

EUROPEAN EQUITIES REMAIN AN OPPORTUNITY AMID GEOPOLITICAL CONFLICT

Brian Manby — Associate, Investment Strategy
03/14/2022

Though the year began with struggling equity markets amid several headline risks, the geopolitical conflict between Russia and Ukraine has taken center stage. While investors have become understandably [risk-off](#), we think an opportunity remains in European equities for those looking to weather the conflict.

Although geopolitics can't be ignored, investors were growing increasingly [bullish](#) on European equities to begin the year, despite [hawkish](#) pivots from the European Central Bank (ECB) and [inflation](#) climbing to nearly 6% year-over-year in February.

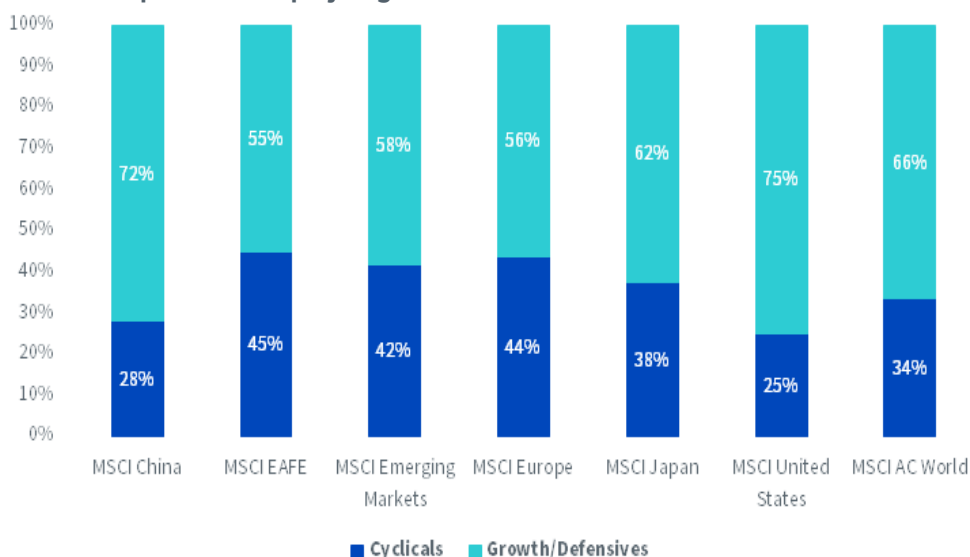
This may seem counterintuitive when markets are frantically assessing every new development in the Russia-Ukraine crisis while evaluating the possibility of a synchronized slowdown in global growth amid restrictive [monetary policy](#). But while the rest of the world endures these headwinds, several potential tailwinds remain intact for the European economy.

European Equities: Positioned for [Cyclical](#) Growth

Though the pace of global growth is expected to slow from the post-pandemic economic recovery, the World Bank anticipates that euro area real GDP may grow 4.2% year-over-year in 2022, according to its January forecast. That's slightly better than the 4.1% real growth expected for the entire world but notably higher than the 3.7% and 3.8% rates expected of the United States and advanced economies categories, respectively.

That may be related to the sector makeup of the European economy, which tilts heavily toward cyclical industries relative to other markets.

Sector Composition of Equity Regions



Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Compositions are subject to change.

The European equity market, as represented by the MSCI Europe Index, is about 45% concentrated in cyclical sectors,

comprised of Financials, Industrials, Materials and Energy, with the remainder in [GICS®](#) sectors classified as growth or defensive. This contrasts notably with the rest of the world, where the U.S. and other equity regions are more concentrated in non-cyclical industries.

Europe's composition may therefore be beneficial for two reasons:

1. First, growth is still expected, albeit at a slower pace. A modest growth projection may indicate that certain pro-cyclical industries may account for more growth than their non-cyclical counterparts. It's important to discern what sectors may grow rather than simply where economic growth is expected.

Consider the 16% concentration of Financials in the European economy and the nature of their business. Banks traditionally benefit from economic growth and rising interest rates because they can earn a greater spread on the interest they pay versus the interest they receive from assets.

This is where a hawkish ECB may aid the banking sector. Though mindful of the escalating conflict and its impact on European economic data, ECB President Christine Lagarde has been vocal this year about the need to temper inflation by raising interest rates without stifling the ongoing economic recovery.

