
HOW TO COUNTER PESSIMISM ON EUROPEAN EQUITIES

Christopher Gannatti – Global Head of Research
04/05/2017

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.

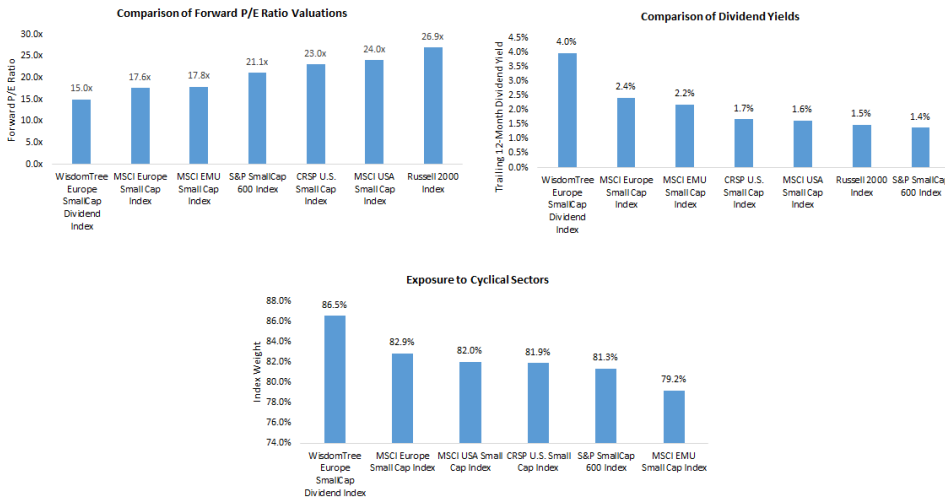
Of course, this reflects an aversion of the “worst-case” scenario on the Netherlands election, but the risk in the much more widely discussed French election is still not behind us. There can be little question that the continuation of this trend will be related to the ultimate result not going in the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

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

DEFINITIONS

STOXX Europe 600 Index : The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

FTSE 100 Index : A market capitalization-weighted index measuring the performance of the 100 largest companies listed on the London Stock Exchange.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Effective tax rate : The average tax rate at which a corporation's pre-tax profits are taxed, taking into account all forms of taxation paid by the company.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.