MARIO DRAGHI: TURKEY'S HELPER?

Jeff Weniger – Head of Equity Strategy
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This is Part 2 of a two-part series on Turkey's crisis and the implications for Europe. In Part One, Getting More Defensive in European Portfolios, we identified the WisdomTree Germany Hedged Equity Fund (DXGE) and the WisdomTree Europe Hedged Equity Fund (HEDJ) as two ETFs that may help minimize European financial sector risk, specific bank risk from the four institutions that hold Turkish debt in size, and currency risk.

Erdogan's Luck

Turkey's President, Recep Tayyip Erdogan, may find a four-leaf clover in the form of an implicit bailout from European Central Bank (ECB) president Mario Draghi.

According to the Bank for International Settlements, Spanish, French and Italian banks own \$83.3bn, \$38.4bn and \$17bn of Turkish paper.[1] The banks with exposure include ING (Netherlands), BBVA (Spain), BNP Paribas (France) and UniCredit (Italy). In looking at the latter four eurozone banks, we found WisdomTree ETFs tracking European stocks all have lower exposure to them than MSCI EMU (European Monetary Union), with some of our European funds holding none of those 4 banks at all.

Refugees as a Political Weapon

Our minds are on the 3.5 million Syrian refugees in Turkey. Erdogan can gain leverage on Europe by threatening to send them westward, which would increase voter support for hardline immigration hawks such as Matteo Salvini, the nativist power broker in Italy. Draghi, a Europhile, knows that an exacerbation of the migrant crisis threatens the European Project.

Using the refugees for negotiating leverage, Erdogan can demand debt haircuts. If so, that would seemingly come hand-in-hand with Draghi attempting to push the euro down to help European competitiveness amid bank balance sheet headline risk. Remember, all four banks in question were hanging by a string during the Lehman and Greek crises.

In other words, we think Draghi is going to surprise the market not by being "hawkish," as some are predicting, but by doing the opposite: being dovish, bringing pain to long euro bets while maybe even pleasantly surprising European equities.

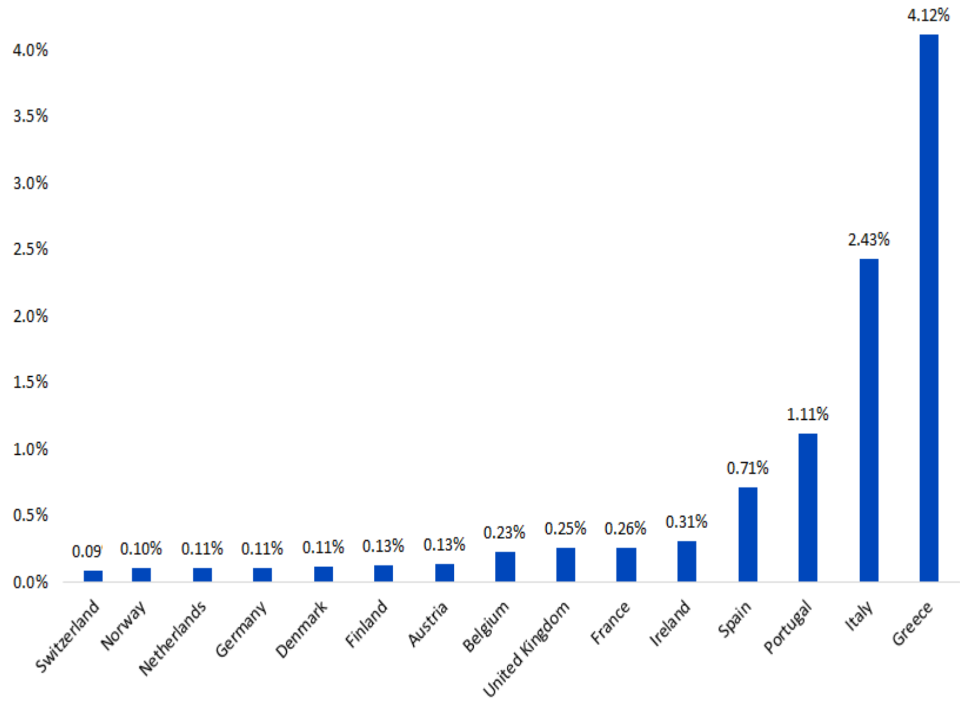
How That Happens

The ECB currently is on pace to end its €30 billion-per-month bond purchase program (which used to be €60 billion) in just a few months. The Wall Street consensus is that there is a 1-in-3 chance that the central bank will hike its policy rate in 2019's second half. We think the probability is lower.