She maintained the bank's position in its March meeting, committing to taper the pandemic emergency purchase program (PEPP) and asset purchase program (APP). Bond yields have responded accordingly, climbing this year in anticipation of future rate hikes. The German 10-Year Bund yield has risen nearly 50 [basis points](#) into positive territory to begin the year in response to the bank's hawkish stance. A regime change in the rates market may prove to be a strong tailwind for European Financials.

2. Second, the cyclical economy may be structurally insulated from inflation, which has been rising steadily above the ECB's 2% target since summertime last year.

Euro Area Year-Over-Year Inflation Rate



Sources: WisdomTree, Trading Economics, as of 2/28/22

The larger size of Europe's companies and Europe's prevalent position in value-oriented, pro-cyclical sectors may position it to accept rising input costs, wages and interest rates and pass them on to consumers. This could potentially protect operating margins, as rising revenues may mitigate cost increases near the top line.

Russia-Ukraine Cannot Be Overlooked

We remain bullish that European equities present a potential opportunity but acknowledge the fluidity of the Russia-Ukraine crisis as a key risk to our outlook.

We think most risks to Europe's economy and equity market are confined to the Energy sector due to the region's reliance on Russian oil and natural gas resources.

Despite sanctions from several global powers, Russia has yet to weaponize its resources by choking off these much-needed supplies to Europe, which may not materially impact the economy.

However, Russia certainly could use its supplies as geopolitical leverage, and Deputy Prime Minister Alexander Novak has threatened to halt flows to Europe in response to other countries' decisions to embargo Russian oil. Should resources be curtailed, that may exacerbate inflation even further and pose the risk of a recession if these rising costs cannot be efficiently absorbed.

That may challenge the ECB, which may be confronted with the decision to either raise rates to temper inflation or remain accommodative to combat the threat of a slowdown. The impact of either decision will be highly uncertain. Thus far, the ECB has maintained its hawkish stance in support of tapering the pandemic emergency purchase and asset

purchase programs, signaling that purchases may potentially end by Q3.

As of now, energy price increases may be tolerable, potentially keeping monetary policy plans on schedule. But prolonged turmoil in energy markets is forcing Europe to prepare a backup plan. As of this writing, the European Union is contemplating the joint issuance of bonds intended to blunt the impact of energy market volatility. Details, however, are vague, and the intended effects of the debt issuance may take time to materialize.

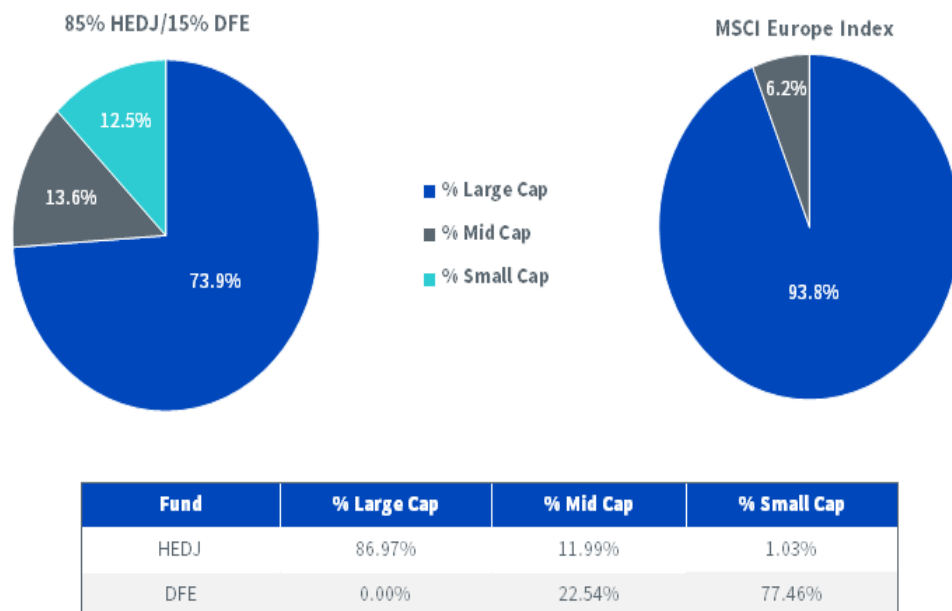
A secondary, though potentially less severe, risk is the Financials sector. The most recently available data from the Bank for International Settlements shows that European banks are exposed to about \$75 billion in Russian claims, which is relatively low. The banking sector is likely healthier and better capitalized post-global financial crisis as well, potentially improving its ability to withstand imported economic weakness from Russia.

