MACRON OR DRAGHI? WHY WE STICK WITH THE ITALIAN STALLION

Jeff Weniger — Head of Equity Strategy
09/25/2017

It's been just a few months since Emmanuel Macron took the French presidency, yet already the punditry is hailing a new era of euro strength and economic vibrancy amid a story of long-awaited systemic reform. With the success that his party, En Marche, recently found in parliamentary elections, those cries have gotten louder (even if Macron's approval ratings have gone quieter).

Like most modern politicians, Macron has a large (€50 billion) infrastructure plan in his pocket, a tax cutting vision and designs on labor market reforms—along with a governing majority that can push through many of these changes. Stronger leadership in France should provide a counterweight to Germany, theoretically offering a bit of a pushback against Teutonic government austerity targets. A stronger, more laissez faire France is one of Europe's long overdue bright signs.

But all is not completely clear. Growth and inflation are very modest if not disappointing in most of Europe.

Eurozone gross domestic product (GDP) grew 0.6% in Q2 and was up 2.3% over the year. That's promising, and it comes with a newfound surge in U.S. GDP growth to a 3.0% annualized rate. Nevertheless, the feeling that the monetary union is plodding along through sludge persists. European inflation is trying to percolate, but look at some of the Consumer Price Index growth rates of late: Italy (+1.4%), France (+0.9%) and Germany (+1.8%) are indicating that inflation is unequivocally tame.[1]

Euro bulls may be left leaning on the lamppost if they anticipate a rapid tapering of the bond purchase program to €40 billion (or less) or an outright termination anytime soon. Ask European Central Bank (ECB) president Mario Draghi:

"The ECB will be in the market a long time."
- Mario Draghi, June 7, 2017

Short and simple. Easy money surprises by the ECB are the play here. It may be better to focus on Draghi than traditional politicians like Macron.

European Equities Looking Attractive

Unlike the case with the euro, a bullish thesis for European equities is on sounder footing, in our view, especially when the market is compared to the U.S. For example, the yawning gap between 3+% European dividend yields and shorter-end gilt-edged German government bonds is more than 4 percentage points, a stark contrast to the tiny margin in the U.S.[2]

No doubt about it, tax cuts and labor reform are a breath of fresh air, but let's not get ahead of ourselves by doubling down on both the equities and the currency, an endeavor reserved for only the most bullish of euro bulls.

Consider the danger that lurks in the currency. The market still expects the ECB to announce a tapering of its €60 billion monthly bond purchase program, perhaps at its October meeting.

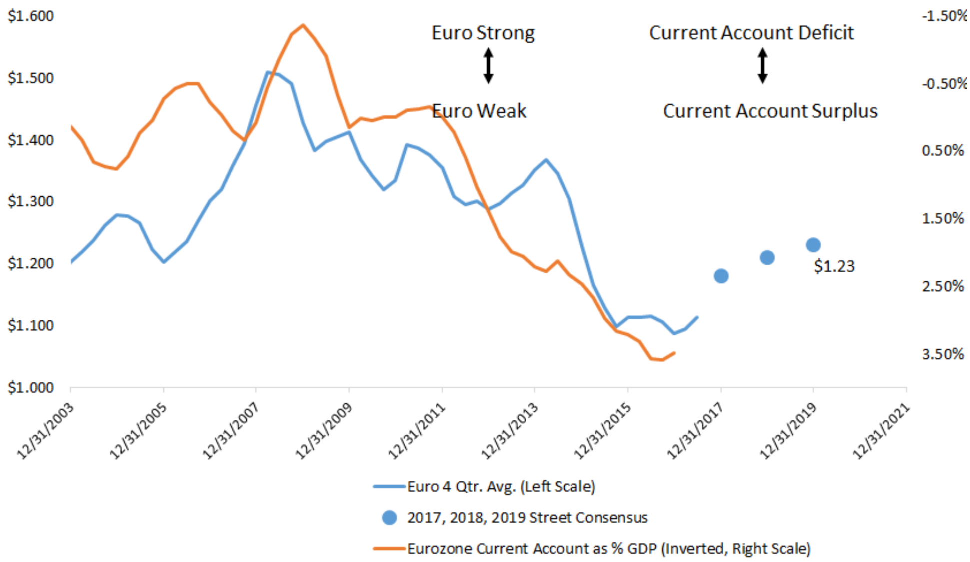
If the ECB instead decides to extend the program again and again and again, as it has been doing, euro longs could be vulnerable. Evidence is mounting that the easy-money program and an environment of very low interest rates will likely continue for years, throwing cold water on EUR bulls' wants and desires.

The Art of Not Making a Call

My colleagues Jeremy Schwartz and Christopher Gannatti argue that forex exposure is an uncompensated risk in equity investments. WisdomTree's house view is that, barring a bullish euro thesis, European equity exposures should be currency hedged as a matter of course. Our $8.9 billion[3] WisdomTree Europe Hedged Equity Fund (HEDJ) has a permanent hedge in place for just this purpose, the lowering of volatility in European stocks.

In Figure 1, we see that the Street anticipates a slight tick higher in EURUSD to $1.23 by the end of 2019 from the current $1.20 level, so not much of a change. EUR bulls point to Germany's 7.9% current account surplus in making their case. However, an objective look at the aggregate eurozone current account shows it is a coincident indicator that has not diverged from the exchange rate one way or another. The logical conclusion to draw from the figure is basically a neutral view on EUR, one that sees its fate from this point as a coin toss.

Figure 1



Sources: Bloomberg, WisdomTree, as of 9/1/17. Past performance is not indicative of future results.

No Strong Euro Opinion? When in Doubt, Hedge

Because unhedged foreign equities pose a double-barreled risk, we believe investors who are either EUR bearish or neutral should have on a forex hedge. Promisingly, hedging is not expensive in the developed world; the exercise has typically had annual execution costs of 2–3 basis point (bps) for HEDJ.[4] Currency hedging also comes with a 161 bps benefit because short-term European yields are lower than in the U.S., benefitting euro shorts.[5]

European Equities Without the Heartache

The WisdomTree Europe Hedged Equity Fund seeks to cut out the drama that may come when foreign stock returns get knocked by adverse currency movements. A Wall Street consensus for euro strength has sprouted up amid hopes of ECB tightening and economic reform in France. If those dreams get dashed, many investors may wish in retrospect that they had played it safe by leaving the euro out of the mix in the first place.

[1]Source: Eurostat via Bloomberg, as of 8/31/17.

[2]MSCI Europe dividend yield = 3.40%, German 2 Yr government bond yield = -0.70%. Difference = 4.10%. MSCI USA dividend yield = 1.97%, US 2 Yr government bond yield = 1.38%. Difference = 0.59%. Data from Bloomberg, as of 9/15/17.

[3]Source: Bloomberg, as of 9/20/17.

[4]Sources: WisdomTree Capital Markets, Record Currency Management.

[5]Sources: WisdomTree, Bloomberg, as of 6/30/17. Cost of hedging EUR with 1-month forwards (trailing 12 months).

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.

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, Kara Marciscano, 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

Inflation : Characterized by rising price levels.

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

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Bullish : a position that benefits when asset prices rise.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Basis point : 1/100th of 1 percent.

1-Month Currency Forward : A binding one month contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on the following one month.