ECONOMIC OUTLOOK: THE GOOD, THE BAD AND THE UGLY

We just endured a horrible first half of the year, caused by the global pandemic.

The first quarter was bad, and the second quarter was ugly.

But we now see signs of recovery.

As the economy slowly reopens (with stops and starts as new cases of the virus flare up—which is inevitable until we have a vaccine), we envision a gradual improvement in GDP. While the data resembles a “V”-shaped recovery, it may actually feel more like a “U.” The bottom line is that we expect to see growth resuming in the second half of the year. But, given the depth of the Q2 “GDP crater,” a return to pre-COVID-19 levels may not occur until 2021.

The steepness of the recovery slope depends on consumers’ willingness to come out of their homes and resume spending. Monetary and fiscal stimulus (with more to come) has injected an enormous amount of liquidity into the system, with much of it going directly to consumers. We expect this stimulus to support a nice recovery.

Overall business activity in both the U.S. and the eurozone has increased since bottoming this spring. The most recent (June) PMI reports certainly resemble a V-shaped recovery (a recurring theme), as both the manufacturing and service sectors bounced back. In fact, the latest manufacturing data from the Institute for Supply Management (ISM) showed the U.S. moved back into expansionary territory, notching a figure of 52.6—the highest since April of last year. Any reading above 50 is considered expansionary.

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1 Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

2 Purchasing Managers’ Index (PMI): An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month, below 50 represents a contraction and 50 indicates no change.
Not surprisingly, the service sectors of the economy took the biggest hits during the pandemic. Even the ISM Non-Manufacturing (Services) indicator has climbed back into expansionary territory.

Source: Bloomberg, as of 7/1/20.

From the personal consumption perspective, retail sales bounced back strongly these past two months and have almost retraced to levels just prior to the onset of the pandemic.

Source: St. Louis Federal Reserve, as of 7/1/20.
Obviously, the state of the labor force will be a key factor moving forward. While the government’s fiscal response has provided much needed relief, the “job growth engine” needs to turn on again to generate sustainable growth. Additional stimulus is more than likely, but it’s not a sustainable solution. Jobs are.

The June Employment Situation report showed further progress, but it also highlighted how much further we need to go. The May/June combined payroll gain was about 7.5 million, but the March/April combined job losses were 22.2 million. So far, we’ve recovered only about one-third of the job losses previously incurred.

Weekly jobless claims are a key economic indicator to watch going forward. The lion’s share of data releases that investors receive are not forward-looking, but jobless claims are. In fact, it’s part of The Conference Board Leading Economic Index®. After forming a “reverse V,” the decline in the number of new claimants has stalled out in recent weeks.

For the broader jobs market, the recent increase in COVID-19 cases and attendant effects on reopenings could make it a bit choppier in the coming months. But we still see the overall trend as one of improvement.
In summary, after a bad reading of -5.0% for Q1 GDP growth, the Wall Street Journal reports a consensus estimate of a dismaying ugly -33.5% for Q2. Entering the second half of the year, it reports an equally uplifting and good +14.5% reading for Q3 and +7.5% for Q4, bringing the annual GDP growth for 2020 to an estimated -5.9%.³ Barring a second government-mandated economic lockdown, we believe we will see a slow-but-steady recovery of the U.S. economy in the second half of 2020.

**FED WATCH: HIGH GRADES...SO FAR**

For official policy responses to the COVID-19 pandemic, you have to admit the Fed earns high grades. Its actions have been both proactive and, it appears at this point, preemptive.

While dropping the Fed Funds target rate into zero-interest rate policy and turbocharging quantitative easing (QE) are certainly accommodative moves, the policymakers were left with another mission: prevent another financial crisis.

By utilizing their playbook from the financial crisis, Chairman Jerome Powell made the preemptive strike, and the markets responded in a positive way, as most funding market gauges are either close to or at pre-pandemic levels.