It will be important to monitor the impacts to sectors dependent on, or exposed to, Russia's economy and its natural resources to assess the broader implications for Europe.

A European Equity Solution

Despite these near-term risks, we think dedicated exposure to Europe's cyclical economy may still be a beneficial equity allocation. One combination that may prove opportune is a blend of the [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#) and the [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#). The former can provide core exposure, while the other complements it with economically sensitive small-cap stocks.

Consider a portfolio consisting of 85% [HEDJ](#) and 15% [DFE](#). The 15% [DFE](#) position delivers an over-weight to European small caps, which are absent from the MSCI Europe Index.



Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Weightings are subject to change.

For definitions of terms in the chart above, please visit our [glossary](#).

Sector exposures may combat risks as well. The blend provides about a net 4.5% over-weight in cyclical sectors, which could exhibit mixed performance depending on conflict outcomes due to under-weights in Financials and Energy.

Cyclical Sector Comparison

	Industrials	Financials	Materials	Energy
85% HEDJ/15% DFE	19.17%	10.36%	17.64%	1.19%
HEDJ	18.05%	8.93%	19.24%	0.78%
DFE	25.48%	18.47%	8.62%	3.50%
MSCI Europe Index	14.62%	16.20%	7.71%	5.43%
85%/15% Overweight / Underweight	4.55%	-5.84%	9.93%	-4.24%

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index. Weightings are subject to change.

However, these under-weights may be rewarded via over-weights in Industrials and Materials. They are both among the most diversified sectors by geographic revenue of the MSCI Europe Index, meaning they generate large portions of their revenue from outside Europe. This may help the blend diversify its core Europe exposure by adding a global tilt while remaining anchored by sectors more levered to the European economy, such as Utilities.

Geographic Revenue Exposure

Fund/Sector/Index	Europe
MSCI Europe - Real Estate	96.27%
MSCI Europe - Utilities	73.44%
DFE	72.53%
MSCI Europe - Communication Services	60.33%
MSCI Europe - Financials	59.46%
MSCI Europe - Energy	44.31%
MSCI Europe	39.10%
MSCI Europe - Consumer Discretionary	37.30%
MSCI Europe - Industrials	34.89%
MSCI Europe - Consumer Staples	28.19%
MSCI Europe - Materials	28.10%
HEDJ	26.12%
MSCI Europe - Health Care	24.56%
MSCI Europe - Information Technology	21.06%

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index.

The fundamentals of this pairing are also compelling, offering the blend at lower valuations than the broader European market with a comparable dividend yield and higher-quality measurements.

Funds/Index	Price-to-Earnings (P/E)	Forward P/E	Dividend Yield	Return on Equity	Return on Assets	Leverage
85% HEDJ/15% DFE	14.5x	13.2x	2.58%	12.89%	2.32%	5.7x
HEDJ	15.1x	13.6x	2.19%	13.22%	2.17%	6.1x
DFE	11.1x	11.1x	4.78%	11.05%	3.15%	3.5x
MSCI Europe Index	15.5x	14.0x	2.53%	13.70%	1.85%	7.4x

Sources: WisdomTree, FactSet, as of 2/28/22. You cannot invest directly in an index.

For the most recent standardized performance, 30-day SEC yield and month-end performance of the Funds, please click their respective tickers: [DFE](#), [HEDJ](#). For definitions of terms in the chart above, please visit our [glossary](#).

Overall, we believe this combination can be an opportunistic way to invest in Europe amid a potentially moderate growth economy, higher inflation and an ongoing cyclical recovery while being conscious of evolving risks.

Important Risks Related to this Article

This material must be preceded or accompanied by a prospectus. Please read the prospectus carefully before investing. Visit: <https://www.wisdomtree.com/resource-library/prospectus-regulatory-reports>.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as the risk of loss from currency fluctuation or political or economic uncertainty. 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. 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 HEDJ 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 HEDJ, it may make higher capital gain distributions than other ETFs. Dividends are not guaranteed, and a company currently

paying dividends may cease paying dividends at any time. Please read each 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.

Related Funds

+ [WisdomTree Europe SmallCap Dividend Fund](#)

+ [WisdomTree Europe Hedged Equity Fund](#)

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

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Bullish : a position that benefits when asset prices rise.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Inflation : Characterized by rising price levels.

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.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

GICS : Global Investment Classification System, which assigns companies to specific industries and sectors.

Basis point : 1/100th of 1 percent.