WHAT ARE GLOBAL SMALL CAPS TELLING US ABOUT THE MARKET'S RECENT PULLBACK?

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One of the nice things about watching the exchange-traded fund (ETF) industry every day is that you get to see how the universe of ETF users reacts to changing market conditions. That collective response usually takes the form of aggregated net inflows into or outflows from defined asset classes, which ETFs track pretty precisely. Through February 5, 2014, more than $20 billion had flowed out of ETFs year-to-date, as investors took cover during a sharp market pullback. What categories did the money flow out of? U.S. large-, mid- and small caps, emerging market equity and the more sensitive and cyclical sectors of the S&P 500 ranked within the top categories for redemptions. But the more interesting question is, what were investors buying? Billions flowed into U.S. Treasury ETFs of both intermediate- and longer-term durations. No surprise there. What may surprise some is that, despite the global sell-off in stocks, on a year-to-date basis billions in new inflows still remained in ETFs that provide exposure to the European and U.K. equity markets. On Thursday, February 6, 2014, the European Central Bank (ECB) and the Bank of England (BOE) gave European investors a reason to cheer: both central banks left their already low interest rates unchanged. Whereas inflation in the U.K. is running at 2%, inflation in Europe is running below 1%, less than half the ECB's target. With unemployment for the euro region estimated at 12%, and economic recovery just beginning to kindle on the continent, the ECB said in a written statement that its key interest rates would "remain at present or lower levels for an extended period of time." If the inflation rate continues to trend toward zero, it's possible that the ECB could entertain ever more creative forms of monetary easing, including U.S. and Japan-style quantitative easing. Europe needs both faster economic growth and some measure of inflation, in part so that the region's heavily indebted governments to the south have some way of growing out of, or inflating away, their sovereign debt burden. European and U.K. equity markets rallied on the interest rate news, although major equity indexes in Europe still remain well below their 2007 peaks. One of the reasons I'm optimistic that global equity markets will rally from these levels is that if investors were really worried about the global economy heading into recession, we would probably have seen small-cap stocks decline more than large-cap stocks around the world over the past three weeks. That happened in the U.S.—probably because small caps, after a huge 2013, were a juicy target for profit taking. But it did not happen in Europe, Japan or the rest of the developed and emerging world. In all of those regions, broad-based small-cap indexes held up better than large-caps during the sell-off. That may be a signal that global reflation and recovery lie ahead—not deflation and recession. The chart below shows that the WisdomTree Europe SmallCap Dividend Index actually posted positive gains through February 5, whereas both the S&P Europe 350 Index and the MSCI EMU Index (both predominately large cap) posted declines.

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Source: Bloomberg, as of 2/5/14. You cannot invest directly in an index. Past performance is not indicative of future results.

Read more on European Small Caps here.

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DEFINITIONS

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.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund’s weight.

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

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

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.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.

WisdomTree Europe SmallCap Dividend Index : A fundamentally weighted index meant to measure the performance of small-cap European dividend-paying equities weighted by cash dividends paid.

S&P Europe 350 Index : A float adjusted market capitalization-weighted measure of the performance of large cap equities within European markets.

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