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# HOW TO THINK ABOUT EUROPEAN EQUITIES AMID CURRENCY VOLATILITY

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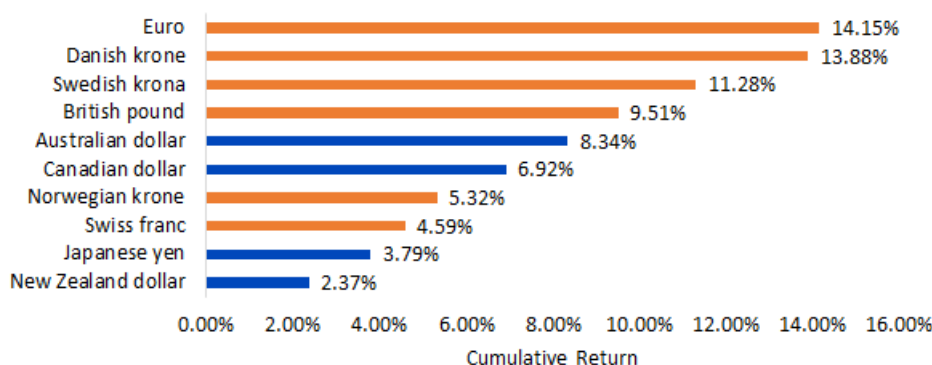
**04/06/2018**

One of the most interesting (and surprising) results of 2017 was the magnitude of the strength of the euro against the U.S. dollar. The greater than 14% appreciation that was observed represented the best performance of any of the [G10](#) currencies against the U.S. dollar during that period.<sup>1</sup>

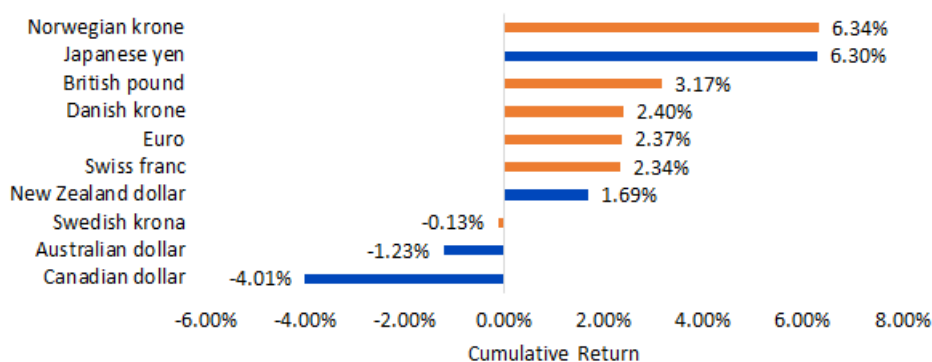
So, as we enter the end of the first quarter of 2018, have any new trends come to light, or has the U.S. dollar largely continued to weaken? The answer thus far looks like the trend of dollar weakness remains intact, but that the yen and the Norwegian krone have taken over as the strongest currencies, with the euro in the middle of the pack.

**Trends of the G10: Dollar Weakness but Shifting Leadership Has Been the Rule from 2017 to 2018**

G10 Currency Performance against the Dollar in 2017 (European Currencies in Orange)



G10 Currency Performance against the Dollar YTD 2018 (European Currencies in Orange)



Sources: WisdomTree, Bloomberg, with data for 2017 from 12/31/16 to 12/31/17 and data for YTD 2018 from 12/31/17 to 3/16/18. Past performance is not indicative of future results.

### Translating Currency Moves into Equity Performance

No one can say exactly what will happen with the U.S. dollar (or any other currency) ahead of time. We can, however, utilize WisdomTree's extensive European equity toolkit to see if any stories emerge about underlying drivers of European equities. These drivers could offer insight into where opportunities may be for 2018 and beyond.

