

How to Counter Pessimism on European Equities

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Christopher Gannatti, CFA

Global Head of Research

2017 has been a difficult year to find investors willing to allocate exposure to European equities. Yet we find the following:¹

- The STOXX Europe 600 Index is up 4.84% in local currency terms, and the euro has appreciated by 2.67% against the U.S. dollar.
- The FTSE 100 Index is up 3.80% in local terms, and the pound has appreciated by 1.08% against the U.S. dollar.

This is at a time when the [S&P 500 Index](#) was up 5.20%, and it's notably a far cry from the truly challenged performance that we saw for the first six months of 2016 in Japan (-19.46%)² or during the 2015 year in emerging markets (-14.92%).³

The bottom line: While *sentiment* toward Europe—especially with all of the elections set to occur throughout 2017—has been quite bearish, equity market performance (at least so far) has been fairly stable.

What's the Biggest Challenge You Face Today?

On an informal basis, this is a question that we ask our clients time and again. Investors of all types and sizes have indicated to us that one of their biggest challenges today is figuring out **what to do with new dollars coming in the door**. U.S. equities have outperformed for the better part of the last decade.⁴

In our opinion, it has never been more important to search for investment opportunities globally, as we may be entering a period of international equity outperformance.

The Allure of European Small Caps

[U.S. small caps performed quite strongly in 2016](#), especially once the news of President Donald Trump's election became clear in November. One important catalyst for this concerned [how small caps tend to do most of their business inside of the U.S.](#) and therefore typically pay higher effective tax rates. Therefore, corporate tax cuts have the potential to have a significant impact, but we've also seen that the precise timeline as to when corporate tax cuts could occur is far from certain.

On the other hand, European small caps have been faced with the specters of Brexit and further 2017 European elections for some time, and if sentiment were to simply become "less bad," we believe that there may be a distinct possibility for outperformance.

The WisdomTree Europe SmallCap Dividend Index Already Outperformed the Russell 2000 Index



Sources: WisdomTree, Bloomberg, with data from 6/1/06 to 3/24/17. Past performance is not indicative of future results. You cannot invest directly in an index.

- Big Shift in 2017:** After President Donald Trump's victory to the end of 2016, the Russell 2000 Index crushed the WisdomTree Europe SmallCap Dividend Index, 13.86% to 4.72%. However, thus far in 2017, positions have been reversed, with the WisdomTree Europe SmallCap Dividend Index leading, 8.22% to .09%.⁵ While it's impossible to know if this trend will continue, we don't believe that many would have predicted that a measure of European small-cap equities would outperform the Russell 2000 Index by this magnitude.

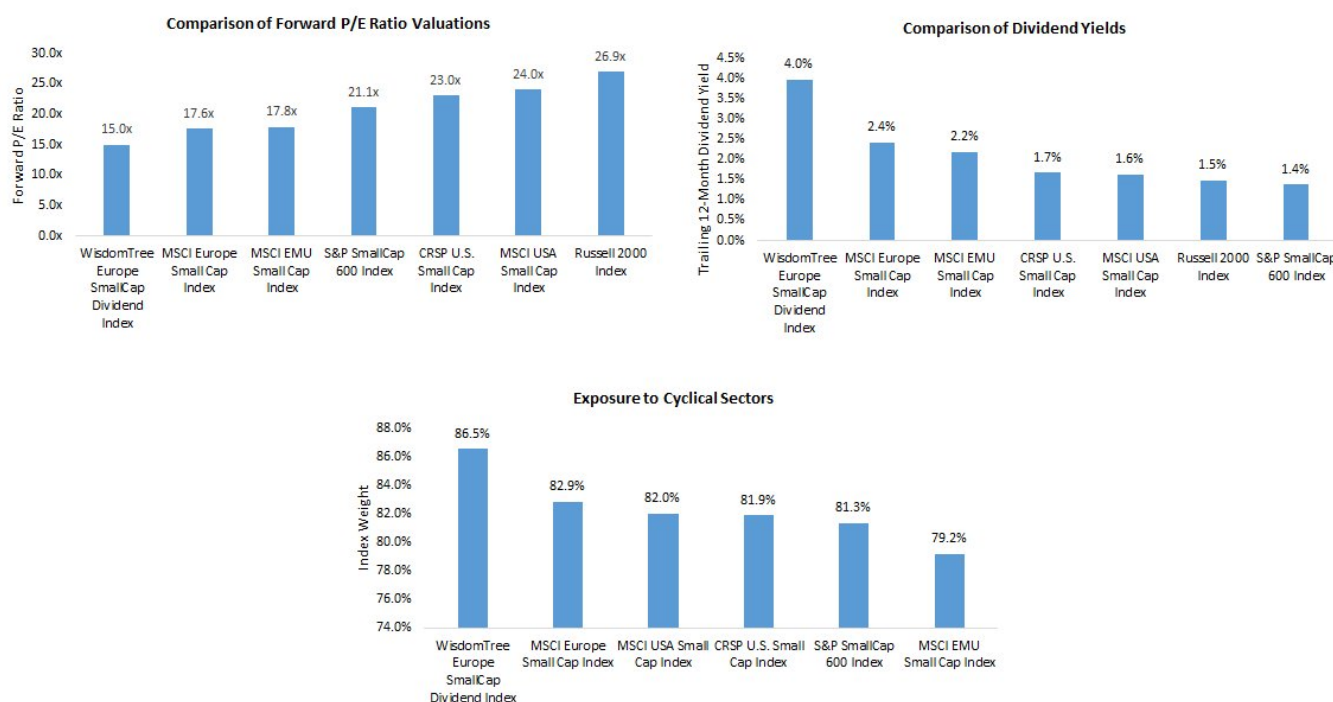
Of course, this reflects an aversion of the "worst-case" scenario on the Netherlands election, but the risk in the much more widely discussed French election is still not behind us. There can be little question that the continuation of this trend will be related to the ultimate result not going in the "anti-market" direction.

