EUROPEAN CENTRAL BANK CUTS INTEREST RATES AS RECESSION DRAGS ON

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The European Central Bank (ECB) recently cut its key interest rate by 0.25% to a record low of 0.50%. I view the rate cut as a positive step but think more could be done by the ECB to help stimulate the economy. The European economy has contracted for five consecutive quarters, bank lending remains tight, and the overall unemployment rate continues to trend higher. Below are a few comments Mario Draghi, president of the ECB, recently made while addressing some of the concerns the region faces in a press conference following the rate cut. **ECB Remains Frustrated With Results** ***Draghi:*** **"We are – I would not use the word – well, yeah, I would use the word "frustrated," yes, certainly."** Draghi is obviously frustrated that the actions the ECB has taken thus far have not directly lowered the unemployment rate and driven stronger economic growth. The monetary policy actions have helped the broad European financial markets post positive year-to-date performance, and the majority of companies in the eurozone remain profitable. Unfortunately, this hasn't translated into any sizable economic recovery or broad business hiring. The ECB's actions are very limited and remain muted when compared to actions taken by the Federal Reserve since the crisis, or even the recent actions by the Bank of Japan, which I discussed here. **ECB Has Policy Limits** ***Draghi:*** **"The ECB certainly cannot supplant governments for their lack of structural reforms. Second thing is, the ECB cannot clean banks' balance sheets. And the third thing is that the ECB is not in the business of monetary financing, so buying government bonds."** Unfortunately, the ECB has to deal with many different countries, each with a different economy and a different set of fiscal policies. This can create potential problems and disagreements between the member countries, and the monetary policy doesn't always align with each country's own goals (i.e., the Germans are not interested in buying another government's bonds). Unlike the Federal Reserve and the Bank of Japan, the ECB is not interested in making open-ended purchases of government bonds to drive down borrowing costs. **Draghi Pledged to Do "Whatever It Takes"** ***Draghi:*** **"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."** Back in July 2012, Draghi's comments to do "whatever it takes" to preserve the euro relieved a lot of the market stress and anxiety about what a breakup of the euro would entail. Those words were undoubtedly a positive that eased pressure on the immediate European crisis and escalating borrowing costs for the peripheral countries. Yet this most recent rate cut was the first in over 10 months, and the current rate still is above the policy rates of the Bank of Japan and the U.S. Federal Reserve—and the European economies are still struggling. Some have argued that the ECB should make the deposit facility rate negative (i.e., charge banks interest to keep money at the ECB instead of paying them interest). This might encourage banks to lend more money instead of keeping large amounts of excess reserves parked at the ECB. Draghi expressed willingness to look at this option with an open mind if the ECB could get comfortable with the ramifications and unintended consequences of this approach. **Currency Still a Concern** The euro has strengthened against the majority of developed currencies—notably the yen and the British pound—year-to-date, which does not help European competitiveness. The peripheral countries need structural labor reform to be more competitive, and a strengthening currency further hurts their competitiveness. A weakening euro could potentially give the European economies an immediate economic benefit, because it would make their goods more attractively priced. Because Germany is a relatively big exporter, a weaker euro that improves exports would create more inflation pressure for Germany than for the peripheral countries (which have higher unemployment and would face less wage pressure). **Hedge Your Currency Risk** As the European economy remains stagnant, I believe the U.S. and other economies will ultimately improve compared to Europe. A weakening euro might be good for European companies who operate on a global basis, but it is not good for U.S. investors in European equities, unless they hedge that currency risk. If the euro were to weaken against the dollar, U.S. investors would realize a negative currency return, which detracts from their total return—unless they hedge the currency. Currency-hedged strategies allow investors to focus on the equities without the worry over currency declines. **Focus on European Exporters** Another way to diversify the Europe-specific risks is to focus on European exporters. Exporters domiciled in Europe compete in many global markets, and many of these companies are not as severely impacted by Europe's woes and are able to remain profitable as the world economy continues to recover. In a previous blog I looked at the long-term earnings growth estimates of European companies, and their growth opportunities were potentially just as promising as those for the companies in the S&P 500 Index, if not a little better. **WisdomTree Europe Hedged Equity Index** Often the greatest potential opportunities are found when conditions are least certain. I believe exposure to European equities is important for diversification benefits and that there could be potential value among European exporters based on long-term growth prospects. The WisdomTree Europe Hedged Equity Index is designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the euro and the U.S. dollar. The Index is based on dividend-paying companies that are domiciled in Europe and derive at least 50% of their revenue in the latest fiscal year from countries outside Europe. The revenue screen allows the Index to focus on exporters, which could potentially perform better in a weak economic environment or during a period of currency weakness. *Take the euro out of Europe* (Video)

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