IF AT FIRST YOU DON'T SECEDE… GREXIT RISK AGAIN?

Jeff Weniger, CFA, Director, Head of Equity Strategy

I'm often asked about unappreciated risks that can bite the stock market. Here's one: the threat of a Greek exit from the eurozone—Grexit—coming back.

Should this end up on the radar, the play is to underweight continental Europe in developed market equity allocations. At the end of this report, I will lay out some WisdomTree ETFs for this thesis.

Now, onto how things can fall apart for Greece.

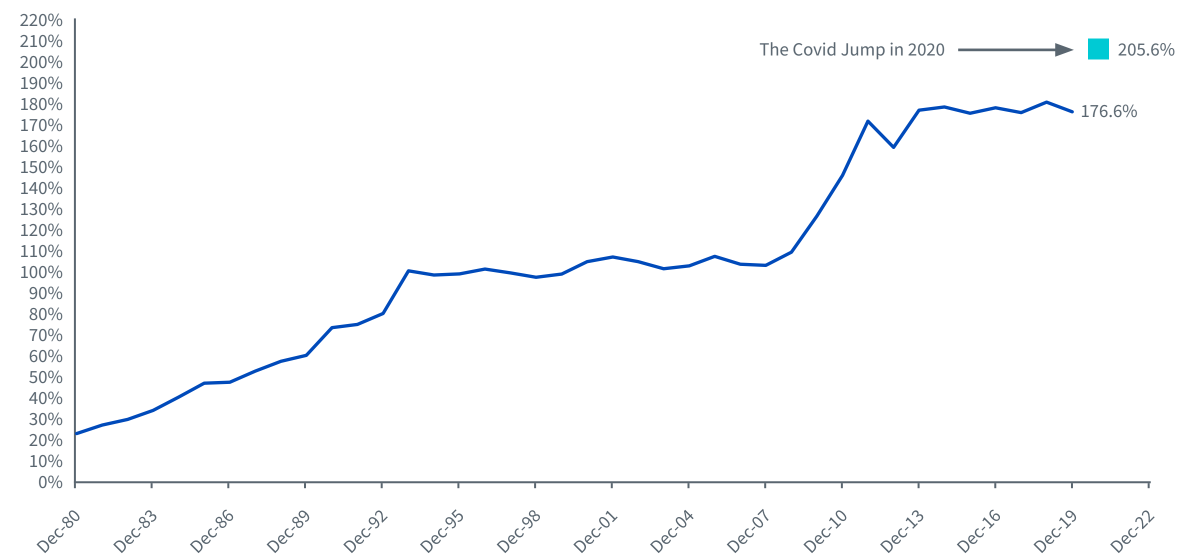
Though the country faded from the front page in recent years, Greece's overwhelming debt load never actually went down; the burden just stayed on an even keel as the government—to its credit—abided by EU-mandated deep austerity packages. Many do not realize it, but Greece ran budget surpluses from 2016–2019.

COVID-19 lockdowns changed that.

Like most governments, Greece's national budget was blown out in 2020 as it marked a deficit equal to 10% of GDP. Deutsche Bank's economists see the country continuing to run a 7+% budget deficit this year and next. Another economics team at UBS is more optimistic, anticipating a deficit equal to 6% of GDP this year and 3% in 2022.

So much for a stabilized debt-to-GDP ratio. According to Eurostat, that figure jumped to 205.6% last year, a new high that looks to be heading higher. Toss in a recession somewhere along the line and this statistic will have a hard time falling.

Greece Government Debt-to-GDP Ratio (%)



Source: Koyfin, 12/31/1980–12/31/2019, with data for 2020 from Eurostat and the European Commission.

The country also has one of the worst demographic profiles in Europe, which is saying something because low birth rates are ubiquitous, from the sunny climes of Italy to the frozen tundra of Scandinavia. With a birth rate of just 1.35 babies per woman—and with many of its young adults leaving for employment opportunities in more vibrant countries—I am not sure what could catalyze a reversal in Greece's population trend.

Population of Greece

Year	Population	% Change
2011	11,104,899	—
2012	11,045,011	-0.54%
2013	10,965,211	-0.72%
2014	10,892,413	-0.66%
2015	10,820,883	-0.66%
2016	10,775,971	-0.42%
2017	10,754,679	-0.20%
2018	10,732,882	-0.20%
2019	10,717,169	-0.15%

Source: World Bank.

