

# Euro depreciation: the key to unlocking value in European exporters

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One of the biggest surprises of 2017 was the fact that the euro appreciated 14% against the US dollar—approximately 7% behind the performance of the S&P 500 Index over the same period<sup>1</sup>. As a result, European equities now look quite attractive on an earnings yield basis.

## **Figure 1: Earnings yield minus 10-year bond spreads (11 September 2012 to 26 April 2018)**

*Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an Index. Period is based on data availability for the WisdomTree Europe Hedged Equity Index. Europe Spread: WisdomTree Europe Hedged Equity Index earnings yield minus 10-year German Bund interest rate. US Spread: S&P 500 Index earnings yield minus 10-year Treasury Note interest rate.*

Analysing earnings yield minus 10-year interest rates, European equities currently have a much wider spread than US equities. The differential in the two spreads is a result of central bank policy divergence, as at the time of writing, the 10-year German Bund was around 0.60%—approximately one-fifth of the US 10-year Treasury note level of 2.98%. Yes, the earnings yield of the WisdomTree Europe Hedged Equity Index was 60 basis points higher than that of the S&P 500 Index, but the real reason for the difference in spread was the low level of German interest rates.

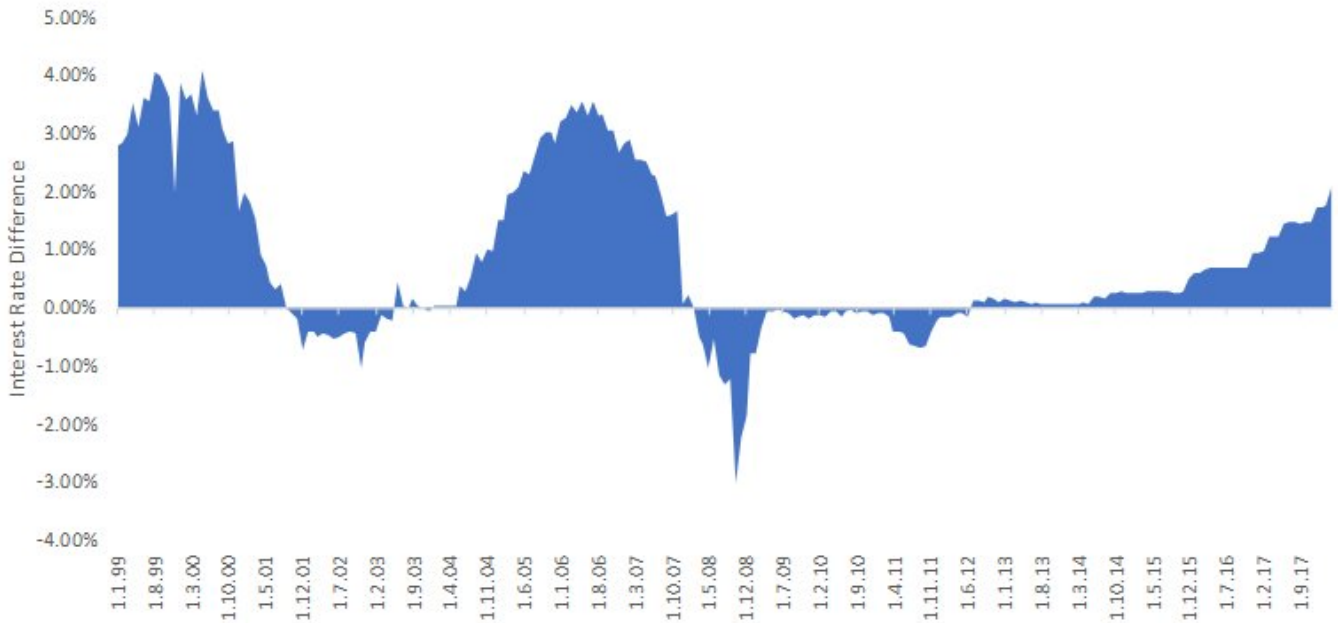
The WisdomTree Europe Hedged Equity Index is focused on export-oriented companies that derive more than 50% of their revenues from outside Europe. The euro's performance is therefore important, because a weaker euro creates a stronger fundamental backdrop for the earnings of these companies.

## **Interest rates matter**

Central bank policy divergence is one of those big themes that has been discussed at length by market participants around the world recently. Many investors have tended to focus on specific policy rates first, as these are what the central banks are directly influencing.

