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**WisdomTree**

**ON THE MARKETS**

**2016 OUTLOOK:**  
WISDOMTREE ROUNDTABLE DISCUSSION

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## 2016 Outlook: WisdomTree Roundtable Discussion

WisdomTree operates 86 exchange-traded funds as of December 31, 2015, listed in the United States, providing exposure to equity, currency and bond markets in more than 40 countries.

WisdomTree's Chief Investment Strategist, Luciano Siracusano (L.S.); its Director of Research, Jeremy Schwartz (J.S.); and its Head of Fixed Income and Currency, Rick Harper (R.H.) sat down in mid-December to reflect on 2015 and discuss the forces that could impact global financial markets in 2016.

### **LUCIANO SIRACUSANO (L.S.),** Chief Investment Strategist



Luciano Siracusano is WisdomTree's Chief Investment Strategist. He is the co-creator, with CEO Jonathan Steinberg, of WisdomTree's patented Indexing methodology. Mr. Siracusano led WisdomTree's sales organization from October 2008 until June of 2015, while also serving as the firm's Chief Investment Strategist. Luciano stepped down as WisdomTree's Head of Sales in 2015 to focus full time on his duties as Chief Investment Strategist. From 2001 until October 2008, Luciano was WisdomTree's Director of Research and was responsible for the creation and development of WisdomTree's proprietary stock indexes. Luciano is a regular guest on CNBC and FOX Business, and speaks and writes frequently on ETFs, indexing and global financial markets. A former equity analyst at Value Line, Luciano began his career as a speechwriter for former New York Governor Mario Cuomo and HUD Secretary Henry Cisneros. He graduated from Columbia University with a B.A. in Political Science in 1987.

### **JEREMY SCHWARTZ (J.S.),** Director of Research



As Director of Research, Jeremy Schwartz is responsible for the WisdomTree Equity Index construction process and oversees research across the WisdomTree equity family. Prior to joining WisdomTree, Jeremy was Professor Jeremy Siegel's head research assistant and helped with the research and writing of *Stocks for the Long Run* and *The Future for Investors*. He is also the coauthor of the Financial Analysts Journal paper "What Happened to the Original Stocks in the S&P 500?" and the Wall Street Journal article "The Great American Bond Bubble." Jeremy is a graduate of The Wharton School at the University of Pennsylvania and a member of the CFA Society of Philadelphia.

### **RICK HARPER (R.H.),** Head of Fixed Income and Currency



Rick Harper serves as the Head of Fixed Income and Currency for WisdomTree Asset Management, where he oversees fixed income and currency products developed through our collaborations with the Mellon Capital Management and Western Asset Management. Rick has over 19 years investment experience in strategy and portfolio management positions at prominent investment firms. Prior to joining WisdomTree in 2007, Rick held senior-level strategist roles with RBC Dain Rauscher, Bank One Capital Markets, ETF Advisors and Nuveen Investments. At ETF Advisors, he was also the portfolio manager for some of the early fixed income exchange-traded funds. His research has been featured in leading periodicals, including the *Journal of Portfolio Management* and the *Journal of Indexes*. He is a graduate of Emory University and earned his MBA at Indiana University.

## 2016 MARKET OUTLOOK

**Q:** What did we get right in 2015? What did we get wrong? What surprised you?

**J.S.** One of our calls going into 2015 was that Japan would outperform global equity markets, and we reflected this with an over-weight position in equity model portfolios toward Japan, particularly on a currency-hedged basis, because we thought the Bank of Japan (BOJ) would take further action and we would see the yen weaken more. While Japan did outperform global markets on the back of robust earnings growth and continued allocations from local pension funds, we were surprised the BOJ kept its monetary policy unchanged in 2015. Our CEO of WisdomTree Japan, Jesper Koll, also felt we would see further easing in either the October or November meetings. We still believe the BOJ will eventually add to their stimulus package, but that it is now being delayed potentially until the April or June time frame.

The strength in the U.S. dollar has been one of the major themes of 2015, which is something we have been discussing all year and also a trend we will continue to see at work in 2016. One thing that is surprising given the strength in the U.S. dollar is how large caps outperformed both mid- and small caps, despite the more multinational nature of large-cap indexes that have more global business impacted by the U.S. dollar. The U.S. dollar was one of the two factors—including oil price declines—that caused the earnings on the S&P 500 Index to decline by about 6% in 2015. We might see further pressure on multinational earnings next year if the dollar continues its gain, and this would potentially be a relative favorable argument for mid- and small caps.

**L.S.** A year ago, I said the Federal Reserve (Fed) would wait until late in the year to raise rates and that the euro would decline, so I got those two right. I was wrong on oil. I thought the stronger dollar would be a headwind for U.S. multinationals and that the appreciating greenback, combined with a slowing economy in China, would take a toll on the currencies of the commodity-exporting countries, particularly in emerging markets (EM). Korea, India, China and Taiwan did manage to hold up better than the broader emerging world. But again, relative gains are not the same as absolute gains. We were right to tilt toward Japan and Europe, and I was pleased that we increased weight to European small caps in our asset allocation models earlier in the year. As it was the small caps outside, not inside, the U.S.—in Europe and Japan—that produced some of the year's best returns.