So, if phase one was characterized by preventing another financial crisis, then what’s in store for phase two?

Let’s call it “normalizing” the money and bond markets.

Policymakers have already seen progress on this front. U.S. investment-grade and high-yield spreads\(^4\) have seen noticeable retracement from their March peak spread widenings, while the unusual dislocations that were witnessed in the U.S. Treasury (UST) market also seem to have dissipated.

![Fed Holdings of Treasuries, Agency Debt and MBS](chart.png)

Source: Federal Reserve, as of 7/06/20.

The Fed's balance sheet holds the clues to this policy shift.

Looking at its holdings of Treasuries, agency debt and mortgage-backed securities (MBS), you can clearly see the unprecedented spike in purchases during the March through early-May period. But since then, the pace and magnitude of QE buying has been visibly scaled back. In fact, as of this writing, the Fed's overall balance sheet has actually shrunk a bit, as facilities that were needed early in the process have been scaling back, while purchases of U.S. corporate and municipal bonds have been modest.

That's the good news, in our opinion. Markets are operating far better, so they don't need an aggressive Fed at this point.

That being said, Chairman Powell has made it clear that monetary policy will remain overly accommodative for the foreseeable future.

Going forward, Fed facilities will provide a signal and support, but not a lifeline. The degree to which corporations tap the Fed's facilities could prove to be a critical sign for the trajectory of the domestic economy.

In terms of potential future policy moves, "target-based" forward guidance and QE remain the most likely options. The Fed doesn't seem to be on board for negative rates, while yield curve control (YCC) remains a study in progress.

\(^4\) Spread: Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.
U.S. RATES: LOWER FOR LONGER DOESN’T MEAN UST YIELDS CAN’T GO UP

The first half of 2020 brought the UST 10-year yield down to a new record low point of 0.31%.

With its present yield of roughly 0.70%, the 10-year has now experienced a sizeable drop of about 120 bps this calendar year. At these historically low levels, we feel a good deal of “bad news” has already been priced in, and the UST market is now turning its attention to the pandemic recovery process.

IS IT A ‘V’, ‘U’, ‘W’ OR ‘L’ SHAPE?

While the shape of the recovery will be an integral aspect of where the UST 10-year yield will be headed, we believe “lower for longer” remains a valid mantra—but the rate could still move up from here. Just go back to early June, when the 10-year yield was only 5 bps away from the 1% threshold. Certainly a 50% retracement back to the 1.25% vicinity does not seem unreasonable, barring any future pandemic-related setbacks.

What other factors should investors be keeping their eye on?

The federal budget deficit and attendant supply burden come to mind. If, as we expect, another fiscal stimulus package is forthcoming later this summer, the U.S. budget deficit could easily exceed the $4 trillion mark. For the Treasury market, that means future supply needs will continue to be in the multi-trillion dollar range.

With intermediate-to-longer-dated rates being so low, the nation’s debt managers could look to take advantage of these incredibly low funding costs.

Source: Bloomberg, as of 6/26/20. Basis point: 1/100th of 1 percent.
Remember when zero or negative developed sovereign debt yields abroad were all the rage?

Take a look at this graph showing the basis points spread between the UST 10-year yield and its German Bund counterpart. Not only has the spread between these two instruments narrowed by 170 bps from its November 2018 peak, but long-term Treasuries are no longer a carry opportunity for many foreign investors, especially when currency hedging the 10-year Treasury into euros.

Against this backdrop, we look for the UST 2-year/10-year curve to steepen in the second half, as short-term rates remain anchored by the Fed’s zero-interest rate policy and the backend sees a moderate rise in rates.

Opportunities still exist in corporate bonds, and we expect the recovery we saw in corporate bonds to continue, but at a much slower pace.

Valuations are attractive, and the Fed is buying corporate debt for the first time. As of June 30, 2020, yield spreads for investment-grade corporates over Treasuries (1.50%) remain about 55 bps wider than their February lows, and at the 68th percentile historically over the last 10 years. High-yield spreads (6.26%) were 2.85% wider than their February lows and at the 86th percentile over the last 10 years.