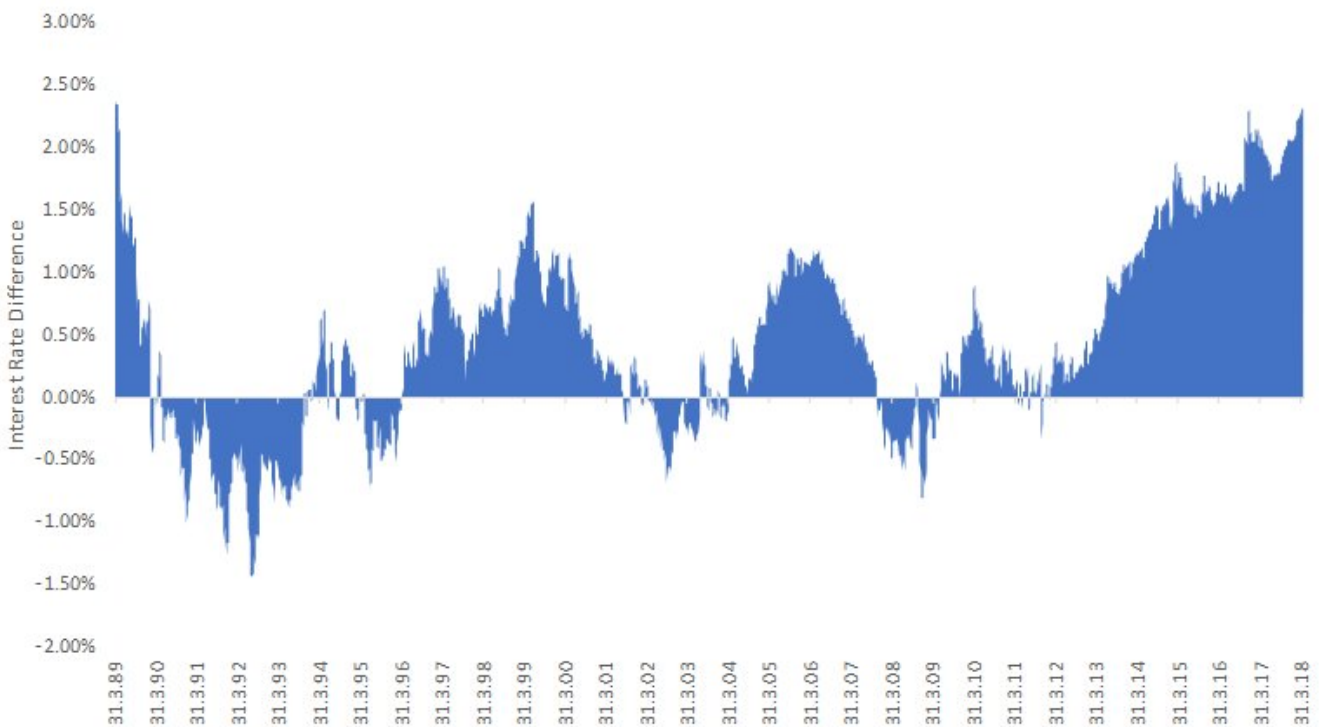
However, it's important to look further out on the interest rate curve. 10-year government bond interest rate differences between Germany and the US imply a broader spectrum of differences beyond central bank policy, with implications for growth and inflation differentials.

## **Figure 2a: Difference in central bank policy rates: US Federal Reserve minus ECB**



Source: Bloomberg, with period based on available data from the ECB policy rate, 31 Jan 1999 to 31 March 2018. Past performance is not indicative of future results. You cannot invest directly in an Index. US Federal Reserve is the US Federal Funds Effective Rate. ECB rate is the ECB Deposit Facility Announcement rate.

**Figure 2b: Difference in US 10-year Treasury interest rate minus 10-year German Bund interest rate**



Source: Bloomberg, with period based on available data for the German 10-year bund, 31 Mar. 1989 to 31 Mar. 2018. Past performance is not indicative of future results. You cannot invest directly in an Index.

It's very clear that the US Federal Reserve has tended toward a higher policy rate than the ECB over the vast majority of the period analysed above. The difference peaked—meaning the Fed policy reached its highest level in a relative sense—in 2000 and in 2006. The critical question is whether we are travelling toward a third peak, being currently at about a 2% difference, around half of the historical maximum in the 4% range.

Going back to 1989, the US 10-year Treasury note had an approximate 2.3-2.4% yield advantage over the 10-year German bund. Markets had to wait until recently for this level of difference to be re-attained—a period of nearly 30 years. This suggests that the USA has much higher growth/inflation expectations than the eurozone over the next 10 years and that European investors have an opportunity to pick up a historically large spread when investing in US government debt.