**R.H.** Our highest conviction call—the continued strengthening of the U.S. dollar—also proved to be our most prescient. The U.S. dollar rose 9.0% against a broad basket of currencies over the course of the year. In fact, among 50 global currencies, only two managed to appreciate against the U.S. dollar in 2015 (Hong Kong dollar and Israeli shekel). Broad-based dollar strength was primarily driven by rotating periods of strength against the euro and yen, currencies of developed market commodity producers and those of EMs. As a result, positions directly benefitting from a stronger dollar and currency hedging continued to add value to U.S.-based investor portfolios.

In our 2015 outlook, we had anticipated that domestic growth could be poised to improve and conditions abroad to be more supportive of a series of rate hikes by the Fed. Domestic expectations cooled very quickly as a winter freeze gripped the Northeast in the first quarter. Concerns about global growth came to a head in August when the Chinese government sparked a global market selloff by abruptly weakening the Chinese yuan. Historically, the yuan has generally been a low-volatility<sup>1</sup> currency. While the magnitude of the devaluation was minor when compared to other EM currencies, it struck many forecasters as atypical for Beijing. In response, global markets swooned on fears that the situation in China (and the global economy) was much worse than many believed.

**Q: What's your outlook for the U.S. and the global economy in 2016? Let's start with the U.S. and go from there. What is your take on where we are right now?**

**L.S.** On the U.S. front, I believe the economy will muddle ahead at a 2% to 2.5% annual clip. The strong dollar will likely constrain net export growth, and weak capex spending means business investment, depressed by a contracting Energy sector, is likely to remain tepid. Recent gains in the housing market have the potential to offset the hit to gross domestic product<sup>2</sup> (GDP) from net exports, and though manufacturing is likely to remain weak, it represents just 12% of the economy. So I think it's the consumer and the service sector that will propel us forward. With gas prices now less than \$2 a gallon, with a savings rate at 5.6% and with 2 million more people working than a year ago, the 70% of the economy that is driven by consumer spending should remain strong in 2016. With short-term interest rates likely to rise in 2016, seniors and those who have invested several trillions in bank and money market accounts will finally get a raise on their savings. That additional investment income will create some additional demand and could potentially help reduce the savings rate, which would also fuel consumer spending. In aggregate, personal income is up about 4% over the past year. After five years of deleveraging their balance sheets, households are borrowing again (household debt to GDP is scaling back up to 79% of GDP). All of this should support consumer spending to continue growing at a 3% clip, which is why I believe the U.S. economy will be one of the faster growing economies in the developed world—which doesn't say much for global growth in 2016.

**J.S.** The U.S. economy appears to be the strongest in the developed world, and the U.S. had the first central bank in the developed world to start removing its extraordinary monetary policy accommodation.

We are seeing positive signs in the European economy from forward-looking economic indicators like money supply growth and some of the sentiment indicators we track, and the European Central Bank (ECB) added to its stimulus program in December, which should provide continued support for its recovery. We have seen European strength in the domestic-focused businesses in 2015, as there was weakness in EMs that hurt some of the exporters of Europe.

<sup>1</sup> Volatility: A measure of the dispersion of actual returns around a particular average level.

<sup>2</sup> Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

**R.H.** Looking ahead to 2016, uncertainty remains elevated, volatility has increased and expectations for global growth remain subdued. Small surprises to the upside could resonate more given the high levels of pessimism. The pace of job gains could slow as we near full employment, but wage pressures may continue to build from low levels. As a result, both realized inflation and inflation expectations could tick higher from very low levels in 2016. This mix of modest U.S. growth and low inflation point to continued durability in the “just so” recovery as it enters its seventh year. Investors should also keep in mind that economic expansions characterized by low inflation tend to last considerably longer than those with higher levels and greater variability in inflation.

In my view, the key threats to the U.S. economy remain global in nature. Uncertainty in the pace of China’s economic growth has significantly impacted global demand for commodities and finished goods. While the Chinese government has stepped up stimulus, global economic participants still greet each economic report from China with a great deal of trepidation. Europe continues to show signs of recovery, but little progress has been made on lifting inflation expectations. We anticipate that additional injections of extraordinary stimulus from Europe and Japan and easier monetary policy from China will keep the global monetary accommodation high even as the Fed begins the slow move off of a zero interest rate policy.

**Q:** **The Fed announced on December 16 a 25-basis-point increase in the Federal Funds Rate to a new target range of 25 to 50 basis points. Where do you see the 10-Year Treasury yield at the end of 2016? Where do you think the Fed Funds Rate ends in 2016?**

**R.H.** The Fed increased the Federal Funds Rate<sup>3</sup> for the first time in nine years. In the announcement, the Fed sought to emphasize its intention to “gradually” normalize short rates from the level of emergency accommodation that has been in place since the financial crisis. The short end of the U.S. yield curve will be driven by the market’s perception of the pace of Fed tightening this year. The market is currently pricing two additional hikes for 2016, whereas the Fed still anticipates that four will be necessary. My assessment is they are likely to end in the middle, lifting the rate corridor to 1.00% to 1.25% with three hikes. However, a breakout rise in the dollar could do some of the tightening for the Fed. With coupon<sup>4</sup> levels very low, the quicker pace could generate losses for short maturity bonds. We anticipate the 2-Year Treasury note to hit 1.75% by the end of next year.