Figure 1 shows the pecking order of national risk in Europe using five-year credit default swaps (CDS). The safe domiciles in northern Europe are priced as low as .09%, meaning that it costs about $9,000 per year to insure against default of $10 million of government bonds. In contrast, CDS for riskier Italy would be $242,000 per year for $10 million of sovereign bonds.

Of the banks that are on the radar—ING, BNP Paribas, BBVA and UniCredit—two are in the big-risk countries (Spain and Italy).

Figure 1: Five-Year Credit Default Swaps, Sovereign Debt, USD



Sources: WisdomTree, Bloomberg, as of 8/17/18. Past performance is not indicative of future results.

Figure 2 shows the country exposures of the seven WisdomTree European equity Indexes that have ETFs tracking them, along with the MSCI EMU Index. At the bottom is the weighted-average CDS prices of the component nations. The equity Indexes that are tracked by DXGE, EUDG (the WisdomTree Europe Quality Dividend Growth Fund) and HEDJ currently have low weighted-average CDS prices of 0.11%, 0.25% and 0.30%, respectively. For comparison, the weighted-average CDS prices for nations in the MSCI EMU Index are a riskier 0.41%.

Figure 2: European Equity Country Weights + Weighted-Average 5-Year CDS Prices

Country	WisdomTree Germany Hedged Equity Index (ETF = DXGE)	WisdomTree Europe Quality Dividend Growth Index (ETF = EUDG)	WisdomTree Europe Hedged Equity Index (ETF = HEDJ)	MSCI EMU Index	WisdomTree Europe SmallCap Dividend Index (ETF = DFE)	WisdomTree Dynamic Currency Hedged Europe Equity Index (ETF = DDEZ)	WisdomTree Europe Domestic Economy Index (ETF = EDOM)	WisdomTree Europe Hedged SmallCap Equity Index (ETF = EUSC)
Austria	--	1.0%	0.6%		0.8%	1.4%	3.6%	5.3%
Belgium	--	0.7%	8.0%		2.1%	6.5%	4.4%	5.0%
Denmark	--	7.2%	--		3.1%	--	--	--
Finland	--	3.4%	4.7%		4.9%	4.8%	5.3%	10.2%
France	--	7.7%	25.1%	33.7%	5.8%	25.0%	24.8%	15.6%
Germany	100.0%	7.5%	24.1%	29.4%	7.8%	24.5%	21.8%	16.0%
Greece	--	--	--		--	--	--	--
Ireland	--	0.9%	1.3%		1.0%	1.1%	2.7%	1.0%
Italy	--	2.2%	1.7%	7.4%	11.1%	11.4%	16.9%	24.1%
Netherlands	--	10.3%	17.3%	11.0%	4.9%	9.9%	7.7%	8.1%
Norway	--	4.2%	--		6.3%	0.0%	--	--
Portugal	--	0.8%	0.8%		3.1%	1.3%	1.6%	3.4%
Spain	--	5.8%	16.5%	9.4%	5.8%	14.1%	11.3%	11.3%
Sweden	--	7.3%	--		13.5%	--	--	--
Switzerland	--	15.4%	--		3.1%	--	--	--
United Kingdom	--	25.8%	--		26.7%	--	--	--
Other	--	--	--	9.3%	--	--	--	--
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Weighted Average Credit Default Swaps*	0.11%	0.25%	0.30%	0.41%	0.48%	0.52%	0.63%	0.80%

Sources: WisdomTree, as of 6/30/18; MSCI, as of 7/31/18. At the time of writing, WisdomTree's country databases were current through June, while MSCI's publicly available information was updated through July. ETF sector weights may differ slightly from index-level weights. Subject to change. CDS takes the weighted average of each component nation's five-year USD CDS. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein. Additional Index information is available at www.wisdomtree.com.

Our Solutions

Of the seven WisdomTree ETFs for Europe (above), the ones with no exposure to the four banks are: **EUDG** (European quality dividend growth), **DXGE** (Germany, currency-hedged), WisdomTree Europe Hedged SmallCap Equity Fund (EUSC) and one we haven't mentioned yet, the WisdomTree Europe SmallCap Dividend Fund (DFE). The MSCI EMU Index currently has more exposure to the four risky banks than every one of our ETFs, not just these ones.

The WisdomTree ETFs that have lower Financials sector weights than MSCI EMU are: **EUDG** (European quality dividend growth), **DXGE** (Germany, currency hedged) and **HEDJ** (exporters, currency hedged).

The lowest country risk ETFs as gauged by sovereign credit default swaps are: **DXGE** (Germany, currency hedged), **EUDG** (multifactor) and **HEDJ** (exporters, currency hedged).

[1]Source: Silvia Amara, "If Turkey Implodes, Here's Who Else Gets Hurt," CNBC, 8/10/18.

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DEFINITIONS

MSCI EMU Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Credit Default Swap : A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.