

THE BANK OF ENGLAND: ROUNDING OUT THE CENTRAL BANK TRIFECTA

Jeff Weniger — Head of Equity Strategy
08/11/2017

Investing in European equities means different things to different people. For example, the [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#), our \$8.9 billion¹ 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

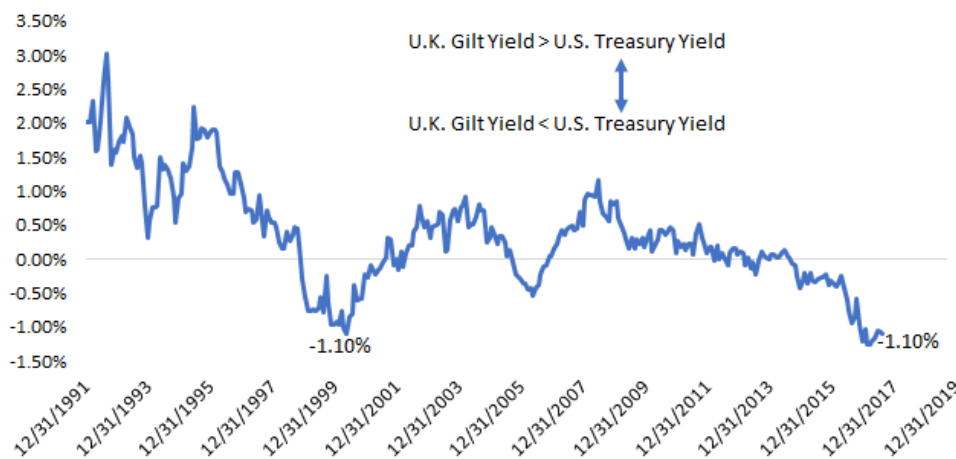
For investors who are not keen on having 24% to 28% of their European exposure in the U.K., HEDJ may be the answer. For those who want broader exposure to Europe—with the currency exposure—either because they see [Brexit](#) as having already been priced in or because sterling has grown cheaper through 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 [mean 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 capitalization-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 [active managers](#) and ETFs huddle in [megacaps](#). Please see more WisdomTree Research on [European small caps](#) and [European 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.

²Source: BlackRock, as of 8/3/2017.

³Source: Bloomberg, as of 8/4/2017.

⁴Source: WisdomTree, as of 8/3/2017.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

This Fund focuses its investments in Europe, thereby increasing the impact of events and developments associated with the region which can adversely affect performance. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit and the Fund does not attempt to outperform its Index or take defensive positions in declining markets.

Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

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 Union.

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.