POTENTIAL HEADWINDS FOR EUROPEAN FINANCIALS

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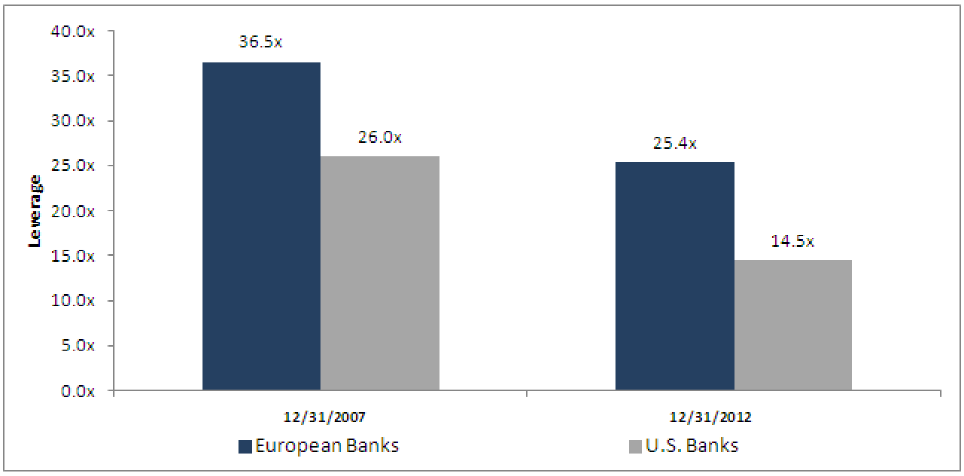
Talks of a European banking crisis have subsided. The U.S. equity markets are hitting new highs, and European bond yields from peripheral countries are starting to come down from their highs. Italy's 10-year bond yield is 3.89% (down from a high of 7.26%), while Spain's is 4.20%, down from a high of 7.62%.[1] Yet there may be some key headwinds ahead for European banks: the ongoing recession in Europe that could put pressure on loan losses in an environment where the banks may need to raise significant amounts of capital. **Banks Still Writing Off Bad Loans** The Cyprus banking situation was one recent example. Cypriot banks had a large share of their assets invested in Greek bonds that took steep [haircuts](#) in value. As a result, those assets eventually had to be written down and could not cover the banks' liabilities, and not all depositors were made whole on their savings. This was the case of a supposedly safe asset—sovereign bonds—that took a 75% haircut in value. What about other assets on balance sheets in the "less safe" part of the asset spectrum? Slovenia's banking system may be the next poster child for these types of banking issues. Some are speculating that Slovenian banks will need about 20% of the country's current Gross Domestic Product (GDP) as a result of bad loans that have soured with the European recession. A housing bust, coupled with a lack of due diligence and relaxed credit standards, has resulted in numerous bad loans. Some estimate that non-performing loans may exceed 30%. With the unemployment rate for Slovenia currently at 13.6%[2] and the economy still struggling through a recession, there is speculation the loan situation could deteriorate further. If the European Central Bank (ECB) is forced to provide assistance to Slovenia, will it require depositors to take haircuts? The precedent was set with Cyprus, when the country forced uninsured depositors to share some of the losses. If uninsured depositors are required to take losses in Slovenia as well, it could again raise questions about the quality of assets at many of the peripheral-country banks. These stories are important—not because of the size of the banks or their economy (both are quite small in relation to the broader eurozone), but rather because they call into question the quality of current bank assets in Europe. They constantly force one to ask, what is the next shoe to drop? **European Banks Have Higher Leverage** One thing appears to be clear: Many European banks still exhibit high degrees of leverage. This leverage will need to come down over time, and the process will dilute current equity shareholders. Deutsche Bank recently announced it was raising approximately 6.5 billion dollars of capital, just a few months after its CEO had proclaimed that the bank did not need to raise more capital and that doing so would be bad for shareholders. Recently, the Bank of England urged British banks to raise more capital, and some at the U.S. Federal Reserve have argued for a stricter cap on bank leverage. Given the leverage ratios we're still seeing, we believe more of these capital raises may be forthcoming. European banks are still operating in a slow-growth, recessionary environment with high leverage and potentially poor asset quality. They are likely to face serious headwinds, as they might be forced to increase their equity capital and potentially dilute their existing shareholders. Consider that leverage of the European banking system today looks very much like that of the U.S. banks before our financial crisis.

Figure 1: Bank leverage ratios



Source: Bloomberg

• **Five Years Ago (as of 12/31/2007):** The five largest banks[3] in the European Monetary Union (EMU) had average leverage of nearly 37x—meaning that assets on their balance sheets were approximately 37 times the size of the level of their equity. The five largest U.S. banks[4] were also high at this point in time, with asset levels that were 26 times the size of their equity.

• **Most Recent Year-End (as of 12/31/2012):** In both the EMU and the U.S., the largest banks have taken down their levels of leverage, to a degree. However, where the U.S. banks have cut their leverage nearly in half from the levels seen five years ago, EMU banks still have asset levels more than 25 times the size of their equity—in other words, much higher than their U.S. counterparts.

Mitigating the Financials Risk The greatest potential opportunities are often found when conditions are least certain. Not all banks are the same, and it is possible that certain European banks might add value to a portfolio if one can mitigate the risks. To be sure, U.S. banks look to be in a stronger capital position than European banks, given their lower leverage ratios. WisdomTree has devised two Indexes to measure the performance of equities, which we believe ultimately mitigate the risk of a Financials sector exposure in Europe:

• **WisdomTree International Dividend ex-Financials Index**: This Index focuses on dividend-paying companies within developed international equity markets, specifically excluding the Financials sector. As of 3/31/2012, there was an approximately 65%–70% exposure to European equities, but to be fair, this Index is not purely focused on firms incorporated in European countries. To learn more about this Index, please see the Index details.

• **WisdomTree Europe Hedged Equity Index**: This Index focuses on the exporters of Europe, which tends to mean greater weights in Consumer Staples, Consumer Discretionary and Industrials companies and less on Financials (which are a large under-weight compared to standard European benchmarks[5]). We believe hedging the euro also provides a lower volatility approach to this region, as we wrote here. To learn more about this index, please see the Index details.

Take the euro out of Europe (Video)

[1]Source: Bloomberg; current yields as of 05/10/13, high for Italy 11/25/11, high for Spain 07/24/12. [2]Source: Bloomberg; as of February 2013. [3]Refers to the five largest banks by market capitalization included in the MSCI EMU Index equity universe. [4]Refers to the five largest banks by market capitalization included in the S&P 500 Index. [5]As of 3/31/2013, the MSCI EMU Index had an approximately 20% weight to Financials, whereas the WisdomTree Europe Hedged Equity Index had an approximate weight to financials of 7% as of the same date.

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WisdomTree International Dividend ex-Financials Index : Measures the performance of high dividend-yielding stocks outside the financial sector. Selects the 10 largest dividend-paying stocks within each sector outside of financials, then the resulting list is weighted by dividend yield.

WisdomTree Europe Hedged Equity Index : Index designed to provide exposure to European equities while at the same time neutralizing exposure to fluctuations between the Euro and the U.S. dollar. Constituents are European dividend-paying firms with a least 50% of their revenues from outside of Europe. Weighting is by cash dividends paid.

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

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.