We cannot overstate the significance of the Federal Reserve’s facilities in supporting the recovery in corporate debt markets. The Fed signaled intent in their announcements and restored liquidity to levels where issuers could effectively tap the funding and capital markets to address near-term liquidity needs. The presence of the facilities should limit unnecessary defaults, mitigate downside systematic risk and provide big technical support for the market.

EQUITY CONDITIONS

A big market misconception is that conditions—business, social, political—need to be stable or rosy to support a bull case for stocks. It’s the opposite of how things often work.

Look at the last three Bank of America Global Fund Manager surveys, which showed just 15%, 10% and 18% of respondents expecting a “V-shaped” economic recovery in April, May and June, respectively.

The key variable impacting all markets has been the virus, and our weekly calls with Professor Siegel have focused more on virus developments than any economic data.

We are encouraged that the recent resurgence in COVID-19 hospitalizations is occurring in tandem with ever-declining daily deaths, perhaps signaling that the virus is weakening. Key word: perhaps. Also, we can all agree that medical practitioners have more information and treatments at their disposal than in the initial days of scramble.

To give one example, take Italy’s 98% decline in daily deaths. Just three months ago, its seven-day average of daily deaths was astonishingly grim: 814 souls lost every 24 hours at the peak. Currently, that average is down to 18 per day, or about double Italy’s pre-COVID-19 daily automobile fatality rate, according to the OECD.

Another positive catalyst for the market is sell-side strategists’ caution on their S&P 500 price targets, which is a bullish contrarian signal.

If this was a “normal” year, it would not come as a surprise to see all or most of the 14 strategists in CNBC’s tally penciling in 2020 price targets somewhere north of the Index’s current 3,172 level. But this year there is a degree of skepticism, with the range of targets falling between 2,750 and 3,400, and five forecasting a December 31 close below 3,000.
This is a good thing: Bull markets are often healthiest when there are still skeptics to convert.

Another catalyst for further upside could be the market’s realization that some of the stimulus actions we have seen so far—$2.9 trillion by the U.S. government alone—are likely to be extended in the coming months.

Disconcertingly though, we hypothesize that the government’s largesse will be paid for via inflation. M1 money supply, which measures the sums in money market funds, checking accounts and physically in our pockets, is up 34% over the last year—an increase that would make the 1970s blush. The promising prospect for value investors like us, who screen for cheap stocks, is that it is virtually impossible to find a soul who will even entertain the prospect of something like 3% U.S. consumer price inflation. Yet that condition was witnessed in every single presidential administration, save this one, dating back to the Lyndon Johnson era.

Evidence of upside price pressures are right under our noses. How many people could possibly be aggressively hunting for a new car right now, for example? Yet Kelley Blue Book tabulated a 3% year-over-year increase in new car prices in June. If a ramping up of money supply sends car prices higher when no one is driving, what happens as we get a vaccine that brings back more confidence? Or look at the housing market. We aren’t the only ones who know friends or family members who closed on a house in Q2 at full asking price, or worse, amid a bidding war. None of this is normal in a depression, no matter how temporary.

In a system allowed to correct itself, throwing 44 million people off the employment rolls is not the recipe for a hot housing market. But sprinkle in 34% money supply growth, and the game changes.

Beyond cars and housing, check base metals. “Doctor” Copper, known for predicting the economy, has a chart that looks like the S&P’s. Now flat in 2020, the red metal is challenging $3 per pound again; it was in freefall just a few months ago, threatening a downside breach of $2. That is corroborated by silver, which is both a precious and industrial metal; silver has popped seven points to the high-$18 area.

All of this means we see a case for reflation.

