Contrarian alert: European exporters as trade war rhetoric ramps up

Published 7 August 2018

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Attempting to read the political tea leaves is becoming a greater and greater part of investment discussions in 2018. A popular line of questioning regards the so-called “trade war”, which at this point reflects a large amount of rhetoric that investors outside of the US are attempting to properly digest.

Is it more a negotiating tactic? Are we progressing toward a world in which “free trade” is an idea of the past? Predicting the future has been getting more and more difficult.

Core principle: currency movements impact equity earnings

At times like this where we have a political element in play that can be quite difficult to analyse, we find it useful to return to core principles that we know to be true. One of these is that, in markets around the world, large cap multinationals see a boost to their earnings when their currency weakens on the global stage.

A great example of this was in 2017 in the US, where the S&P 500 returned more than 20% for the year. Earnings were quite strong, and one of the key reasons for this was widespread dollar weakness.

Markets shift to “dollar strength” consensus view

As we write these words, the page is turning toward the second half of 2018. With each passing day in June of 2018, it felt like the consensus for a stronger US Dollar was growing. During the second quarter of 2018, the dollar did in fact strengthen against all currencies within the G10 complex.

Figure 1: US Dollar vs. G10 currencies in the second quarter of 2018 indicated significant strength

Source: Bloomberg. Period is from 31 March 2018 to 30 June 2018.

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The Euro entered a significant trend of weakness vs. the US Dollar

Here, we turn our focus to the Euro. Going back over the past ten years, the Euro has been in an overall depreciating trend. Of course, trends can be measured in several ways, and at WisdomTree we tend to use the measure of the 10-day versus 240-day moving averages.

- If the 10-day moving average is above the 240-day moving average, we indicate an appreciating trend for the Euro
- If the 10-day moving average is below the 240-day moving average, we indicate a depreciating trend for the Euro

Currencies have and do exhibit trending behaviour, and it is helpful to place things into their current context and then consider what types of catalysts may occur that could cause trends to shift in the future.

Figure 2: The Euro recently entered a weakening trend against the US Dollar

Source: Bloomberg. Period is from 31 December 2007 to 30 June 2018.

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Gauging the equity response in the Eurozone

Now, it is possible every day to see a new series of tweets from the US presidential administration. Within these tweets, there may be allusions or indications to potential future policies—tariffs certainly among them. We must recognize that the US is the world's largest economy and it also represents the largest consumer market by value, even if China and India exceed it by numbers of people. Severe US tariffs on European exports to the US—although not implemented yet—would pose a problem for European multinationals.

As we were looking at the data, we'd expect that the WisdomTree Europe Hedged Equity Index, which requires each constituent to derive more than 50% of revenue from outside of Europe, would have faced a rather challenging environment.

Surprisingly, this was not necessarily the case.

Figures 3 and 4: first half 2018 (top) and second quarter 2018 (bottom) performance of Eurozone equities

Source: Bloomberg. Top figure is from 31 December 2017 to 30 June 2018. Bottom figure is from 31 March 2018 to 30 June 2018.

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2018 has started out with a much different tone than we saw in 2017, which was really a strong year for typically risky assets. Benchmarks, as measured by the MSCI EMU and Euro STOXX 50 Indexes were slightly down. The WisdomTree Europe Hedged Equity Index was up 1.51% as the Euro depreciated against the US dollar to the tune of 2.67%.

- The second quarter saw a markedly positive move for Eurozone equities as the Euro depreciated 5.19% against the US Dollar. In this period, the WisdomTree Europe Hedged Equity Index also outperformed the market capitalization-weighted benchmarks shown here.

Conclusion: we know about the weaker Euro, but not the tariffs

While it is certainly true that the tariff situation represents a risk that may deteriorate before it improves, we do not, as of this writing, know all the details as to what it might (or might not) entail. We do, however, know that the Euro has entered a trend of weakness, in direct contrast to 2017's period of strength. This has historically favoured large cap multinationals, and that is exactly what we've seen within Eurozone equity markets of late.

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