FOLLOW THE LEADER

Before COVID-19 came to dominate our world, a few national independence movements owned prominent spots in the market's attention. After Scotland's failed referendum to split off from the UK in 2014, focus turned to Spain's Catalan region, where proponents of partition wished (and still wish) to form their own country.

That never came to pass. But one independence movement did: Britain's exit from the EU—Brexit.

Despite the five-year back-and-forth since the June 2016 Brexit vote, the notion that Greece may one day reject the euro and readopt its old currency, the drachma, has faded from the market's list of concerns. The decline in perceived riskiness of Greek assets owes itself to the pre-COVID-19 global economic expansion as well as Greece's multi-year balanced budget trend. Those two forces mitigated the big fear from a decade ago that Grexit would cause a domino effect that would send Italy, Portugal and Spain also on a path to eurozone exit.

Again, that was all pre-COVID-19.

But Greece only opened its beaches to tourists in May—and you have to be vaccinated to visit. Like Las Vegas or Orlando, Greece's economy revolves around tourism, so much so that about one-fifth of its GDP is attributed to it. If ever there were a country that needs COVID-19 to go away once and for all, it is Greece.

Consider this Pied Piper situation, where a possible chain of events plants seeds of disenfranchisement in Greece's collective psyche. First in the chain was Brexit. The UK has had its stumbles, but many people view Britain's vaccination program as a wild success—perhaps one that would not have happened if the country were still attached to the EU's bureaucracy.

However, many in Scotland are seething about Brexit, believing their interests are being ignored by politicians who govern in England's interests, not those of the UK as a whole. The Scottish National Party wants out of the UK but still wishes to be in the EU. An independence referendum in 2022 is possible, if not probable.

Plot twist: The power structure in Spain does not like the Scotland ordeal, as the last thing mainstream Spanish politicians want is a crop of Scottish secessionists inside the EU. The thinking goes, according to Spanish unionists, that the Scots could lay a roadmap for fence-sitting Catalonian voters. Perhaps something like: "Hey, if Scotland can break off from the UK and stay in the EU, Catalonia can do the same here in Spain. I was wishy-washy on Catalan independence before, but now I am on board."

Or so goes the theory.

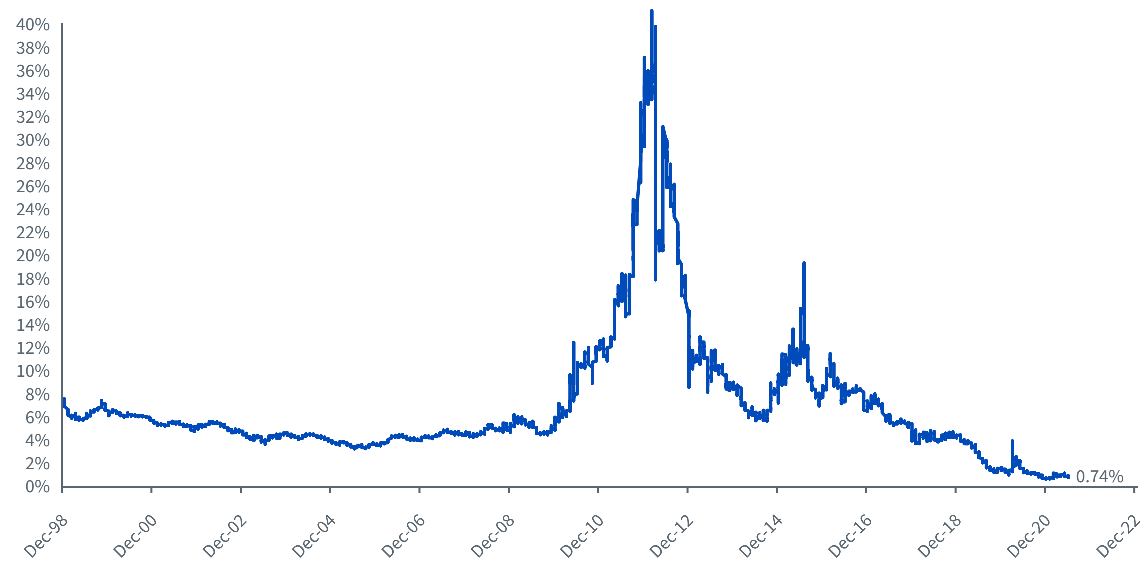
This all means that a few years from now we may find ourselves investing in an environment in which Britain is out of the EU, while Scotland is out of Britain, trying to figure out if it fits in the EU. Sprinkle in a recession or major shock event like a pandemic and suddenly Catalan secession is back on the table in Spain.

