

The Bank of England: Rounding Out the Central Bank Trifecta

Published August 11, 2017

Jeff Weniger, CFA

Head of Equity Strategy

Investing in European equities means different things to different people. For example, the [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#), our \$8.9 billion¹ currency-hedged European equity exchange-traded fund (ETF), has a contingent of investors who are attracted by its “ex-U.K.” status and its focus on the returns to eurozone stocks without the hassle of being long the euro.

U.K. equity exposure makes up 28% of the broader MSCI Europe Index, nearly double the weight accorded to second-place France (16%).² Similarly, the FTSE Developed Europe All Cap Index also has nearly one-quarter of its exposure in the U.K., more than 10 percentage points more than France, which is number two in that index too.³

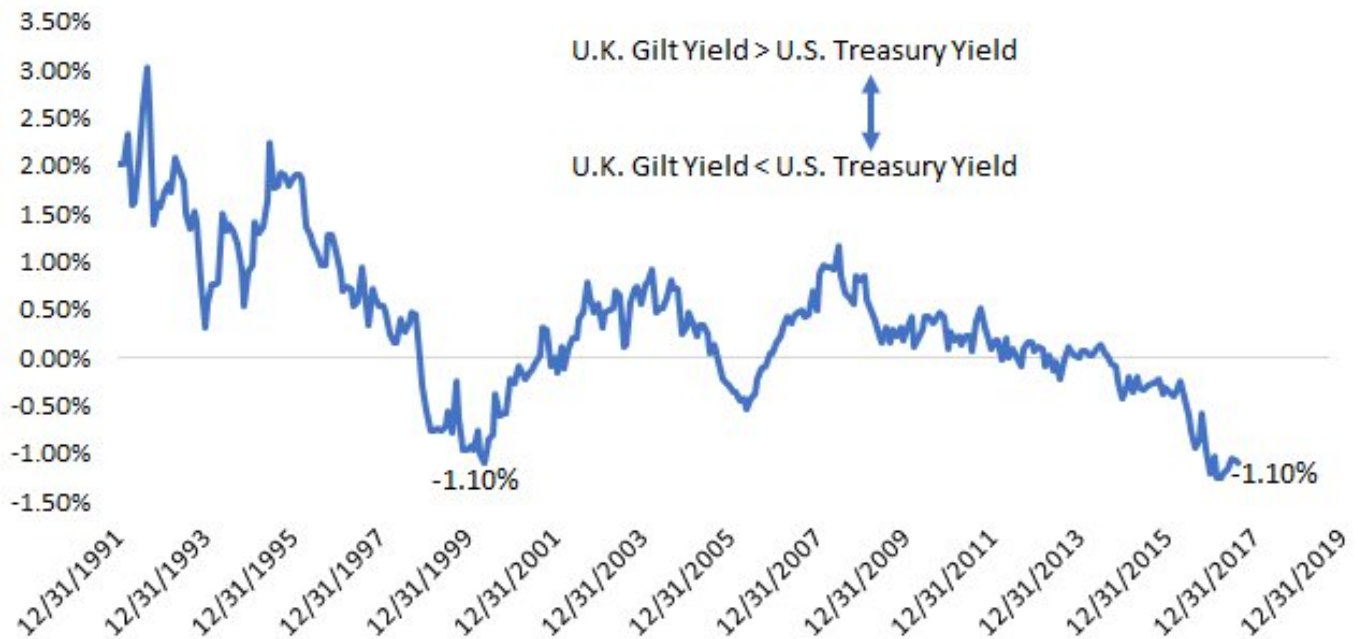
For investors who are not keen on having 24% to 28% of their European exposure in the U.K., HEDJ may be the answer. For those who want broader exposure to Europe—with the currency exposure—either because they see Brexit as having already been priced in or because sterling has grown cheaper through the years, WisdomTree has other European ETFs that allocate to Britain in size.

The [WisdomTree Europe Quality Dividend Growth Fund \(EUDG\)](#) and the [WisdomTree Europe SmallCap Dividend Fund \(DFE\)](#) both provide broad “European” exposure—but they also have 24.1% and 25.6% weights in the U.K., respectively.⁴ Non-euro Europe (Sweden, Switzerland, etc.) is also widely held throughout both ETFs.