Yields on longer-term Treasuries are also likely to rise over the course of the year as inflation expectations tick higher and investors start to demand additional compensation for bearing interest rate risk. We anticipate 10-Year Treasuries to rise to 2.75% over the course of the year, roughly 25 basis points<sup>5</sup> (bps) above forwards and in line with Wall Street consensus estimates. It is unlikely to be a steady climb,

<sup>3</sup> Federal Funds Rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

<sup>4</sup> Coupon: The annual interest rate stated on a bond when it’s issued. The coupon is typically paid semiannually. This is also referred to as the “coupon rate” or “coupon percent rate.”

<sup>5</sup> Basis point: 1/100th of 1 percent.

however, as structural pressures exist for both sides of the curve. Reduced Treasury supply, low relative global rates and low inflation levels provide resistance to a sudden rise in yields. However, an uptick in inflation as well as potential selling pressure by EM central banks could boost Treasury yields. Tactical opportunities to add and reduce duration are likely to materialize, but over the course of the year, we think investors will be rewarded for reducing exposure to interest rate risk. Short rates are likely to lead, but long rates will also rise, generating a bear-flattening move in the yield curve.

**L.S.** The Federal Open Market Committee<sup>6</sup> (FOMC) stressed the gradual nature of future rate hikes, so my best guess is the FOMC only does two hikes in 2016, and we end with a Fed Funds Rate somewhere between 75 bps and 1.00% in 2016. I think the Fed will continue to hold a view that the major domestic and international risks are to the downside—deflation over inflation, recession over stronger growth. I don't think they get above 2% until the unemployment rate breaches 4%, which may not come until 2018. At that point, I think the Fed risks inverting the curve and tipping us into recession. I reserve the right to re-evaluate that as more data becomes available in 2017 and after we get presidential election returns in November.

**Q:** **The U.S. dollar had another great year versus foreign currencies. What are your thoughts on where the dollar goes from here?**

**J.S.** I would expect continued gains in the U.S. dollar. WisdomTree recently partnered with a currency manager to create dynamically hedged currency strategies that look at three factors to target profitable currency hedges and avoid unprofitable ones: interest rates (more specifically the difference in short-term interest rates in each country), momentum (trends in currencies) and value (based on a fair value model for the currency). The first of these two signals—interest rates and momentum—are rather unambiguous.

Interest rate differentials<sup>7</sup>: The Fed just hiked interest rates while the ECB made its deposit rate more negative. For Europe and Japan in particular, the rate differential model would suggest further dollar strength and advocate for hedged positions in international equity allocations.

Momentum: Relative to all the currencies other than the yen in the MSCI EAFE complex, the momentum models are suggesting further strength in the U.S. dollar and advocate for hedged positions in international equity allocations.

The value model is more complex. The U.S. dollar, on some value models, looks slightly overvalued, and our model would suggest only 50% hedging in our framework most of the developed world currencies, besides for the Swiss franc (CHF), which we would advocate full hedging. While the value signal has long-term implications, in past dollar rallies the U.S. currency became much more overvalued than it is today, and we can see it gaining further before the valuation-based signals start to have greater impact and imply even less hedging. On balance, this model still suggests hedging a portion of your currency risk when investing in international equities.

<sup>6</sup> Federal Open Market Committee (FOMC): The branch of the Federal Reserve that determines the direction of monetary policy.

<sup>7</sup> Interest rate differentials: The difference between the two-year interest rate swaps of the United Kingdom vs. the United States.

**R.H.** The trend of U.S. dollar strength established in 2011 continued in 2015. The near double-digit returns for the dollar last year are likely to slow absent much more aggressive easing moves by foreign central banks. But policy divergence remains intact, making a repeat of the synchronized global rate hikes of past tightening periods unlikely. Forward rate differentials point to continued strength in the dollar. But value metrics are less conclusive, and growth differentials could become more challenging. Emerging currencies face near-term uncertainty from China, commodities and the Fed, but have been beaten down to levels that could offer long-term value. Overall, we anticipate a meaningful but modest appreciation of the dollar of roughly 5%.

**L.S.** I agree with Rick and Jer. I don't think U.S. dollar will match gains posted in 2015, but gains in the 5% range would not surprise me in the next 12 months against a broad basket of developed and EM currencies. I think China's announcement that it will manage its currency to trade in a range against a basket of foreign currencies—and not primarily against the dollar—is significant. That will give Chinese authorities the ability to allow the yuan to depreciate gradually against the dollar. This, combined with China's softening economy—and the shrinking percentage of its GDP that comes from investment—will likely put a ceiling on how quickly or how high EM currencies can bounce from their current depressed levels in the year ahead.

**Q:** **Global central banks have been fighting disinflationary trends since the financial crisis. Will 2016 be the year when we see a bottoming of inflation expectations in the U.S., Europe and Japan and start to move toward more normal levels of inflation?**

**L.S.** Falling oil and commodity prices will likely keep headline inflation at bay for the coming year, but I do expect some pickup in the core Consumer Price Index<sup>8</sup> (CPI) and personal consumption expenditure<sup>9</sup> (PCE) rates in the U.S. and in core CPI in Europe. We may even get near 2% by the end of 2016. But the big force globally that is putting pressure on prices will be with us for many years to come: a global labor pool that depresses wages, technological competition that erodes pricing power and aging populations that can impact aggregate demand in the developed world, outside the health care sector. With advances in artificial intelligence and robotics, you may have a job shortage globally at the same time you have ample capacity to produce and replace future workers with machines. So, I see deflation continuing to be the biggest threat to global asset values and to the mountain of credit that has been created to keep the developed world growing over the last few decades. Governments and central banks still have a ways to go to inflate away these huge debt burdens. Just look at the negative interest rates years out on the curve in Europe. Creating inflation and expectations of future inflation is proving harder to do than many expected, given all the easy money sloshing around the world.