In the meantime, suppose we get to 2023 or 2024 and Greece's public finances have not recovered from COVID-19. That is a world that may witness a frustrated Greek populace perhaps playing hardball with wealthy northern neighbors, namely Germany, in future debt bailout negotiations.

The source of trouble could be as simple as the bond market getting fidgety. With Greece's 10-year government bonds yielding less than 1%, that is clearly not currently the case. I also do not want to leave out the positive portents. For example, Standard & Poor's upgraded the country's sovereign debt from BB- to BB in April, citing robust economic growth in 2021 and 2022.

Nevertheless, BB is below investment grade. We cannot forget that.

Greece 10-Year Bond Yield (%)



Source: Koyfin, 12/31/1998–6/17/2021.

There's a German plot twist, too.

A contented Greek bond market presupposes the status quo in Europe's anchor nation. About a decade ago, when the southern European nations found themselves against the debt wall in the wake of the global financial crisis, markets became assuaged when longtime German Chancellor Angela Merkel showed a decided willingness to stump up the money for bailouts in the interest of keeping the European Project together.

But Angela Merkel is walking out the door come September. Who replaces her? Your guess is as good as mine, but the traditional parties of the left and right—Germany's equivalents of the Democrats and Republicans in the U.S.—may be on the outside looking in. The victor could possibly be the Greens, who play on the left flank of Germany's center-left SPD. (Merkel is in the center-right alliance of the CDU and its sister party, the CSU.)

Critically, the other half of the Franco-German alliance that holds the whole union together looks like it could shift *in the other direction,* rightward.

As things stand now, Merkel's center-right CDU can maintain friendly relations with French Prime Minister Emmanuel Macron's call-it-centrist government. But Macron could seemingly suffer an election loss to the nationalist Marine Le Pen in 2022.

In other words, Germany may shift left of the mainstream left, while France shifts right of the mainstream right. While neither of these political shifts are odds-on, they are possible, and should be on investors' radars.

And these two countries are supposed to be the bulwark of the EU, keeping it all together. I would not hang my hat on a cohesive "core Europe" coming together to give Athens another shot if its creditors balk.

WISDOMTREE SOLUTIONS: HOW TO INVEST AROUND THIS THESIS

Start with the benchmark MSCI EAFE Index, which has 31% of its holdings in the eurozone.

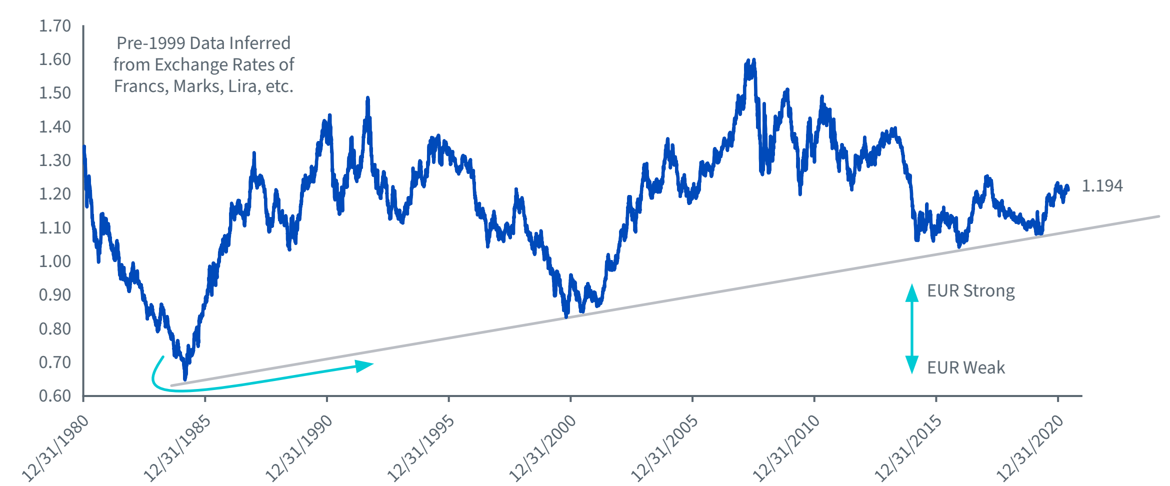
Here are a few ideas, ordered by how much they tweak eurozone exposure relative to that Index.