A PARADIGM SHIFT

Pearl Harbor, the assassinations of Bobby Kennedy and MLK, September 11th and now this dual shock of both COVID-19 and social unrest. These are once-in-a-generation regime changes, societally, socially and economically. They upend the existing order.

What emerges from such turmoil is often a very different stock market than the preceding one.

This means that now is as good a time as ever to witness a loss of leadership by the winners of yesteryear, groups like U.S. stocks, the Technology and Communications sectors—anything that plays on disinflation sensitivities.

What comes out of the COVID-19 shock is an environment where yield curves steepen on account of inflation frights that “nobody” saw coming, an environment where Basic Materials and Energy lose pariah status and an environment where valuations actually start to matter.

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5 Inflation: Characterized by rising price levels.
What else might confront the market?

A sense that the key risk to the top of the S&P 500 is collective denial that the Silicon Valley giants, one by one, are ripe for trust busting, the heavy hand of regulation, a tax grab—or all three.

If we are right, it means growth stocks’ dominance over value gives way, fears of a dollar shortage become talk of dollar abundance, unloved assets like emerging markets find favor, tech is out, gold is in and the days of having a P/E ratio of 50 or 100 because of a pretty story give way to mathematical reality.

Investors who are positioned for the 2010s may be sorely disappointed in the 2020s.

ASSET ALLOCATION OUTLOOK: STEADY AS SHE GOES

Despite the disruptions caused by the pandemic in the first half of the year, our outlook from an asset allocation perspective has not changed from where we entered the year.

It follows four main themes.

1. Stocks over Bonds. The simple fact is that nothing looks attractively valued right now across the capital spectrum. But we still believe that equities offer better performance potential over the remainder of this year and into 2021.

The market bounce back in the second quarter has brought equity valuations back to the dizzying levels we saw before the pandemic hit.

Markets have already discounted the horrible first half and are expecting terrible earnings news from Q2. But they are also pricing in (a) an anticipation of earnings improvement as we finish out 2020 and head into 2021, and (b) the continuation of massive monetary and fiscal stimulus.

As we go to press, the consensus is that we will see at least another $1 trillion in fiscal stimulus over the course of the summer. Certainly, President Trump wants the economy to be in recovery as we head into the election cycle, and the Democrats are equally interested in additional stimulus for their own purposes. There will be deep differences between the two parties as to how that additional stimulus should be allocated and implemented, but we believe there is enough common ground for a bargain to be struck.

2. Shorten Duration, Over-weight Credit and Tilt toward Quality. On the rates and credit front, we believe that interest rates will grind slowly higher as the economy recovers. But that is on a relative basis, as they currently are at near all-time lows. From an absolute rate level, our outlook remains “lower for longer.”

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6 Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the value factor, which associates these stock characteristics with excess returns versus the market over time.

7 Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

8 Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets and operating profitability, as well as others. This term is also related to the quality factor, which associates these stock characteristics with excess returns versus the market over time.
In the current yield and duration environment, even small increases in yield can trigger price losses exceeding projected annual coupon payments. These current valuations position Treasuries as a hedge against extreme events, not as a resilient investment for an entire cycle.

Given our outlook for economic recovery and unprecedented Federal Reserve support, we prefer spread risk in corporate and mortgage-backed securities over pure interest rate risk in Treasuries over the coming six months and are thus under-weight duration in portfolios. We feature over-weights in corporate debt and securitized debt at the expense of Treasuries. We are also positioned for further steepening in the Treasury curve, given our belief that rate increases will be concentrated in longer maturity securities.

Investors need to be selective, as the Federal Reserve’s programs are not a panacea. The pandemic triggered a sudden stop in the economy, and a number of corporate debt issuers will go bankrupt or lose their investment-grade status. Investors should focus on the debt of fundamentally sound companies offering attractive risk-adjusted income levels: a strategy style we call quality income with attractive yields.