<sup>8</sup> Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

<sup>9</sup> Personal consumption expenditure (PCE): A measure of price changes in consumer goods and services.

**Q: Does anyone have a view on what happens to oil and commodities generally for 2016?**

**L.S.** The rising dollar has played into the decline of oil prices, but the larger issue is the imbalance in the global production of oil versus global demand. The world likely ended 2015 producing about 2 million barrels a day more than it was consuming, creating a supply glut and a large inventory overhang to work through. Rig counts in the U.S. have come way down in the last six months, which in time will matter. But in the absence of a sharp pickup in global trade and global growth, I think the world will be awash in too much oil well into 2016, and so I expect prices to remain low for longer. Given that that Iran, unshackled from Western sanctions, will soon add to global supply, and that the U.S. Congress recently lifted the ban on the U.S. export of oil, we could have high inventories weighing on prices through 2016.

**J.S.** Short-term trend signals are bearish, and momentum has been an important factor dictating commodity returns, but value signals (looking at terrible five-year returns) look more optimistic going forward. It would be nice to see commodities rising above longer-term down trends before getting fully bullish.

**Q: How will all this impact emerging markets?**

**J.S.** I have been positively inclined toward EM equities on valuations and have felt investors were overly negative on the ramifications of a slowdown in China. This has been where we have been most wrong in our asset allocation models, particularly from the pain caused in EM currencies more so than the equities.

I have a more positive view on India and Korea—these are two countries that are benefiting from low commodity prices. Valuations in Korea look low compared to competitors. Korea is lobbying the MSCI Index family to see its country upgraded from EM toward developed world—we see that becoming a greater focus story in the coming year or two. I started writing about Korea on a currency-hedged basis in August 2014. Since then, EMs broadly have declined by over 20%, while Korean-hedged equities have declined by less than half that amount. I think Korea will continue to be a country that outperforms the broader EM indexes, particularly staying focused on an FX-hedged basis for Korea where the cost to hedge is low compared to other EM indexes. India is one of our favorite long-term growth stories—having the best growth rate for an economy its size. Prime Minister Modi has faced a few setbacks this year in getting his reform agenda passed, but he is making progress.

One of the great risks in EMs is if the U.S. dollar continues its appreciation, as we expect it will. Many are concerned about the implications on the more leveraged EM corporates, particularly in the commodity space. This is one of the reasons last year we launched an index called the WisdomTree Strong Dollar Emerging Markets Index that excludes both highly leveraged sectors (Telecom, Utilities and Financials) and commodity sectors (Energy, Materials). The result is a lower leverage exposure to EMs that is over-weight Korea, Taiwan, India and technology and consumer names. This is one area worth focusing on within EMs today.



**R.H.** Valuations have fallen to near historic levels, but headwinds persist. Recent currency depreciation has created more favorable terms of trade for many EM nations, and we have seen a bottoming and then improvement in most external balances. In aggregate, an improvement in growth could materialize, as could a bottoming in the economic growth premium for EMs relative to developed markets, but I anticipate a rocky road in getting there.

Anxiety over China, commodities and the Federal Reserve (in that order) continue to dominate thoughts in terms of investing in EM assets. China still faces industries that are struggling with overcapacity (i.e., manufacturing and real estate) as it seeks to transition to a more balanced, service-led economy. Signs from the consumer sector have been much more encouraging, and current policy easing should provide a tailwind to the economy in the coming months. Broad credit growth recently hit a 10-month high, budgeted spending is expanding at its fastest pace since 2012 and the Chinese government has significant ammunition at its disposal.

The recent expansion in EM corporate debt has also drawn scrutiny, centered on the robust growth in the debt of Chinese companies. Over the last few years, the level of private financial credit in the EM has risen from 100% to 132% of gross domestic product. Excluding China, the level of debt has risen from 70% to 85% of gross domestic product. Comparable levels of debt for corporations in developed market countries are 164% of GDP. However, while developed market corporations have been deleveraging, EM corporations took advantage of lower rates to increase leverage.

Also, investors should recall that many EM corporations operate in global markets. Reliance on the global economy remains far more important to their stability than sentiment at home. In our view, global sources of hard currency revenue help to offset the perceived risks about their sustainability given their long-term dollar-denominated liabilities. Additionally, investors often concentrate on outliers such as Brazil, Russia, Turkey and South Africa as representing the risks of EM in general, without looking at the differentiation in economic circumstances and expectations. Brazil and Russia have been punished severely, possibly more than justified, for actions or their inability to make adjustments. But many currencies have been punished in sympathy. The level of currency depreciation and the historically low levels for the Indian rupee and Mexican peso seem out of step given their long-term economic potential.

The fear and dread embodied in EM debt and currency valuations seems overdone, but near-term headwinds argue for patience and diligence when looking for re-entry points. We need to see greater stability in China, a floor in commodities and dissipation in anxiety about the Federal Reserve before we begin to increase our exposure.

**Q: What asset classes are attractive based on valuations?**

**R.H.** Selective investments in corporate debt appear to offer value, given the recent widening in spreads to historically attractive levels. But don't get me wrong—risks are also higher. The debt of commodity producers remains vulnerable with marginal credits under pressure. While we have seen deterioration in micro fundamentals, the extension of the “just so” expansion should provide a strategic opportunity for long-term investors to secure incremental income relative to risk-free investments and navigate a drift higher in yields. The critical question is, will the economic expansion be sustained? If the answer is yes, the incremental income offered by corporates appears to be too wide and offers opportunities.