First, owning the WisdomTree International SmallCap Dividend Fund (DLS) cuts the 31% down a little bit, to 24%. That may fit for someone who wants to underweight the eurozone without going too boldly away from EAFE. Our strategy may also prove more conservative than the MSCI EAFE Index, as 7% of DLS has companies with negative earnings, whereas 11% of the developed world's market capitalization is unprofitable. Additionally, the Fund screens higher on the quality factor, namely return on assets (ROA) and return on equity (ROE). That may help if bears arrive.

If you want to cut out the eurozone more than what you see in DLS, the WisdomTree International Quality Dividend Growth Fund (IQDG) holds 21% in the region. For avoiding the euro, IQDG has a sister fund, IHDG, the WisdomTree International Hedged Quality Dividend Growth Fund, that hedges away the currencies.

That may be helpful because the euro has been in a bull market since the global powers shook hands on the 1985 Plaza Accord, which sent the dollar into a bear spin.

EURUSD



Source: Koyfin, as of 6/17/21.

Finally, maybe you do not want 24% or 21% in Europe, instead preferring to shift capital to a country far, far away. For years, I have held that one of our more conservative mandates is the WisdomTree Japan SmallCap Dividend Fund (DFJ).

To me, its biggest appeal is its low volatility. The standard deviation since its 2006 launch is 13.9%, which is lower than the 17.4% for MSCI EAFE in that time. Critically, DFJ's risk is lower than the 15.2% standard deviation on the S&P 500. That presents an interesting situation where total portfolio risk may be reduced by adding foreign equities—Japanese ones—in the event of a Greek crisis.

Country Weights

Currency	Country	MSCI EAFE Index	WisdomTree International SmallCap Dividend Fund (DLS)	WisdomTree International Hedged Quality Dividend Growth Fund (IHDG)
EUR	France	11.4%	3.5%	6.7%
EUR	Germany	9.4%	3.2%	6.0%
EUR	Netherlands	4.1%	1.0%	3.8%
EUR	Spain	2.6%	3.2%	0.5%
EUR	Italy	2.5%	3.3%	0.9%
EUR	Finland	1.0%	4.4%	2.6%
EUR	Belgium		2.2%	0.1%
EUR	Austria		1.5%	
EUR	Ireland		0.5%	
EUR	Portugal		1.6%	0.2%
Sum EUR		**31.0%**	**24.1%**	**20.7%**
JPY	Japan	23.5%	23.7%	17.9%
GBP	United Kingdom	14.6%	14.4%	26.3%
CHF	Switzerland	9.2%	2.1%	10.2%
AUD	Australia	7.0%	13.0%	11.9%
SEK	Sweden	3.6%	3.3%	3.3%
HKD	Hong Kong	3.3%	4.1%	3.7%
DKK	Denmark	2.5%	1.8%	4.9%
SGD	Singapore	1.1%	4.3%	0.4%
NOK	Norway		3.6%	0.1%
ILS	Israel		4.5%	0.1%
CNY	China		0.5%	0.2%
USD	United States		0.6%	0.1%
	Other	4.4%	0.2%	
Sum Non-EUR		**69.0%**	**75.9%**	**79.3%**
Total		**100.0%**	**100.0%**	**100.0%**

Sources: WisdomTree, MSCI, as of 5/31/21. Subject to change. You cannot invest directly in an index.

Important Information

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, please call 866.909.9473, or visit WisdomTree.com to view or download a prospectus. Investors should read the prospectus carefully before investing.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.

To the extent the Fund invests a significant portion of its assets in the securities of companies of a single country or region, it is likely to be impacted by the events or conditions affecting that country or region. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. WTGM-XXXX