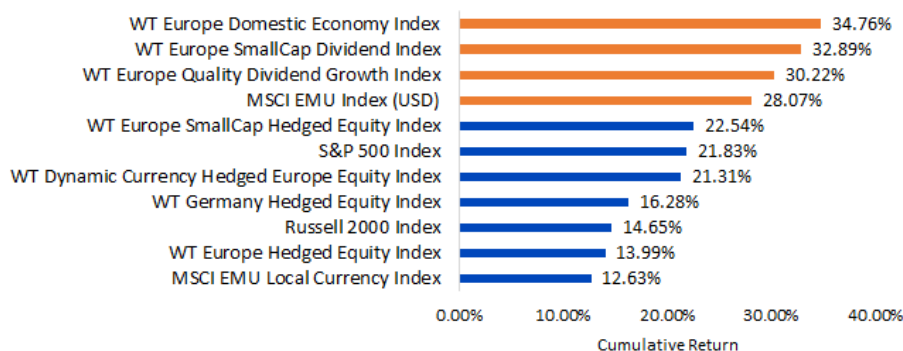
- **2017 Was the Year of Unhedged Strategies:** This is difficult to forecast, but strong performance in 2017 came from exposure to European currencies appreciating against the U.S. dollar.
- **2017 Was the Year of Domestic Strategies:** WisdomTree's two strategies most focused on European equities with domestic revenue streams—the [WisdomTree Europe Domestic Economy](#) and the [WisdomTree Europe SmallCap Dividend Indexes](#)—also did very well in 2017. This makes sense for two reasons. First, they did not face the headwinds that came from having significant exports as European currencies appreciated. Second, 2017 was also characterized by robust improvements in sentiment and economic growth expectations WITHIN Europe, and these strategies were heavily exposed to the cyclical sectors that benefited the most.

However, before thinking about 2018, we should note just how powerful a year 2017 was for European equities overall. Every single European equity Index shown in this chart delivered a positive, double-digit return for the period.

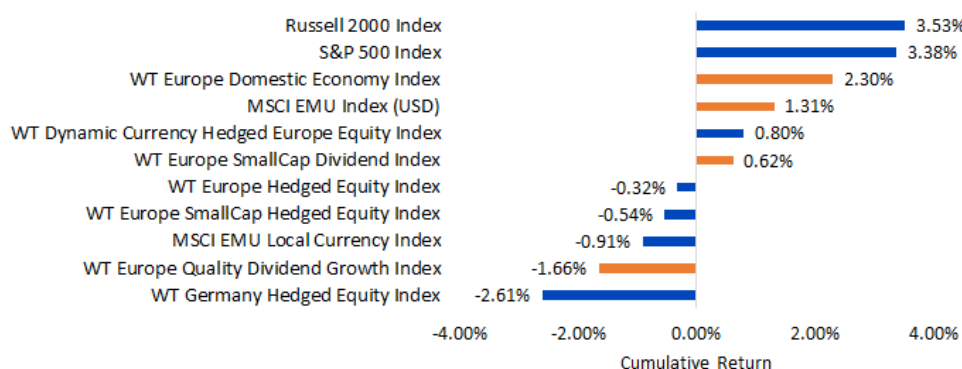
- 2018 Has Shown Significant Differentiation:** As the euro continues to strengthen (though not as much as in 2017), the [WisdomTree Germany Hedged Equity Index](#) has faced a headwind to its focus on exporters. On the other hand, the WisdomTree Europe Domestic Economy Index has remained strong, and the [WisdomTree Dynamic Currency Hedged Europe Equity Index](#) has also delivered a positive return. If currencies are “searching for direction” and reacting more to politics or shifting statements than [fundamentals](#), we think a dynamic approach to currency hedging becomes more interesting, as it can adjust as market conditions change.

## WisdomTree’s European Equity Index Toolkit in 2017 and YTD 2018

WisdomTree’s European Equity Toolkit in 2017 (Strategies with Currency Exposure Highlighted in Orange)



WisdomTree's European Equity Toolkit in 2018 (Strategies with Currency Exposure Highlighted in Orange)



Sources: WisdomTree, Bloomberg, with data for 2017 from 12/31/16 to 12/31/17 and data for 2018 from 12/31/17 to 3/16/18. Past performance is not indicative of future results. You cannot invest directly in an index.