Investment selection remains critical. Lending conditions could tighten, and funding costs are likely to rise, pressuring marginal borrowers. Great care is needed in addressing potential liquidity<sup>10</sup> concerns as investors venture down the credit continuum. Near-term headwinds suggest some caution in high yield, particularly in the Energy and Materials sectors, but the amount of pessimism priced in relative valuations for the credit in general seems a little overdone for this point in the credit cycle. We suggest investors focus on hitting singles in investment-grade credits near term, while selectively building exposures in high-yield credits as the year progresses.

**L.S.** When you look around the world, there are not a lot of equity markets that you could characterize as cheap, on an absolute basis or relative to its own history. Chinese banks and Russian energy are cheap on an absolute basis and relative to their forward P/E multiples going back 10 years. But that has been true for a few years now. Those who were bold enough to buy into Russia in 2015 and take on the currency risk saw modest gains, but there is also a lot of volatility associated with that exposure—and it remains very much tied to the price of oil. Japan remains the cheapest developed equity market (on a forward P/E basis). It's the only major developed equity market trading at discount to its historic average. Its corporations continue to post impressive profit growth. Because of time lags in currency translation, Japanese companies will continue to benefit from the depreciation in the yen over the past two years, even if the yen does not depreciate any further in 2016. Finally, Japan matters. It represents nearly a quarter of EAFE's weight. So I am comfortable tilting toward Japan again in 2016. Even if the yen depreciates no further in 2016 versus the dollar, I think it still makes sense to hedge the currency. As that hedge, given the differential in short-term interest rates between Japan and the U.S., now represents a source of return, assuming the spot price remains unchanged. In the U.S. the only sector that is trading at a discount to its 10-year median forward P/E ratio is Telecom. All the other S&P sectors ended the year trading at a premium to their longer-term histories. So unless you want to load up on AT&T and Verizon, it would not surprise me to see value lag again as a style factor in 2016. Mid-cap value is also trading at a discount to its long-term forward P/E. But with momentum having the upper hand in the market right now over value, I think quality may be the better factor to focus on in 2016, as it becomes more difficult for the overall market to generate earnings gains.

<sup>10</sup> Liquidity: The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

**Q:** Given this backdrop, how else should investors think about how to position their equity and fixed income portfolios in the new year?

**R.H.** I would retain a bias for selective credit risk, relative to interest rate risk for the coming year within fixed income portfolios. Over the course of the year, rates are likely to drift higher, but the confluence of potential risks is likely to create selective tactical opportunities to add interest rate risk. The dynamic interplay of China, commodity markets and questions around central bank policy is likely to present challenges to the “just so” expansion. Incorporating unconstrained strategies that take a more dynamic approach to duration management, but on average maintain a short duration bias, could be a potential option to navigate market crosscurrents.

With respect to EMs, remember they contribute 40% of the world’s growth, hold 55% of the world’s FX reserves and many of their central banks retain flexibility to implement traditional policy. Valuations are cheaper, but near-term headwinds argue for patience and diligence when looking for re-entry points.

**J.S.** In the U.S. markets, we have been advocating for U.S. dividend growth strategies over U.S. high-dividend strategies for much of last year and a half. We think the case for this has only strengthened this year. The U.S. started hiking its monetary policy rate, and this may be the beginning of a normalization cycle in rates. High rates should put pressure on the bond-like proxies within equities—like Telecommunications, Utilities and REITs. The growthier parts of the U.S. dividend space should come under less pressure as they can grow dividends at faster rates. The valuations on these stocks are also relatively more attractive than their higher-dividend benchmarks, which is rare. Favoring U.S. dividend growth strategies is true in both the large-cap and small-cap spaces.

We have described Japan as being in a multiyear bull market for risk assets—both equities and real estate—and we will continue advocating for that here. The price-to-earnings ratio in Japan has not meaningfully increased in last three years since Prime Minister Shinzo Abe has come into power, despite having some of the best price moves. That is because the market is being driven by earnings growth. We see further gains in earnings for Japan, while there are pressures on earnings in the U.S. caused by currency moves. We also see greater shareholder-friendly capital increases both to dividends and buybacks that are attracting more investors.

We’ve been overly bullish on EM valuations in the last few years, but the main headwind has been currency moves. This year may be the bottoming for EM positions. Commodities have been the most out-of-favor sector, and if we can see some stabilization in concerns around China, this can spark a large relief move in these depressed parts of the market.

**L.S.** We continue to maintain a little more than 50% of the international portion of our core equity portfolio in currency-hedged positions. We think one of the easiest ways to implement this view is to add a world ex-U.S. currency-hedged exchange-traded fund (ETF) to the mix. We also recently added an EM

position in a 2 percent weight to our global dividend portfolio that excludes state-owned enterprises. One of the trends that developed in China in the second half of 2015 was the relative strength exhibited by non-state-owned enterprises compared to state-owned enterprises (SOE), largely concentrated in the Financials and Energy sectors. About 30% of the MSCI Emerging Markets Index is state-owned enterprises. So if that trend continues into 2016, this may be one way to add alpha relative to the Index. In our core equity model, we have added a “strong dollar” emerging markets exposure that seeks to find EM companies that collect at least 15% of their revenue from the U.S. and whose stock prices have demonstrated higher correlations to a stronger dollar. As Jeremy noted earlier, we think this may be a better way of getting exposure to EM countries in a strong dollar environment than being 100% hedged against EM currencies, which can come at a significant cost over time.

