DXGE: EUROPEAN EQUITIES' DOUBLE HEDGE

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Italian governments have the shelf life of a loaf of bread. We count 24 new prime ministers sworn in in the last four decades, with the latest, Giuseppe Conte, coming to office in June. His mandate is to implement the desires of a bizarre coalition government comprising a leftist protest party and a nationalistic party of the right.

In our view, European equity investors face two primary risks this year: exposure to Italian stocks themselves and the potential for the euro to be upset by political surprises. Our WisdomTree Germany Hedged Equity Fund (DXGE) may be an answer to these problems because it owns only German equities and hedges euro exposure. It allows investors to shift their European allocations in the direction of one of the continent's more stable "core" countries, while minimizing exposure to "peripheral" allocations and mitigating the volatility of the euro versus the dollar.

The Coalition

As we pointed out in "Italian Economics: Watch Salvini," Italian political risk has become a primary regional headwind. The coalition government between the leftist Five Star Movement and the culturally right-wing League combined for 50% of the vote in March. The continued rise of the League's Matteo Salvini this spring and summer means it is possible that combined public support for the two is even higher now, perhaps with each party having somewhere around 30% of the populace in its embrace.

Although the coalition is warm to a flattening of taxes and an end to corruption, the good economic news basically ends there, and that troubles the euro. The rest of the government's planks generally call for a reversal of much-needed crisis-era spending reforms. Italy continues to coast along with government debt equal to 130% of gross domestic product (GDP), which the markets tolerate so long as the European Central Bank (ECB) buys bonds and good times are rolling. But the feedback loop can sour when the slowdown arrives and the ECB halts its bond-buying program. That makes overturning the Fornero law, which extended pension ages, more disconcerting if the fiscal math deteriorates.

On top of this, leftist elements in both parties are agitating for universal basic income experimentation, which could be challenging for a nation that runs a budget deficit equal to 2.3% of GDP during an economic expansion. We must question the patience of northern European taxpayers, particularly the Germans, who are bound by their quasi-fiscal union with nations to the south. And with Berlin's power structure also now in question for the first time in an eternity, this is the key factor for regional equity market fortunes.

Bye-Bye, Merkel?

Not all is well in Germany's center-right. The conservative coalition between Angela Merkel's Christian Democrats (CDU) and its Bavarian sister party, the Christian Social Union (CSU)—which has held strong since the end of the war—started to fray three years ago, when Germany controversially accepted a million migrants inside of one year. The crisis came to a head this spring when the CSU pondered the prospect of losing votes in Bavaria's upcoming October elections to the right-wing anti-immigration Alternativ für Deutschland (AfD). Amid that fear, Horst Seehofer, the CSU's interior minister, shifted rightward to fend off AfD's rise. His proposal to stop asylum seekers from entering Germany caused ructions with German Chancellor Merkel, who wanted to maintain the status quo. To save her government, Merkel recently agreed to build border camps for asylum seekers.

The Counterintuitive German Equity Bull Case

With Germany in flux, maybe it's time to over-weight German equities. Why?

Consider the 2008 global financial crisis. Even though the source of the malaise was a U.S. housing collapse, American stocks generally outperformed those of other countries that year. Safe havens are safe havens.

If Germany does continue to lurch toward the cultural right, it is hard to see how that could materially hinder Corporate Germany's fortunes. Corporate Italy though? That's another story.

More seats in the Bundestag for the AfD or simply a shift by either the CDU or the CSU—or both—toward a more hardline stance on continental fiscal union could point the poison arrow at, say, Italian banks. That would reinvigorate the "core versus peripheral Europe" debate, bringing Spain, Portugal and Greece back under the microscope, as was the case a half decade ago.

"Europe" Can Mean Many Things

Figure 1 shows the country composition of the MSCI EMU (European Monetary Union) Index, along with the WisdomTree Germany Hedged Equity Index and six of our other Europe-based Indexes. Exposure to Italy, Spain and Portugal ranges from none in WisdomTree's German equity Index (obviously) to nearly 40% in our European small-cap tracker. Investors worried about Italy could use some combination of DXGE and the WisdomTree Europe Hedged Equity Fund (HEDJ), tracking the first two WisdomTree Indexes in the list, respectively. For investors who also want to cut down Spain and Portugal, another mix could include DXGE for Germany and the WisdomTree Europe Quality Dividend Growth Fund (EU DG), which tracks the WisdomTree Europe Quality Dividend Growth Index.

Figure 1: Index Country Weights

Index	Germany	Core Eurozone ex-Germany	Denmark, Norway, Sweden, Switz.	UK	Italy	Spain, Portugal	Total
MSCI EMU (European Monetary Union)	29.18%	50.55%	0.28%	3.30%	6.57%	10.12%	100.00%
WisdomTree Germany Hedged Equity Index	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%
WisdomTree Europe Hedged Equity Index	25.00%	56.23%	0.00%	0.00%	1.64%	17.14%	100.00%
WisdomTree Europe SmallCap Dividend Index	10.21%	18.78%	26.74%	25.68%	11.71%	6.88%	100.00%
WisdomTree Europe Hedged SmallCap Equity Index	18.06%	43.98%	0.00%	0.00%	23.94%	14.02%	100.00%
WisdomTree Europe Quality Dividend Growth Index	11.15%	23.76%	34.76%	23.88%	2.06%	4.39%	100.00%
WisdomTree Europe Domestic Economy Index	24.13%	47.23%	0.00%	0.00%	17.23%	11.42%	100.00%
WisdomTree Dynamic Currency Hedged Europe Equity Index	25.26%	48.55%	0.00%	0.00%	11.87%	14.32%	100.00%

Source: WisdomTree, as of 6/30/18. Holdings subject to change.

Valuations

MSCI Germany trades at 13.4x earnings estimates for this year, a couple of points more than the 11.4 forward multiple for MSCI Italy. That valuation premium reflects not only the relative safety and security of Germany as a domicile but also headier earnings growth expectations in northern Europe. To wit, the Street is forecasting total cumulative Italian earnings-per-share growth of about 20% from 2017 to 2020, while the German growth estimate is 30.1%.[1] That puts the two at 2020 P/Es of 9.6x and 11.1x, respectively. Saving a point or two on a P/E ratio does not seem like much compensation for clear and present political risk.

With winds constantly shifting across Europe, DXGE may be a way to approach regional equities with more caution than an off-the-shelf market capitalization-weighted, currency-unhedged venture. Investors can use DXGE to mitigate the size of their southern European exposures while "taking the euro out of Europe," a key WisdomTree tagline.

[1]Source: Bloomberg, as of 7/3/08 for EPS growth and price-to-earnings ratios.

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DEFINITIONS

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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

MSCI EMU Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.

MSCI Germany Index : Index weighted by float-adjusted market capitalization designed to measure the performance of the German equity market.

Market capitalization-weighting : 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.