# THE ECB IS TELLING US SOMETHING; OUR DYNAMIC HEDGE IS LISTENING

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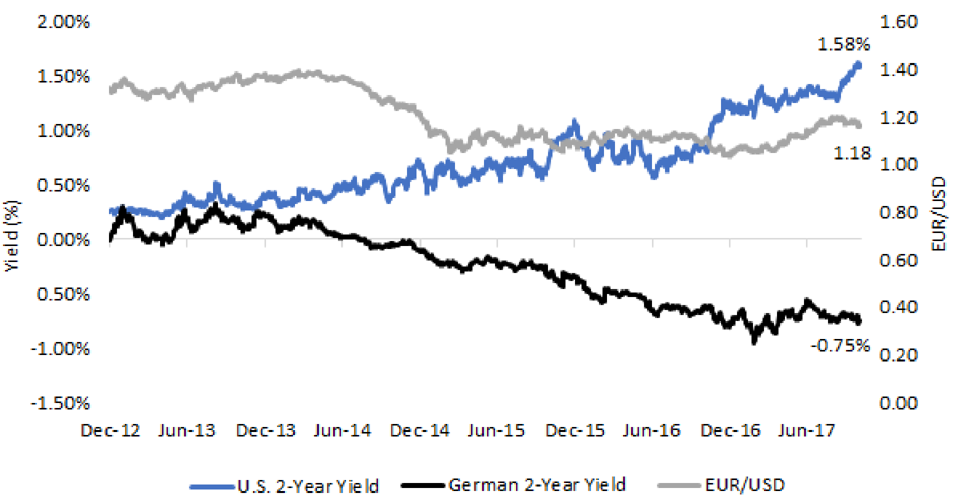
Mario Draghi and the European Central Bank (ECB) provided some much-anticipated clarity on October 26 about the future of its asset purchase program following the governing council's monetary policy meeting. We recently discussed th e details of the ECB announcement here. In short, the planned taper had been well telegraphed ahead of time: the ECB will maintain accommodative financial conditions for the foreseeable future.

A low-rate environment coupled with an accelerating economic recovery provides a supportive backdrop for European equities, but the case for the direction of the currency is a bit more mixed. A review of how a dynamically hedged approach has responded to certain currency signals in recent history may provide some insights into how investors can approach a long-run strategic allocation to international investing.

**Currency Signals**

The ECB's latest update on quantitative easing likely shelves any serious rate hike discussion until 2019, a plan that may help address one of the governing council's concerns over the future of the recovery: a strengthening euro,[1] up 11% relative to the dollar year-to-date.[2] Interest rate differentials are a key driver of short-term currency movements. The "carr y trade" leads investors to sell the lower-yielding currency (the euro) and buy the higher-yielding currency (the dollar) to earn the "carry" on the differential, leading to a relative appreciation of the higher-yielding currency. Following the October 26 announcement, the euro has dropped as much as 3.5% from its September 8 high on the year.[3]

**EUR/USD and 2-Year Sovereign Debt Yields**




Sources: WisdomTree, Bloomberg, for the period 12/31/12–11/1/17. Past performance is not indicative of future results.

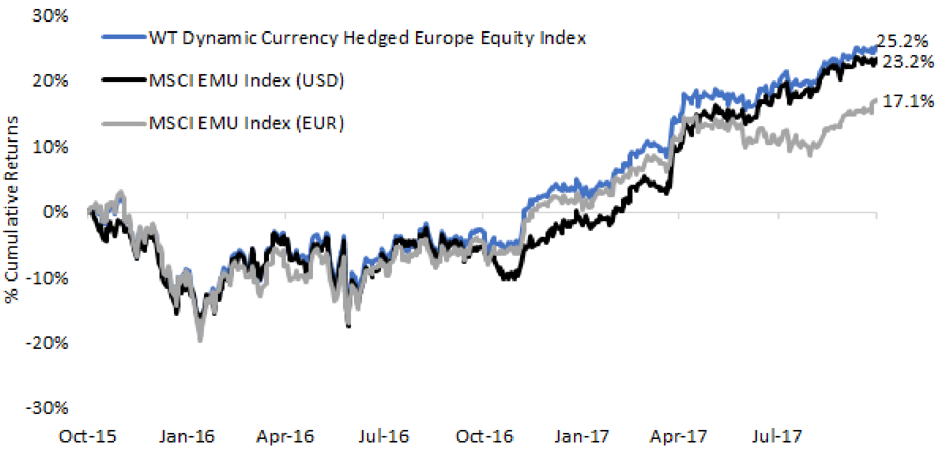
In November 2015, WisdomTree launched a suite of dynamic currency-hedged Indexes with three signals, each with a one-third weight contributing to the hedge ratio, that are screened monthly: momentum, value and interest rate differentials. Since the inception of the WisdomTree Dynamic Currency Hedged Europe Equity Index in November 2015, a strategy designed to dial exposure to the euro up or down depending on the three signals, U.S. short-term rates have been higher than eurozone short-term rates. The above chart of 2-year sovereign yields in the U.S. and Germany shows how short-term interest rate differentials are related to why that rate signal applies a hedge to the euro currently.

