EUROPEAN CENTRAL BANK DISCUSSES VULNERABILITIES IN REGION

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In a previous blog I wrote about European banking institutions' high leverage ratios that leave them vulnerable to higher capital thresholds and, potentially, equity dilution as their leverage ratios come down over time. The European Central Bank (ECB) recently published its semi-annual Financial Stability Review, which also highlights some areas of concern. Below are a few key quotes from the report that address some of the concerns the region faces.

Outlook for Growth Subdued

> *The prospects for the euro area remain well below those for international peers—including major advanced and emerging market economies. Restoring competitiveness is vital for a number of countries within the euro area, with policies needed to ensure sufficient responsiveness in wages and prices, as well as to boost productivity.*

I have argued before that I feel the euro remains relatively high compared to the U.S. dollar and that it would be helpful for peripheral countries' competitiveness, were it to weaken. It is clear that many of the peripheral countries need structural labor reform to increase productivity, but this can take time to accomplish. A weaker currency could potentially give more immediate relief by making exported goods more attractive on the global market.

Concerns Remain over Bank Profitability

> *Further declines in bank profitability, linked to credit losses and a weak macroeconomic environment.*

This concern is highlighted as the number one key risk to euro area financial stability in the ECB's report. The European economy has contracted for five consecutive quarters, bank lending remains tight, and the unemployment rate continues to trend higher. Recently lowered interest rates might help bank lending, but the lower rates may also compress net interest margins. While many of these risks are known and—one could argue—already factored into prices, we may see more downside in bank profitability as a result of the above conditions.

Financial Asset Quality Remains Unclear

> *Concerns—justified or not—related to the lack of information available to evaluate banks' asset quality weigh on the entire euro area banking sector.*

It is almost impossible to know exactly what type of asset quality some financial companies are holding until it is too late. The recent banking crises in Slovenia and Cyprus both occurred quite rapidly, and there was little to be done once the bailout alarm had been sounded. Both countries had a few banks with large exposures to bad loans that continued to operate until their funding dried up as a result. At that point there is no room for preemptive measures, but only reactionary ones to help stop the contagion risks. Many investors still do not feel comfortable with the assets on the broader European bank balance sheets.

Increase in Non-Performing Loans May Lower Capital Ratios

> *Particularly vulnerable are banks that are confronted with a significant deterioration of asset quality with high and rising non-performing loan (NPL) levels, and have low NPL coverage ratios and a weak profit and/or solvency base.*

I previously highlighted these concerns in a blog where I compared the leverage ratios between European and U.S. financials. Many European banks still exhibit high degrees of leverage, and this leverage will need to come down over time. A potential increase in non-performing loans does not help reduce leverage but instead can lead to lower capital ratios. Some European financials are likely to face serious headwinds, as they might be forced to increase their equity capital and potentially dilute their existing shareholders.

Mitigating the Financials Risk

The greatest potential opportunities are often found when conditions are least certain. Not all banks are the same, and it

is possible that certain European banks might add value to a portfolio if one can mitigate the risks.

WisdomTree has devised two Indexes to measure the performance of equities, which we believe ultimately mitigates the risk of a Financials sector exposure in Europe:

- **WisdomTree International Dividend ex-Financials Index:** This Index focuses on dividend-paying companies within developed international equity markets, specifically excluding the Financials sector.
- **WisdomTree Europe Hedged Equity Index:** This Index focuses on the exporters of Europe, which tends to mean greater weights in Consumer Staples, Consumer Discretionary and Industrials companies and less on Financials (which are a large under-weight compared to standard European benchmarks[1]). We believe hedging the euro also provides a lower-volatility approach to this region, as we wrote here.

[1]As of 3/31/2013, the MSCI EMU Index had an approximately 20% weight in Financials, whereas the WisdomTree Europe Hedged Equity Index had an approximate weight of 7% in Financials as of the same date.

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DEFINITIONS

Net interest margin : A measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their (interest-earning) assets.

Contagion : Scenario where one negative event feeds into a strengthening cascade of additional negative events. A singular bank failure could be an example in that once one bank fails, customers at other banks will tend to try and withdraw their funds all at once and adding stress to the overall banking system. .

Non-performing loan : A loan that is in default or close to being in default. Many loans become non-performing after being in default for 90 days, but this can depend on the contract terms.

WisdomTree International Dividend ex-Financials Index : Measures the performance of high dividend-yielding stocks outside the financial sector. Selects the 10 largest dividend-paying stocks within each sector outside of financials, then the resulting list is weighted by dividend yield.

WisdomTree Europe Hedged Equity Index : Index designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the Euro and the U.S. dollar. Constituents are European dividend-paying firms with a least 50% of their revenues from outside of Europe. Weighting is by cash dividends paid.