflation : Characterized by rising price levels.

Deflation : The opposite of inflation, characterized by falling price levels.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Asset-backed security : A fixed income security whose value or cash flows depends on the value of another asset, such as a loan, lease, or receivable.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.