**Q: What are some of the big risks that could impact markets in 2016?**

**R.H.** An acceleration of the downshift in the Chinese economy and the response from the Chinese government are the primary risks faced by market participants. While other questions deserve monitoring, these risks touch everything and could exacerbate the fragile balance within the global economy. Unfortunately, it is also the risk in which we have the least visibility. For years, Chinese growth fueled the demand element of the commodity supercycle. Established corporations are adjusting, but marginal creditors have fallen into a supply-or-die dilemma. An acceleration in the downshift would further exacerbate the supply and demand imbalance. Internal credit concerns and currency positioning are key trigger points, and how Chinese authorities address them will be critically important. Does the veneer of Chinese effectiveness—which was damaged when trying to regulate the equity market—erode further with a similar misguided approach to the bond market? If growth falters, will the Chinese authorities resort to a sizable currency depreciation that resonates through the entire Asian basin? We anticipate the Chinese authorities will move to a more flexible approach to managing the currency, with an increased weight paid to its relationship to the euro. This will engender a managed depreciation next year.

**L.S.** If oil prices stay low for longer, as I suspect they will, the unwinding of high-yielding debt in the Energy sector may be a risk. So could be the corporate debt that has to get paid back in dollars in Brazil, Turkey and China and in the rest of the developing world over the next few years, if the dollar continues to rise. Here at home, I think the risk is not that the economy overheats, but that it runs out of gas.

Before I make any New Year’s resolutions, I usually ask myself what could cause the market to close 20% lower at the end of the coming year. If Energy had been the largest sector in the S&P 500 at the beginning of 2015, we may have reached bear market levels in 2015. But today, Energy is less than 7% of the S&P 500, and even if the major energy companies see continued profit erosion in 2016, I don’t

think that headwind will be enough to negate the positive earnings-per-share (EPS)<sup>11</sup> growth likely to be generated in aggregate by the other sectors. While it is quite normal for the market multiple to contract when rates rise, I think the odds of the trailing price-to-earnings ratio (P/E) on the market declining 20% in the next 12 months—going from, say, 18 to 14.5—are fairly low without a major shock to consumer confidence. Double-digit declines in the U.S. market usually require at least a double-digit decline in the market's P/E multiple or a double-digit decline in overall earnings growth—and that usually takes a recession, which I don't believe will hit in 2016. Over the last 25 years, through 2014, we only had five calendar years where the S&P 500 posted losses. In 2008 and 2001, you saw massive contractions in EPS growth (40% and 31%, respectively). In 2000 and 2002, you saw large double-digit contractions in the P/E multiple (17% and 35%, respectively). In 2008, Financials, the then largest sector of the S&P 500, was in a leverage bubble—making the overall market vulnerable to a downturn. In 2000, the then largest sector, Technology, was in a valuation bubble, jeopardizing the rest of the U.S. market. I don't see the two largest sectors in the S&P 500 today—Information Technology and Financials—in bubbles today. If anything, on a relative basis, they may be positioned to lead the market in 2016.

The other two risks I see relate to the upcoming election. There will be some level of uncertainty as to whom each party will nominate, and a greater degree of uncertainty about who will win until late in the fall. Because the range of potential policy outcomes is so wide, the market may be vulnerable to violent swings as election results near. Over 200 years, the U.S. stock market averages about a 10% return, and declines in only 1 out of 4 years on average. But in open presidential election years, where there is no incumbent, the average gain is only 2% and the odds of a down year rise to 1 in 2, if you use the Dow as your proxy over the last century.

I have a thesis on the “reinvestment risk” of exiting equity position too early in 2016 and missing what could happen in 2017 if the stars align to unleash new animal spirits within the U.S. economy—but I will save that for next year's outlook.

**Q: What are the key innovations and developments that are likely to drive exchange-traded funds in 2016?**

**R.H.** Risk management will be a driving element of innovation and development in the exchange-traded market this year. Increased applications of managing currency risk across assets and reworking weighting approaches to fixed income are two particular developments that could resonate with clients. From the demand side, we are likely to see continued growth in the incorporation of exchange-traded funds within the portfolios of institutional managers. Increasingly, institutions are seeing exchange-traded funds as additive to their investment in individual securities, not incongruent.

<sup>11</sup> 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.

**J.S.** Dynamic currency hedging: Currency-hedged strategies have been one of the growth drivers of WisdomTree and the ETF industry in the last three years. We believe from a strategic standpoint the shift toward currency hedging is largely still in early phases for broad international mandates. In Japan, approximately half the assets in ETFs are allocated to currency-hedged strategies, and in Europe, the number is approximately 40%. But it's early days in broad international allocations when considering the \$1.2 trillion in the foreign large-cap category of open-end mutual funds and ETFs—where maybe 2% to 3% of the overall universe is invested in hedged strategies. One refrain from investors is they leave it to their active manager to decide when to hedge. And yet the active managers claim they are stock pickers and not currency experts—and they use that to justify why they don't hedge and leave it status quo unhedged. WisdomTree believes hedging should more often be the baseline allocation as currency adds to expected risk, but not expected return. We further believe that there are systematic models that one can use to help more profitably time when one should implement currency hedges, and we think the next wave of innovation to occur in the industry will be in this dynamic currency-hedged arena.

