EUROPE'S EARNINGS CYCLE JUST GETTING STARTED

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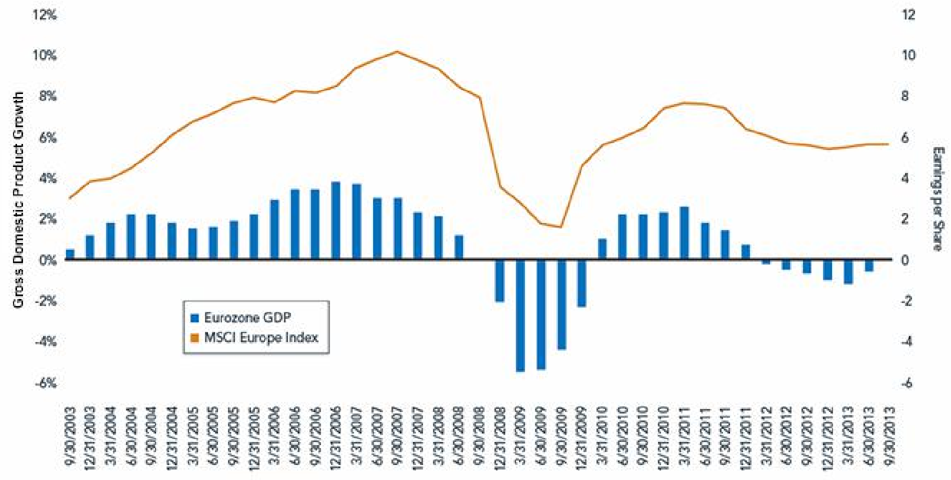
Europe's economy experienced six straight quarters of negative economic growth—or contraction—before returning to a positive growth rate—or expansion—in the second quarter of 2013. The recovery in Europe has been supported by accommodative [monetary policy](), low [inflation]() and a moderation in fiscal [austerity](). Consumer spending has improved and manufacturing surveys are pointing toward expansion. This stabilization of the European economy is encouraging, and many have begun to look for investment opportunities emanating from this nascent recovery. **Early Stages of Economic and Earnings Recovery** One reason to have a positive view on European equities is that the current stage of the economic cycle—being very early in the economic recovery—may imply the earnings cycle is about to also shift into a higher gear. We graphed year-over-year growth in the economy against the MSCI Europe Index earnings per share to highlight how Europe's earnings have responded to growth or contraction in the economy over the last 10 years. The picture shows a tight correspondence of earnings levels with growth and contraction in the economy. **Figure 1: Eurozone Economic Growth and Earnings Growth for MSCI Europe Index**



Sources: WisdomTree, Bloomberg. (9/30/03–9/30/13). You cannot invest directly in an index. Past performance is not indicative of future results.

• **Earnings Cycle Just Getting Started** – It is important to remember that Europe's economy is just starting to show signs of growth, and this recovery has not shown up in the earnings of corporations yet—at least on a trailing 12-month basis. Generally speaking, if an index has a lower estimated price-to-earnings (P/E) ratio compared to its trailing P/E ratio, the forecast is calling for earnings growth. This pickup in earnings expectations for the MSCI Europe Index can be witnessed in the difference between the estimated and trailing 12-month P/E ratios of 19.6x and 14.6x, respectively. But trailing 12-month earnings for MSCI Europe would have to grow approximately 80% to reach the highs of 2007, and grow around 35% to reach the most recent highs of 2011. Putting this in perspective, both the S&P 500 and MSCI Emerging Market indexes have already surpassed their pre-recession earnings highs. • **Economic Growth Expected to Turn Positive** –

The most recent quarter-over-quarter gross domestic product (GDP) print was positive 0.3%, and it marked the first positive growth in six quarters, but the year-over-year change was still negative 0.6%[1]. Since the second-quarter GDP reading, there have been improvements in the Purchasing Managers' Index (PMI), with multiple readings above 50, typically a sign of economic expansion. As a result, many economists are forecasting the eurozone to return to positive economic growth early next year. A positive economic growth environment could be expected to flow through to better growth in earnings. **Small Caps for Recovery** If one believes Europe is recovering, I'd encourage a look at small-cap companies, which are more sensitive to trends in the economy because of their cyclical exposure and are typically more highly leveraged to economic growth. In other words, small caps often have higher beta—or market reactions—to both the ups and downs in the markets. As I previously wrote here, European small caps have outpaced large caps year-to-date, and some of the outperformance can be attributed to a stronger euro hurting the large-cap exporters. Small caps are more domestically sensitive, deriving more of their revenues from a particular region than their large-cap compatriots, which allows them to sidestep the drawbacks of the currency strength. WisdomTree has designed the WisdomTree Europe SmallCap Dividend Index to focus solely on small-cap dividend-paying equities in Europe. To learn more, click here. *Read the full research here.* [1]As of 06/30/2013.

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You cannot invest directly in an index.

DEFINITIONS

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Inflation : Characterized by rising price levels.

Austerity : Policies used by governments to reduce budget deficits during adverse economic conditions.

MSCI Europe Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Trailing 12-month earnings : is the sum of a company's earnings for the previous 12 month.

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.

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.

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

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 while 50 indicates no change.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.