U.S. & EUROPEAN FLOWS: POTENTIAL OPPORTUNITY IN EUROPEAN DEBT?

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While the U.S. remains the global leader in terms of exchange-traded fund (ETF) assets under management[1], the market for European exchange-traded products (ETPs) is continuing to grow at an impressive rate. In discussions with our clients, we often notice their interest in hearing where WisdomTree or the industry is seeing inflows in order to gain new ideas for investment. As the market for global exchange-traded products continues to evolve, we believe that investors will increasingly look to global ETP flows for investment ideas. **Foreign Stocks & Domestic Bonds** Even though the U.S. market is still approximately four times as large as the European market, the trends in flows appear to be quite similar.[2] In both markets, investors appear to have an interest in increasing allocations to international equities while at the same time increasing holdings in their respective domestic bond markets. While this is not entirely surprising, it is interesting that the overwhelming flow leaders in the U.S. are into European equities, whereas Europeans favor opportunities in U.S. equities. From WisdomTree's perspective, we have seen over $1 billion of flows into each of the Europe Hedged Equity Fund (HEDJ) and the Europe SmallCap Dividend Fund (DFE) year-to-date.[3] While equity flows tend to garner the bulk of the headlines, we believe the more interesting development is in what investors are doing with their fixed income allocations. When speaking with investment advisors and professionals, it appears they still harbor an overwhelming preference toward local markets for the bulk of their fixed income portfolios. The most common refrain is that they purchase bond funds as a way to dampen the volatility of their equity positions and generate income. Since foreign fixed income often involves currency risk (and volatility), investors tend to hold a larger percentage of their portfolios in fixed income denominated in their home currency. However, in the current market environment, we believe U.S. investors should consider increasing allocations to European debt to complement their positions in European equities. As one potential way of managing volatility, this view is primarily predicated on the current outlook for inflation and the coming divergence in central bank policy between the Federal Reserve (Fed) and the European Central Bank (ECB). **ECB Enters, Fed Exits** In previous blog posts, we explained the divergence in monetary policy for the ECB and the Fed. Should the Fed continue its current pace of tapering, it could conclude its bond purchase program on October 29. Interestingly, while the ECB has provided only a rough outline and no direct timeline for asset purchases, the potential remains that the ECB could begin its own asset purchase program as early as the end of this year. Regardless of any future ECB actions, we know for sure that the recently announced targeted longer-term refinancing operations(TLTROs) are set to be in effect through September 2018, helping to increase liquidity in the banking system and European capital markets for the next four years.[4] With more money in the system, we believe this could provide support for greater levels of investment, ultimately resulting in higher asset prices. While a great deal of uncertainty remains around the timing of these programs, a simple conclusion is that there could eventually be a divergence in monetary policy between the U.S. and Europe. The forecasted result of this divergence will likely lead to an increase in interest rates in the U.S., whereas rates in Europe could remain near

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current levels or even fall. For bond investors, rising rates in the U.S. should have a negative impact on the performance of U.S. fixed income positions. With rates staying constant or falling in Europe, this would result in higher bond prices for European fixed income. **Risk/Return Trade-Off: Currency versus Interest Rate Risk** While we only briefly discussed the fixed income asset allocation decision above, it is worth having a discussion about currency risk in European fixed income. Unlike a U.S. dollar-denominated fixed income investment, broad-based European fixed income funds such as the WisdomTree Euro Debt Fund (EU) provide exposure not only to European interest rates but to the value of the euro as well. While we believe that a long-term consequence of rising rates in the U.S. will be a strengthening of the U.S. dollar against the euro, currency exchange rates are determined by many more factors than just interest rate differentials. As a result, the primary reason we believe European bonds could offer value relative to U.S. fixed income is because we believe that losses from rising U.S. interest rates could exceed losses caused by a depreciation in the value of the euro in the near-term. In sum, ETF flows can be a valuable indicator for investors to quantify which segments of the market are attracting assets. In the current environment, many U.S. investors see value in European markets. Going forward, European fixed income may provide greater potential for total returns as central bank policies between Europe and the U.S. diverge. [1]Source: Bloomberg, as of 5/31/14. [2]Source: Bloomberg, as of 5/31/14. [3]Source: WisdomTree, as of 5/31/14. [4]Source: ECB, 6/5/14.

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DEFINITIONS

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

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Targeted longer-term refinancing operations (TLTRO II) : a periodic open market operation executed via tender offers which mature in June 2020.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.