Alternatives: Investing in hedge funds<sup>12</sup> is fraught with challenges, in particular very high fees, a lack of transparency and the presence of lockup periods that require long holding periods for the investments, sacrificing liquidity. Yet most investors don't have access to the really star performing funds and wrongly assume they'll have an easy time finding the emerging and undiscovered managers. By contrast, we believe many hedge fund-like strategies can be made systematic and have started along a path toward launching more systematic alternative strategies.

**L.S.** I think you will see some meaningful innovations in the area of liquid alternatives that give investors new tools to reduce volatility and potentially help them generate positive returns in environments where stock, bond and commodity prices fall.

In terms of trends, I think one of the biggest ones—the outflows of equity mutual funds—will continue and possibly accelerate over the next 24 months as this current bull market matures and investors look to upgrade their portfolios for what comes next. As the Department of Labor moves forward with its plans to implement a new fiduciary rule for retirement accounts, one of the big winners could be index funds and ETFs. Mutual funds with poor performance, excessive fees or antiquated sales loads may face even greater competitive pressure from ETFs that better serve investors and that better align financial advisors with their clients.

<sup>12</sup> Hedge fund: A hedge fund resembles a pooled investment vehicle administered by a professional management firm. It is often structured as a limited partnership or limited liability company. Hedge funds invest in a diverse range of markets and use a wide variety of investment styles and financial instruments.

Unless otherwise stated, data source is WisdomTree.

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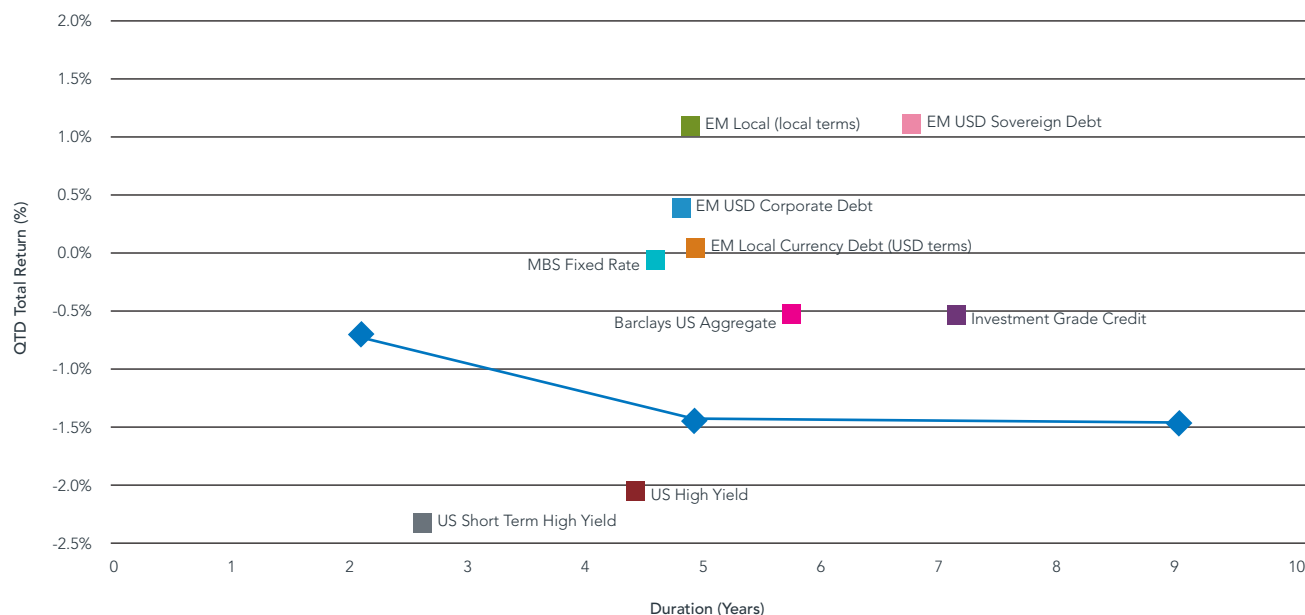
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# Market Monitors

[ As of 12/31/15 ]

## QTD TOTAL RETURN VS. DURATION



Fixed Income Indexes	Yield	QTD Yield Change (bp)	QTD Spread Change (bp)	Duration	QTD	YTD	1Y	3Y Annual	5Y Annual	10Y Annual
2Y Treasury	1.05%	42	-	1.98	-0.46%	0.44%	0.44%	0.48%	0.64%	2.54%
5Y Treasury	1.76%	40	-	4.81	-1.38%	1.35%	1.35%	0.56%	2.56%	4.43%
10Y Treasury	2.27%	23	-	8.93	-1.44%	0.90%	0.90%	0.98%	4.65%	5.05%
US High Yield	8.74%	70	30	4.34	-2.06%	-4.43%	-4.43%	1.70%	5.03%	6.95%
Barclays US Aggregate	2.59%	28	-3	5.68	-0.57%	0.55%	0.55%	1.44%	3.25%	4.51%
Investment Grade Credit	3.67%	25	-4	7.04	-0.58%	-0.68%	-0.68%	1.67%	4.53%	5.28%
MBS Fixed Rate	2.77%	16	-7	4.49	-0.10%	1.51%	1.51%	2.01%	2.96%	4.63%
EM USD Corporate Debt	6.70%	8	-19	4.73	0.82%	1.17%	1.17%	1.15%	4.18%	5.74%
EM USD Sovereign Debt	6.71%	-3	-24	6.67	1.55%	1.23%	1.23%	-0.07%	5.11%	6.72%
EM Local Currency Debt (USD terms)	7.13%	5	-36	4.80	-0.01%	-14.92%	-14.92%	-9.96%	-3.48%	4.30%
EM Local Currency Debt (Local Currency Terms)	7.13%	5	-36	4.80	1.56%	3.28%	3.28%	3.67%	6.55%	8.03%
EM Local Currency Debt (Implied Currency Returns)	-	-	-	-	-1.54%	-17.62%	-17.62%	-13.15%	-9.41%	-3.45%
Bank Loans	6.75%	82	-	0.10	-2.25%	-2.75%	-2.75%	1.04%	2.78%	4.07%
US Short Term High Yield	9.25%	90	42	2.54	-2.28%	-5.15%	-5.15%	0.88%	N/A	N/A

