UNLOCKING VALUE IN CREDIT: DEVELOPED MARKET VS. EMERGING MARKET FINANCIALS

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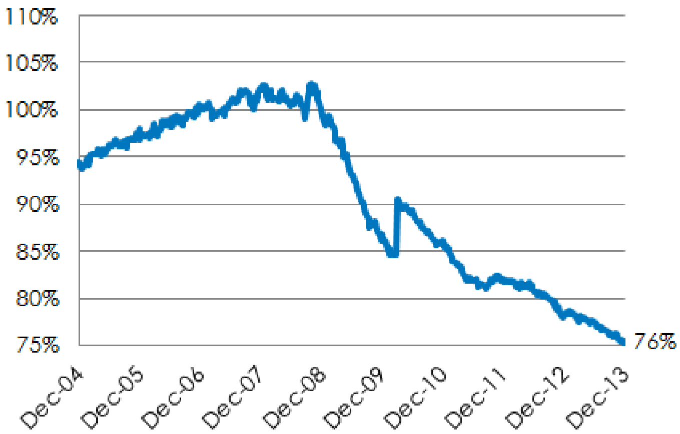
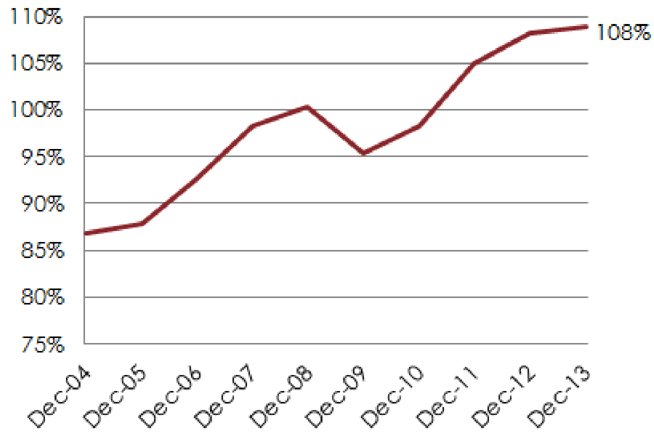
08/05/2014

Simple logic can sometimes steer investors toward invaluable themes. As a fixed income investor, it may be attractive to invest in the debt of issuers that are in the process of deleveraging, particularly after a period of excesses leading up to the global financial crisis. Conversely, investors may demand higher compensation from issuers that have continued to expand their balance sheets. We find this to be particularly true when seeking opportunities for investment in the debt of financials around the world. This notion of deleveraging versus continued balance sheet expansion is particularly evident when comparing U.S. banks to those in the emerging markets (EM). U.S. banks are posting sluggish loan growth, setting aside greater capital reserves and reining in their balance sheets to comply with new regulations post-financial crisis. In a recent roundtable discussion we had with Western Asset Management, one portfolio manager asked rhetorically, "How do banks get into trouble? Bad loans and bad acquisitions."[1] Complying with post-crisis regulation helps mitigate both potential pitfalls. As shown in the chart below, developed market (DM) deleveraging contrasts with the continued expansion we are seeing in many EM bank balance sheets. EM banks continue to post robust loan growth (in excess of the growth of deposits) in order to meet the demands of a burgeoning consumer class. However, this could be an ever-increasing risk to bondholders. Loan growth yields higher profitability only if loan quality remains high. Without a purge of bad loans like we saw across the U.S. post-crisis, emerging market banks may be attempting to grow their way out of past excesses. Loan to Deposit Ratios: 12/31/04 – 12/31/13 **U.S Banks: Loans as a % of Total Deposits**



EM Banks: Loans as a % of Total Deposits



Sources: Federal Reserve, Morgan Stanley, December 2013.

In large and growing economies, it is common for financial issuers to trade at lower yields than industrial bonds of comparable quality. The painful losses experienced by investors in U.S. and European financial debt during the crisis and the painstaking rebuilding process turned that dynamic on its head. Today, U.S. banks now trade at higher levels of compensation compared to the other domestic corporate bonds of similar quality, and EM banks trade at lower yields than EM corporate bonds in aggregate.[2] In the three years prior to the summer of 2007, bank bonds maturing in five to 10 years traded at an 11-basis-point (bp)discount to comparable maturity industrials. Since July 2007, these securities averaged a yield premium of 57 bp compared to the broader universe. Today, financials trade at a 15-bp premium.[3] In today's low-yield environment, we view current valuations as a potential opportunity. DM banks are trading at wider spreads while continuing to delever. Additionally, EM banks remain much less battle-tested than many of the hard asset companies, which have navigated the turmoil of growing emerging market economies for many years. Yet they continue to trade at tighter spreads than many large multinationals in the same country of domicile. While we believe this dynamic to be compelling, being able to express this view is generally difficult for most investors, except institutional money managers. However, both of these themes drive the construction of two of WisdomTree's corporate bond strategies. In the WisdomTree Strategic Corporate Bond Fund (CRDT), the portfolio maintains an over-weight to DM financials relative to other sectors. In EM, the WisdomTree Emerging Markets Corporate Bond Fund (EMCB) has a 0% weight to emerging market financials in favor of opportunities in basic industrials.[4]

[1]Ryan Brist, Western Asset Management, June 2014. [2]Source: J.P. Morgan, as of 6/30/14. [3]Source: Bank of America Merrill Lynch, as of 6/30/14. [4]Source: WisdomTree, as of 6/30/14. Holdings subject to change.

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DEFINITIONS

Deleverage : Bring down levels of debt.

Capital reserves : a pool of assets or collateral set aside to cover unexpected future liabilities.

Basis point : 1/100th of 1 percent.

Yield premium : the additional amount of income investors require for holding a security.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.