THE BANK OF ENGLAND: ROUNDING OUT THE CENTRAL BANK TRIFECTA

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Investing in European equities means different things to different people. For example, the WisdomTree Europe Hedged Equity Fund (HEDJ), our $8.9 billion[1] currency-hedged European equity exchange-traded fund (ETF), has a contingent of investors who are attracted by its "ex-U.K." status and its focus on the returns to eurozone stocks without the hassle of being long the euro.

U.K. equity exposure makes up 28% of the broader MSCI Europe Index, nearly double the weight accorded to second-place France (16%).[2] Similarly, the FTSE Developed Europe All Cap Index also has nearly one-quarter of its exposure in the U.K., more than 10 percentage points more than France, which is number two in that index too.[3]

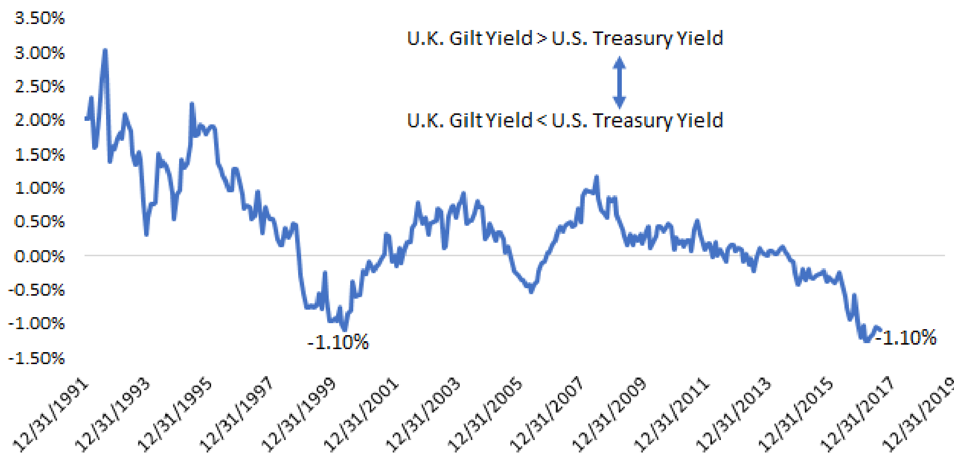
For investors who are not keen on having 24% to 28% of their European exposure in the U.K., HEDJ may be the answer. For those who want broader exposure to Europe—with the currency exposure—either because they see Brexit as having already been priced in or because sterling has grown cheaper through the years, WisdomTree has other European ETFs that allocate to Britain in size.

The WisdomTree Europe Quality Dividend Growth Fund (EUDG) and the WisdomTree Europe SmallCap Dividend Fund (DFE) both provide broad "European" exposure—but they also have 24.1% and 25.6% weights in the U.K., respectively.[4] Non-euro Europe (Sweden, Switzerland, etc.) is also widely held throughout both ETFs.

A Generational Gap: Treasury Notes vs. Gilts

At the moment, the yield differential between 10-Year U.S. Treasury notes and U.K. gilts of the same maturity is near its widest levels of the last quarter century. With the former yielding 2.26% and the latter offering just 1.16%, the gap of 110 basis points (bps) between the two is just off the 125 bps record set this spring, the largest in data back to 1992—and the only time when it got this extreme was at the turn of this century.

Figure 1: 10-Year U.K. Gilt Yields Minus 10-Year U.S. Treasury Note Yields



Source: WisdomTree, Bloomberg, as of 8/4/2017. Past performance is not indicative of future results.

Note the Extreme, Play the Reversal

Critically, it would seem that whenever the yield gap reaches an extreme, the investor may be well served to put on a me an reversion allocation. For example, gilt yields were a full 110 bps lower than U.S. Treasury yields in May 2000, and that proved a great time to sell dollars for pounds.

Back then, the market had just spent several years letting the British pound for the most part chop around a tight band from $1.55 to $1.70, a trading range that persisted for most of the late 1990s. The pound then sank to $1.50 when the yield gap reached its apex, following through to its generational low of $1.37 in the summer of the following year.

The pound then embarked on a remarkable run to $2.11 in November 2007. Because of the pound's appreciation in this century's early years, the FTSE 100 Index of British equities returned 8.1% in U.S dollars from May 2000 to November 2007, nearly 6 annual percentage points more than the S&P 500 Index (+2.3%).

The chart seems to indicate that we are at an extreme sovereign yield gap once again; only this time around, the pound's starting point is $1.30, even lower than it was 17 years ago.

Catching the Trifecta

When this year started, the lone central bank that was setting itself up for potential restrictive monetary policy was the U.S. Federal Reserve (Fed). The Bank of Canada (BOC) joined the mix on July 12, raising rates 25 bps. Now a big question looms as to whether the Bank of England (BoE) will make it a trifecta.

With the U.K. experiencing strong labor markets (albeit with frustratingly low wage growth), perhaps a whiff of thus-far elusive inflation could get the somewhat reluctant BoE to act. If it happens, it probably will not come until 2018. Nevertheless, should it come to pass, the market has the trifecta: the Fed, the BoC and the BoE.

If the BoE follows along with the North Americans in hiking rates, the generationally wide gap between longer-dated U.S. Treasuries and gilts may prove vulnerable as investors realize the BoE is loath to let the rate gap stretch wider. And if that gap gives way, the pound, trading down here at $1.30, could conceivably catch a strong bid.

Using EUDG and DFE for a Bullish U.K. Case

Unlike with cap-weighted mandates, EUDG and DFE cover broad Europe (the eurozone, U.K., Switzerland and the

Nordics) with a keen eye on actual fundamentals, a phenomenon that is lost on strategies that blindly follow market capit alization-weighting methodologies.

By pairing up EUDG and DFE, investors capture several smart beta factors, including companies that have exhibited strong profitability and earnings growth, in addition to a weighting methodology that focuses on actual volumes of cash paid out to shareholders. Also, combining EUDG and DFE allows investors to cover the total size spectrum, while many a ctive managers and ETFs huddle in megacaps. Please see more WisdomTree Research on European small caps and Euro pean quality strategies.

Perhaps most critically, if U.K. companies start displaying better profitability and earnings growth, or if they ratchet up their dividends, our Indexes will include those companies in greater size at our annual Index rebalancing, regardless of whatever their market capitalization happens to be. Combine that with a potential closing of the U.S.-U.K. interest rate gap from its 17-year extremes and the case for being long both U.K. equities and sterling shapes up to be particularly interesting.

1Source: WisdomTree, as of 8/3/2017.

[2]Source: BlackRock, as of 8/3/2017.

[3]Source: Bloomberg, as of 8/4/2017.

[4]Source: WisdomTree, as of 8/3/2017.

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You cannot invest directly in an index.

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).

MSCI Europe Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe.

FTSE Developed Europe All Cap Index : a market- capitalization index representing the performance of companies in developed European markets, including UK.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Gilt : Bonds issued by the UK government and generally considered to be low risk and the primary vehicle in which QE is carried out in the UK.

Basis point : 1/100th of 1 percent.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

FTSE 100 Index : A market capitalization-weighted index measuring the performance of the 100 largest companies listed on the London Stock Exchange.

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.

Sovereign Bond Yield : the interest rate paid on a government (sovereign) bond.

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.

Inflation : Characterized by rising price levels.

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.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Earnings growth estimates : Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Mega Cap : Market Capitalization over $100 Billion.

Dividend : A portion of corporate profits paid out to shareholders.

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