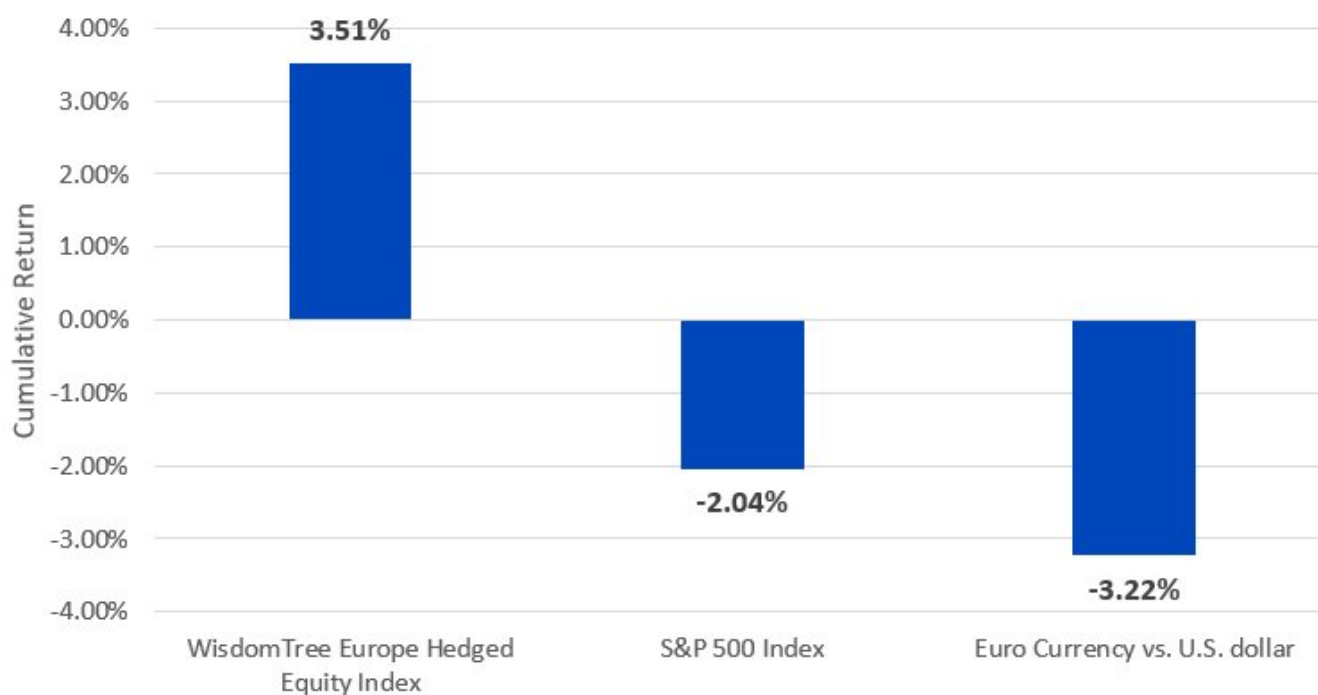
The bottom line is that these spreads favour a stronger US dollar and a weaker euro. Now, we're careful to say 'favour' for a reason, in that other factors clearly influence the picture. The market has known about these developments for some time and the euro is still trading at close to 1.20 to the dollar.

### **2018: Will the ECB begin tapering?**

The 26 April 2018 ECB press conference was basically as expected. Not much in the way of new information and policy will be assessed flexibly on an ongoing basis. Right now, we know that the asset purchase plan will continue at a rate of 30 billion euros per month through to September. Weak data could result in this being extended, but as yet, we do not have any new information—we just know that indicators such as the Citi Economic Surprise Index haven't been at their most positive thus far in 2018. Extending the time frame for easing—contingent on economic data—may come to light in June. If we can assume this is not currently priced into the euro, then it may be a catalyst for euro weakness.

### **Figure 3: Euro depreciation impacts equity prices**

## Recent euro Depreciation (15 February 2018 to 26 April 2018)



Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an Index.

15 February 2018 was a near-term peak in the euro, where it traded above 1.25. At the time of writing, it's trading around 1.21, a decline of approximately 3.2%. Since 15 February, the WisdomTree Europe Hedged Equity Index has risen 3.51%, outperforming the S&P 500 Index by around 5.5% cumulatively. This shows what can happen to European exporters when the euro weakens.

**Conclusion: a weaker euro could unlock the valuation potential of European exporters**

We've seen the US 10-year Treasury yield break through 3% for the first time since early 2014 and we've written about the appointment of Larry Kudlow to the Council of Economic Advisors and possible 'King Dollar' policy. We had a glimpse of this during the week of 27 of April, and will have to now examine the staying power of this trend.

1 Source: Bloomberg, with 2017 performance measured from 12/31/2016 to 12/31/2017.

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