## Fundamentals: The Gravitational Pull in the Investment Universe

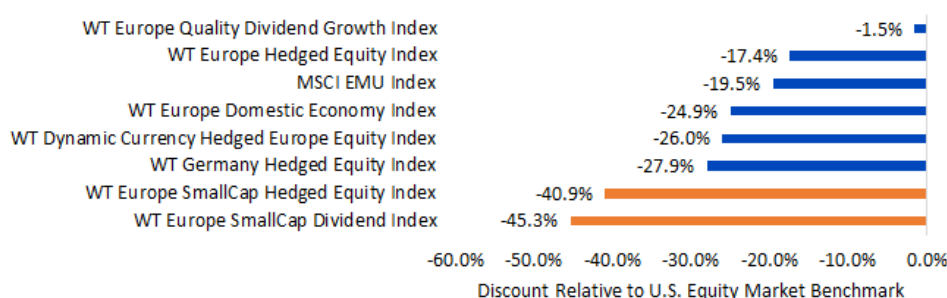
While fundamentals may not be able to accurately help investors become better at predicting short- or medium-term movements in asset markets, historically they have tended to exert their power over the longer term. Therefore, things such as [relative valuation](#), which may not accurately predict what may or may not outperform in a single year, cannot be ignored. We would therefore draw investors toward two important pictures as they consider European equities in 2018:<sup>2</sup>

- European equities, with the exception of the [WisdomTree Europe Quality Dividend Growth Index](#), are trading at significant discounts to U.S. equities. Both the WisdomTree Germany Hedged Equity and the WisdomTree Dynamic Currency Hedged Europe Equity Indexes are trading at forward P/E ratio discounts of more than 25% against the [S&P 500 Index](#). On the small-cap side, both of the WisdomTree small-cap strategies shown are trading at forward P/E ratio discounts of more than 40% compared to the [Russell 2000 Index](#).

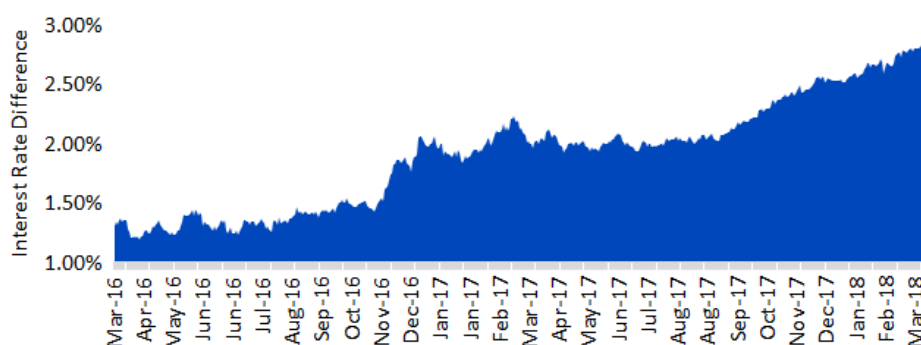
2. The euro appreciated more than any other G10 currency in 2017, and it continues to appreciate in 2018. One of the most important currency fundamentals, [carry](#), has indicated a movement in favor of the dollar, particularly when comparing the 2-Year government bond yields of the U.S. and Germany. This spread hasn't just increased in favor of the U.S. dollar—it has more than doubled. Political statements and anticipation of changes in policy in the U.S. may be overwhelming the force of carry in the near term, but would you want to continue to bet against this fundamental after all the euro appreciation that we've already seen? One has to think it is getting harder and harder to position portfolios for continued euro appreciation layered on top of European equity exposures.

## European Markets: Fundamentals Supportive of Lower Valuations against the U.S. with "Carry" More and More in Favor of the U.S. Dollar against the Euro

Forward P/E Comparisons between WisdomTree European Toolkit & U.S.  
Equity Market Benchmarks (Blue = S&P 500 Index, Orange=Russell 2000 Index)



U.S. 2YR Yield minus German 2YR Yield (Mar. 16, 2016 to Mar. 16, 2018)



Sources: WisdomTree, Bloomberg, with data as of 3/16/18. Past performance is not indicative of future results. You cannot invest directly in an index.

<sup>1</sup>Sources: WisdomTree, Bloomberg, with data from 12/31/16 to 12/31/17.

<sup>2</sup>All equity market discounts in the bullet points are looking at a comparison of the forward price-to-earnings (P/E) ratio of the respective European large-cap strategy to the S&P 500 Index and the respective European small-cap strategy to the Russell 2000 Index. Source is Bloomberg and data is as of 3/16/18.

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

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

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

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You cannot invest directly in an index.

## **DEFINITIONS**

**G10/Group of Ten** : A group of industrialized nations that meet on an annual basis to plan, debate, and cooperate on international financial matters. Member countries include: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and United States.

**Unhedged** : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

**Fundamentals** : Attributes related to a company's actual operations and production as opposed to changes in share price.

**Relative value** : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

**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.

**Russell 2000 Index** : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Carry** : The amount of return that accrues from investing in fixed income or currency forward contracts.