How to Mitigate Risk in European Small-Cap Equities

One of the things that keep markets so interesting is that the more details are known about an outcome, the lower the returns typically will be. For the optimistic among us, this is where opportunities are created and why thinking about European small caps prior to the French presidential election can be particularly interesting.

Crucial point: If sentiment is overly pessimistic, giving too much credence to the possibility of a nationalistic, right-wing result, investors may see outsized returns if in fact that risk is proven false and taken off the table. While it's far from certain, we believe there is no way for global equity investors to ignore the possibility that the pro-market party may win.

Valuation and Cyclical Exposure: Mitigating Risk and Capturing Opportunity



Sources: WisdomTree, Bloomberg, with data as of 3/24/17, except for cyclical sectors due to data licensing, which is as of nearest month-end, 2/28/17. Exposure to cyclical sectors of the Russell 2000 Index is not shown, due to restrictions on constituent data availability. Cyclical sectors refer to all those outside of Consumer Staples, Health Care, Telecommunication Services and Utilities.

- **Managing Risk:** In our view, the most important element in managing risk is avoiding pockets in equity markets that have grown expensive relative to their fundamentals. The WisdomTree Europe SmallCap Dividend Index at 15.0x forward earnings is significantly different from the U.S. small-cap indexes shown, which were at 21.1x to 26.9x forward earnings. More interestingly, the dividend-focused methodology of the WisdomTree Europe SmallCap Dividend Index led to a 4.0% dividend yield, while the U.S. small-cap indexes shown were all below 2.0% on this measure.
- **Capturing Opportunity:** We saw it in U.S. markets after President Trump's victory—as economic growth expectations were adjusted upward, more cyclical sectors rallied. In European equities, if the specter of nationalism is kept at bay at least for this cycle, we believe that the more cyclically oriented vehicles could rally. Note that 86.5% is a larger exposure to cyclical sectors for the WisdomTree Europe SmallCap Dividend Index.

Countering Pessimism in European Equities

While election outcomes are far from certain, it must be remembered that it is this uncertainty out of which opportunities are born. For those looking to align with an improving fundamental picture in Europe that could react strongly to more pro-market election results, we believe that the WisdomTree Europe SmallCap Dividend Index presents an interesting strategy.

1Source for both: Bloomberg, with data measured from 12/31/16 to 3/24/17.

2Source: Bloomberg, with Japan referring to the MSCI Japan Index measured in local currency from 12/31/15 to 6/30/16.

3Source: Bloomberg, with emerging markets referring to the MSCI Emerging Markets Index measured in U.S. dollars from 12/31/14 to 12/31/15.

4Source: Bloomberg, with U.S. equity performance referring to the S&P 500 Index measured since the global financial crisis of 2008 and 2009.

5Source: Bloomberg. President Donald Trump's victory to the end of 2016 is from 11/8/16 to 12/31/16. The period thus far in 2017 is from 12/31/2016 to 3/24/2017.

Important Risks Related to this Article

Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development.