A Generational Gap: Treasury Notes vs. Gilts

At the moment, the yield differential between 10-Year U.S. Treasury notes and U.K. gilts of the same maturity is near its widest levels of the last quarter century. With the former yielding 2.26% and the latter offering just 1.16%, the gap of 110 basis points (bps) between the two is just off the 125 bps record set this spring, the largest in data back to 1992—and the only time when it got this extreme was at the turn of this century.

Figure 1: 10-Year U.K. Gilt Yields Minus 10-Year U.S. Treasury Note Yields



Source: WisdomTree, Bloomberg, as of 8/4/2017. Past performance is not indicative of future results.

Note the Extreme, Play the Reversal

Critically, it would seem that whenever the yield gap reaches an extreme, the investor may be well served to put on a mean reversion allocation. For example, gilt yields were a full 110 bps lower than U.S. Treasury yields in May 2000, and that proved a great time to sell dollars for pounds.

Back then, the market had just spent several years letting the British pound for the most part chop around a tight band from \$1.55 to \$1.70, a trading range that persisted for most of the late 1990s. The pound then sank to \$1.50 when the yield gap reached its apex, following through to its generational low of \$1.37 in the summer of the following year.

The pound then embarked on a remarkable run to \$2.11 in November 2007. Because of the pound's appreciation in this century's early years, the FTSE 100 Index of British equities returned 8.1% in U.S. dollars from May 2000 to November 2007, nearly 6 annual percentage points more than the [S&P 500 Index](#) (+2.3%).

The chart seems to indicate that we are at an extreme sovereign yield gap once again; only this time around, the pound's starting point is \$1.30, even lower than it was 17 years ago.

Catching the Trifecta

When this year started, the lone central bank that was setting itself up for potential restrictive monetary policy was the U.S. Federal Reserve (Fed). The Bank of Canada (BOC) joined the mix on July 12, raising rates 25 bps. Now a big question looms as to whether the Bank of England (BoE) will make it a trifecta.

With the U.K. experiencing strong labor markets (albeit with frustratingly low wage growth), perhaps a whiff of thus-far elusive inflation could get the somewhat reluctant BoE to act. If it happens, it probably will not

come until 2018. Nevertheless, should it come to pass, the market has the trifecta: the Fed, the BoC and the BoE.

If the BoE follows along with the North Americans in hiking rates, the generationally wide gap between longer-dated U.S. Treasuries and gilts may prove vulnerable as investors realize the BoE is loath to let the rate gap stretch wider. And if that gap gives way, the pound, trading down here at \$1.30, could conceivably catch a strong bid.

Using EUDG and DFE for a Bullish U.K. Case

Unlike with cap-weighted mandates, EUDG and DFE cover broad Europe (the eurozone, U.K., Switzerland and the Nordics) with a keen eye on actual fundamentals, a phenomenon that is lost on strategies that blindly follow market capitalization-weighting methodologies.

By pairing up EUDG and DFE, investors capture several smart beta factors, including companies that have exhibited strong profitability and earnings growth, in addition to a weighting methodology that focuses on actual volumes of cash paid out to shareholders. Also, combining EUDG and DFE allows investors to cover the total size spectrum, while many active managers and ETFs huddle in megacaps. Please see more WisdomTree Research on [European small caps](#) and [European quality strategies](#).

Perhaps most critically, if U.K. companies start displaying better profitability and earnings growth, or if they ratchet up their dividends, our Indexes will include those companies in greater size at our annual Index rebalancing, regardless of whatever their market capitalization happens to be. Combine that with a potential closing of the U.S.-U.K. interest rate gap from its 17-year extremes and the case for being long both U.K. equities and sterling shapes up to be particularly interesting.

1Source: WisdomTree, as of 8/3/2017.

2Source: BlackRock, as of 8/3/2017.

3Source: Bloomberg, as of 8/4/2017.

4Source: WisdomTree, as of 8/3/2017.

Important Risks Related to this Article

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. 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. 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.

This Fund focuses its investments in Europe, thereby increasing the impact of events and developments associated with the region which can adversely affect performance. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. 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.

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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.