The interest rate differential signal of the dynamic hedge will keep the Index at minimum at a one-third hedge for the foreseeable future.

The other two signals included in the dynamic model are valuations and momentum. The value signal shows the euro as undervalued, and that hedge ratio dropped to zero earlier this year. So in short, interest rates and valuations are pulling in opposite directions. The deciding factor is just raw price momentum, which captures changes in sentiment. Largely, the euro has been appreciating, so that signal lowered the aggregate hedge ratio in June to 33.3%.

With less than a 50% hedge for the past five months during a strong euro environment, the dynamic hedge is doing exactly what would be expected: dialing up the exposure to the currency based on the quick to respond momentum signal and reaping some of the tailwinds of the currency. Over the short two-year live history, a period where the euro has appreciated nearly 5% versus the dollar, the WisdomTree Index has been able to maintain a 200-basis point (bps) outperformance advantage over the MSCI EMU Index in dollars, and an over 800-bps outperformance over the MSCI EM U Index in euros.[4]

**Index Cumulative Total Returns (10/30/15–10/30/17)**

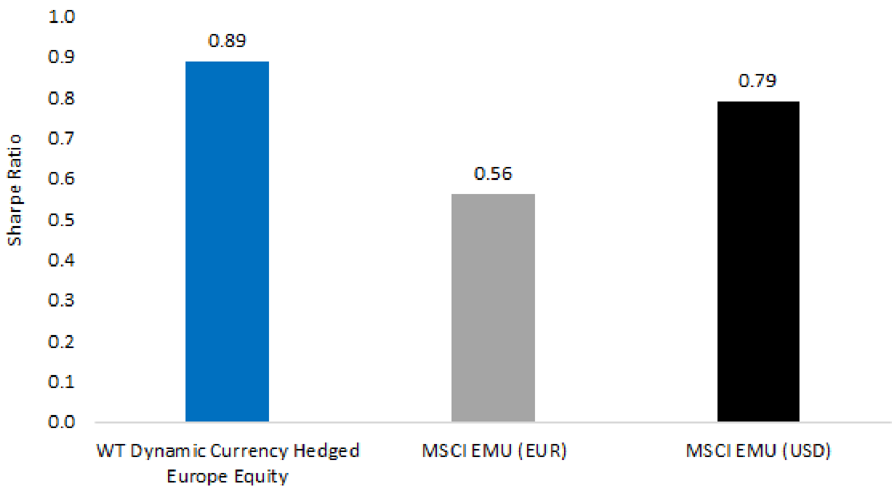



Sources: WisdomTree, Bloomberg. You cannot invest directly in an index. Past performance is not indicative of future results.

**The Goal: Improved Risk/Return Characteristics**

There is a compelling investment case in European equities grounded in relative valuations, a slew of positive macroeconomic indicators and sustained easy monetary policy conditions. The key for international investors then becomes tapping this market while minimizing the impact of currency fluctuations that may result in significant moves in either direction for protracted periods. For most investors that do not see themselves as expert currency managers, making a call on the next double-digit move in the euro is a coin flip.

**Sharpe Ratio across Indexes since Inception**




Source: WisdomTree, Zephyr StyleADVISOR, 10/30/15–9/30/17. You cannot invest directly in an index.

At WisdomTree, we aim to construct unique Indexes that can improve the investor experience beyond the traditional market cap-weighted strategies. The approach for the WisdomTree Dynamic Currency Hedged Europe Equity Index was no different: combine a fundamentals-based *Dividend Stream®*-weighted strategy with a dynamic currency hedge to produce a valuation-sensitive index with improved risk and return characteristics over the long run.

The results thus far? Improved risk-adjusted returns, as measured by Sharpe ratios, were above not only the unhedged MSCI EMU Index but also the MSCI EMU Index in local currency. With European equities offering a great opportunity at present, this dynamic currency-hedged approach may be worth considering for those seeking equity exposure while relying on a rules-based approach to reduce the currency drag.

[1]Source: Claire Jones, "ECB Minutes Reveal Concern over Euro Strength," Financial Times, 8/17/17.

[2]Source: Bloomberg, for the period 12/30/16–11/1/17.

[3]Source: Bloomberg, low point on October 27.

[4]Source: Bloomberg, for the period 10/30/15–10/30/17.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

## DEFINITIONS

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Tapering** : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

**Dynamic Hedge** : Strategy in which a currency hedge can be varied (as opposed to targeting a constant level) and change over the course of time.

**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.

**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.

**Interest Rate Differentials** : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

**Global carry trades** : Occur when investors borrow money in a low-interest-rate country at low cost and use it to invest in a higher-interest-rate country. The potential profit that exists relates to the difference in interest rates between the two countries, minus applicable trading costs.

**Yield** : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**Currency hedging** : Strategies designed to mitigate the impact of currency performance on investment returns.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

**Sovereign Bond Yield** : the interest rate paid on a government (sovereign) bond.

**Valuation** : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**Hedge** : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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

**Basis point** : 1/100th of 1 percent.

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

**Market capitalization-weighting** : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.