EUROPE RETURNS TO GROWTH AFTER SIX QUARTERS OF CONTRACTION

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Europe's economy had seen six straight quarters of negative growth—or contraction—before returning to a positive gross domestic product (GDP) growth in the second quarter of 2013. This stabilization of the European economy is encouraging and a first step toward alleviating a major concern for the global economy. To date, the recovery in Europe has been supported by a backdrop of accommodative monetary policy, low inflation feeding household consumption, and a moderation in fiscal austerity. Yet the road to recovery has been an uphill battle in light of various regional political and economic risks. There are pockets of strength and weakness across various European regions, and unsurprisingly, Germany leads the pack while the peripherals grapple with high unemployment and lackluster growth. Signs for the second half of 2013 appear promising, with consumers showing signs of improvement and the manufacturing surveys pointing toward expansion. Harsh domestic conditions in Europe have contributed to lower labor costs and have improved the competitiveness of the peripheral countries. With the eurozone revving up its export engine due to gains in competitiveness, the current account deficit in many of the peripheral economies has improved. A big drag on growth in 2011 and 2012 has been related to austerity efforts and reining in government spending. The European Commission (EC) estimates that the structural budget deficit of the eurozone was reduced from 3.6% of GDP in 2011 to 2.1% of GDP in 2012, reflecting additional efforts to reduce government spending. According to the new targets set by the EC, austerity (i.e., fiscal effort) is likely to moderate to 0.7% of GDP in 2013. In 2014, the fiscal drag might essentially be zero. All of this implies less headwind to the overall economic picture. **How Has the Consumer Been Faring?** From the end of 2011 to the end of last year, euro area consumer spending contracted sharply, at an average annualized pace of 1.8%[1]. In fact, the peak-to-trough decline in consumer spending was almost twice as large as during the much deeper recession in 2008–09. But since the start of this year, consumers appear to have stabilized their spending again, and indicators such as retail sales, consumer confidence and auto registration paint a more optimistic picture. What has improved in the first half of this year? It appears that self-employment and property income (both factors account for 40% of the total source of income[2]) picked up in Q1 2013. Furthermore, if the economy improves in line with the recent Purchasing Managers' Index (PMI) surveys, it is possible that this source of disposable income could grow at a 2% pace for the remainder of this year. This compares to slight declines during the recession[3]. Finally, inflation is set to run at a slower pace, implying that consumers' real income will be higher. Last year, euro area inflation grew at a 1.8% pace on average, while this year, we expect an average of 1.3% and the move down looks to have been particularly pronounced in the first half of this year. **How Has the Manufacturing Sector Held Up?** Economic activity is often measured by the forward-looking survey called the Purchasing Managers' Index. The way in which the index is constructed suggests that a reading above 50 is indicative of expansionary activity, and a reading below 50 is contractionary. The final euro area composite PMI for July came in at 50.5, which was a robust 1.8 pt. increase from June's final reading, having built on consecutive increases in the past three months. The July euro area PMI stands 4.0 pts. above the March print. Solid increases were observed across all of the EMU4 in July, most notably Italy. The July reading is the highest euro area PMI level observed since July 2011. The trends in country manufacturing PMIs also show positive trends, with Germany, France and Italy showing good readings. Italy's manufacturing PMI has risen 6 points since March. These numbers confirm some of the positive news we are seeing in the latest GDP reading. **Conclusion** Europe has been one of the primary risks for the global economy—with sluggish growth and over-leveraged countries and banks being a prime concern for many investors. If Europe's economy can expand upon its recent growth and exit from recession, this could be very supportive for equity markets. We are starting to see more investment in European equities, and we'd encourage a look at small-cap companies, which are more sensitive to local conditions in Europe, as we have written before. [1]Source: Bloomberg, WisdomTree [2]Source: Eurostat, Q1 2013. [3]Source- JP Morgan Research, Euro Area Consumers- Signs of Stabilization, August 2013

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DEFINITIONS

Current account : The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

Austerity : Policies used by governments to reduce budget deficits during adverse economic conditions.

Structural budget deficit : General government deficit adjusted for cyclical factors and one-offs.

Purchasing Managers' Index (PMI) : An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction while 50 indicates no change.

EMU4 : Consists of Germany, France, Italy and Spain.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.