Past performance is not indicative of future results. You cannot invest directly in an index. Source: Bloomberg, WisdomTree. Data as of 12/31/15.



Equity Indexes	DIV Yield	P/E	P/B	P/CF	QTD	YTD	1Y	3Y Annual	5Y Annual	10Y Annual
WisdomTree Dividend	3.33%	16.8x	2.4x	9.3x	6.43%	-1.02%	-1.02%	13.27%	12.46%	N/A
S&P 500	2.15%	17.4x	2.8x	10.7x	7.04%	1.38%	1.38%	15.13%	12.56%	7.30%
Russell Midcap	1.88%	19.6x	2.4x	11.0x	3.62%	-2.44%	-2.44%	14.18%	11.43%	7.99%
Russell 2000	1.61%	27.9x	2.2x	8.6x	3.59%	-4.41%	-4.41%	11.65%	9.18%	6.80%
MSCI ACWI	2.56%	16.4x	1.9x	5.4x	5.03%	-2.36%	-2.36%	7.69%	6.08%	4.75%
MSCI EAFE	3.26%	15.5x	1.6x	7.9x	4.71%	-0.81%	-0.81%	5.01%	3.60%	3.03%
MSCI EMU (Local)	3.19%	15.2x	1.6x	7.0x	6.47%	9.82%	9.82%	12.22%	7.49%	3.09%
MSCI Europe SmallCap	2.50%	21.0x	1.9x	12.1x	5.33%	10.90%	10.90%	13.07%	8.29%	7.33%
TOPIX (JPY)	1.84%	15.3x	1.3x	8.4x	9.83%	12.06%	12.06%	24.03%	13.86%	1.24%
MSCI Japan SmallCap	1.81%	16.3x	1.2x	7.9x	8.93%	15.32%	15.32%	13.19%	7.70%	0.65%
MSCI Emerging Markets	2.92%	13.4x	1.0x	4.5x	0.66%	-14.92%	-14.92%	-6.76%	-4.80%	3.61%
U.S. REITs (MSCI REIT)	4.06%	36.7x	2.4x	16.7x	7.08%	2.52%	2.52%	11.06%	11.88%	N/A
Foreign REITs (S&P Global ex-U.S. REIT)	4.28%	18.8x	1.1x	16.5x	0.98%	-6.81%	-6.81%	-0.61%	1.62%	N/A

Commodities and Currencies	Level	QTD	YTD	1Y	3Y Annual	5Y Annual	10Y Annual
Commodities (CRB)	375	-7.05%	-14.40%	-14.40%	-8.19%	-6.35%	2.15%
West Texas Crude Oil (spot)	37.04	-17.85%	-30.47%	-30.47%	-26.13%	-16.52%	-4.87%
Gold (spot)	1061	-4.84%	-10.41%	-10.41%	-14.13%	-5.68%	7.45%
Copper (LME Cash)	4706	-9.09%	-26.10%	-26.10%	-15.90%	-13.37%	0.35%
U.S. Dollar (BBDXY)	1233	1.55%	8.98%	8.98%	7.71%	4.79%	N/A
Euro (EUR)	1.09	-2.82%	-10.22%	-10.22%	-6.28%	-4.09%	-0.87%
British Pound (GBP)	1.47	-2.59%	-5.40%	-5.40%	-3.22%	-1.15%	-1.55%
Australian Dollar (AUD)	0.73	3.82%	-10.87%	-10.87%	-11.18%	-6.57%	-0.06%
Brazilian Real (BRL)	3.96	-0.34%	-32.90%	-32.90%	-19.70%	-15.95%	-5.15%
Indian Rupee (INR)	66.15	-0.85%	-4.70%	-4.70%	-5.98%	-7.54%	-3.77%
Chinese Yuan (CNY)	6.49	-2.12%	-4.44%	-4.44%	-1.37%	0.35%	2.20%
Mexican Peso (MXN)	17.21	-1.68%	-14.27%	-14.27%	-9.27%	-6.43%	-4.70%
Russian Ruble (RUB)	72.2	-9.87%	-16.25%	-16.25%	-25.07%	-15.89%	-8.84%
Japanese Yen (JPY)	120.22	-0.28%	-0.37%	-0.37%	-10.31%	-7.57%	-0.21%

Past performance is not indicative of future results. You cannot invest directly in an index. Source: Bloomberg, WisdomTree. Data as of 12/31/15.