For mortgage-backed securities, incremental income relative to Treasuries remains high by historical standards. In an environment in which Treasury rates drift higher, AAA-rated mortgage-backed securities should be able to provide a consistent stream of high-quality income over Treasuries. Prepayment and extension risk can also be mitigated through security and structure selection. Within the securitized credit space, a consumer recovery will support the higher quality segments of many sectors: asset-backed securities, non-agency MBS, CLOs, and agency CMBS. Non-agency CMBS remains driven by underlying collateral, with deals supported by retail and hospitality likely to remain under pressure.

Within more aggressive portfolios, we would suggest small allocations to either emerging market local debt or corporate debt. Each exposure would enhance and diversify income levels. Several emerging market countries still have room to cut monetary policy rates, potentially generating additional bond gains for local debt.

3. U.S. over Non-U.S. From a global asset allocation perspective, and relative to the MSCI ACWI Index, we recommend (a) staying over-weight in the U.S., (b) slightly under-weight in developed international and (c) slightly over-weight in emerging markets.

There has been talk recently about the potential for some degree of the “mutualization” of euro-zone debt, making it easier for the less economically strong southern countries (especially Italy) to access the capital markets. This has the potential for being a game changer for the eurozone, as it struggles to recover from a virus-induced recession. It may ultimately influence our outlook for Europe and the overall developed international markets.

But we continue to believe the structural deficiencies of the European economy (high taxes and entitlements, low labor mobility, high unemployment among the young, rapidly changing demographics, an oppressive regulatory regime, etc.) will be a drag on economic and earnings growth potential for the foreseeable future.

While the pandemic has not played itself out in the emerging markets (especially Russia, Mexico and India), we believe a slowly recovering global economy (especially China) bodes well for the EM sector. At the same time, the U.S. dollar has fallen fairly steadily since late March—a trend we believe will continue, albeit in fits and starts. If we are correct, this will provide an additional tailwind for EM and other non-U.S. risk assets⁹.

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⁹ Risk asset: Any asset that carries a degree of risk. “Risk asset” generally refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate and currencies.
4. **Maintain Risk Factor Diversification.** In addition to the more traditional asset class diversification, we are big believers in risk factor diversification.

Most people are familiar with the traditional asset class “performance quilt” highlighting the benefits of a diversified portfolio:

| EM Equity | 34.5% | REITs | 35.1% | EM Equity | 39.8% | Fixed Income | 5.2% | EM Equity | 79.0% | REITs | 27.9% | REITs | 8.3% | REITs | 19.7% | EM Equity | 38.8% | Cash | 1.8% | Large Cap | 31.5% | Fixed Income | 6.1% | Large Cap | 9.0% | REITs | 22.2% |
| Comdty | 21.4% | EM Equity | 32.6% | Comdty | 16.2% | Cash | 1.8% | High Yield | 59.4% | Small Cap | 26.9% | Fixed Income | 7.8% | High Yield | 19.6% | Large Cap | 32.4% | Large Cap | 13.7% | Large Cap | 14.6% | High Yield | 14.3% | DM Equity | 25.6% | Fixed Income | 0.0% | Large Cap | 25.5% | REITs | 28.7% | Cash | 0.5% | REITs | 8.3% | EM Equity | 22.1% |
| DM Equity | 14.0% | DM Equity | 26.9% | DM Equity | 11.6% | Asset Alloc. | 7.0% | High Yield | 28.0% | REITs | 19.9% | EM Equity | 19.2% | DM Equity | 23.3% | Fixed Income | 0.5% | Large Cap | 12.0% | Large Cap | 21.8% | DM Equity | 12.0% | Fixed Income | 0.5% | Large Cap | 21.8% | REITs | 4.0% | Small Cap | 25.5% | Large Cap | 3.1% | Comdty | 18.6% |
| REITs | 12.2% | Small Cap | 35.6% | Asset Alloc. | 9.1% | Asset Alloc. | 11.1% | High Yield | 26.9% | REITs | 25.0% | Comdty | 16.8% | Large Cap | 2.1% | Asset Alloc. | 5.1% | Large Cap | 2.0% | Large Cap | 16.0% | DM Equity | 17.9% | Fixed Income | 2.9% | Asset Alloc. | 0.0% | REITs | 8.6% | Cash | 0.0% | Large Cap | 10.4% | REITs | 8.7% | DM Equity | 19.8% | EM Equity | 18.9% | EM Equity | 9.7% | Large Cap | 6.6% | Large Cap | 14.6% |
| Asset Alloc. | 8.1% | Large Cap | 15.8% | Asset Alloc. | 7.0% | Small Cap | 33.8% | High Yield | 27.2% | Large Cap | 15.1% | Cash | 0.1% | Small Cap | 16.3% | High Yield | 7.3% | Small Cap | 4.9% | Large Cap | 16.3% | DM Equity | 23.3% | Fixed Income | 0.4% | Asset Alloc. | 0.0% | Large Cap | 2.0% | Large Cap | 14.8% | REITs | 8.7% | Large Cap | 37.0% | Cash | 4.9% | Asset Alloc. | 5.5% | Large Cap | 14.8% | REITs | 8.7% | Large Cap | 37.0% |
| Large Cap | 4.9% | Large Cap | 4.9% | Large Cap | 9.5% | Large Cap | 12.2% | Large Cap | 10.4% | Large Cap | 14.8% | Large Cap | 10.4% | Large Cap | 12.2% | Large Cap | 12.5% | Large Cap | 12.5% | Large Cap | 12.2% | Large Cap | 12.2% | REITs | 8.7% | Large Cap | 37.0% | Cash | 4.9% | Asset Alloc. | 5.5% | Large Cap | 14.8% | REITs | 8.7% | Large Cap | 37.0% |
| High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | High Yield | 3.6% | Large Cap | 12.2% | Large Cap | 12.2% | Large Cap | 12.2% | Large Cap | 12.2% | High Yield | 2.7% | High Yield | 13.3% | High Yield | 13.3% | Cash | 4.8% | High Yield | 12.2% | Cash | 4.8% | High Yield | 12.2% |
| Cash | 3.0% | Fixed Income | 4.3% | Small Cap | 1.6% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | Fixed Income | 6.5% | REITs | 8.7% | Large Cap | 37.0% | Cash | 4.9% | Asset Alloc. | 5.5% | Large Cap | 14.8% | REITs | 8.7% | Large Cap | 37.0% |
| Fixed Income | 3.4% | Comdty | 2.1% | REITs | 15.7% | EM Equity | 53.9% | Cash | 0.1% | Cash | 0.1% | EM Equity | 18.2% | Comdty | 0.0% | Comdty | -0.9% | Comdty | -7.0% | Comdty | -2.4% | Cash | 0.3% | Cash | 0.8% | EM Equity | 14.0% | Cash | 2.2% | Cash | -19.4% | Comdty | -2.6% | Cash | 1.0% 

WisdomTree 2020 MID-YEAR MARKET OUTLOOK

A concept that some investors may be less familiar with is that risk factors, just like asset classes, also rotate in and out of favor:

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A core investment tenet at WisdomTree is that by maintaining both asset class and risk factor diversification, advisors and investors have the potential to achieve a more consistent performance profile over time—something we believe will be increasingly important for today’s environment.

**CONCLUSION**

To summarize our overall team’s positioning, we are relatively optimistic on the trajectory of the virus and the reopening of our global economy. We believe we will have a strong economy going into 2021, and we are over-weight risk assets both in equities and bonds.

At the moment, the virus trumps all when it comes to the short-term direction of global risk markets, but there is no shortage of additional geopolitical risk factors also present. We expect a much more volatile environment than we’ve experienced prior to 2020, and investors should strive for strategy, geography and style diversification to manage through this higher volatility environment.

10 Volatility: A measure of the dispersion of actual returns around a particular average level.
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