ASSESSING VALUE IN EMERGING MARKET CURRENCIES

Bradley Krom — U.S. Head of Research
09/07/2017

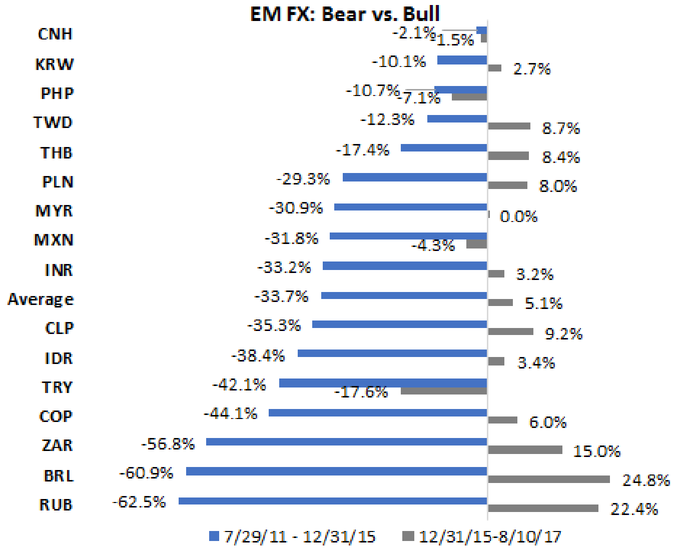
During a period of robust inflows and more positive sentiment, emerging markets[1] (EM) have outperformed developed markets by a margin of 6%[2] to 12%[3] year-to-date. This is primarily a function of a rebound in earnings, higher asset prices and a rise in the value of EM currencies against the U.S. dollar. With many emerging equity markets up over 20% year-to-date, the logical question many investors are asking is, "Have I missed the rally?" Using currency foreign exchange (FX) performance as one barometer, we hope to provide greater context for investors considering a strategic shift back to EM assets.

EM FX: A Harbinger of Flows

Over the last several years, we've spent a tremendous amount of time speaking about currency risk and analyzing trends in currency markets. We have provided dedicated exposure to EM FX through the WisdomTree Emerging Markets Currency Strategy Fund (CEW) since 2009. In our view, the most significant (and intuitive) driver of EM FX is global demand. When businesses or investors seek to buy an asset or engage in trade in an emerging market, often they convert hard currency into local. If demand for a currency outstrips supply, a currency will tend to appreciate.

Unfortunately for EM policymakers, the opposite of this process had been occurring over the last five or six years (ahead of 2016). When foreign investors seek to liquidate their holdings and repatriate their foreign currency back to dollars, this leads to a decline in the value of these currencies. From the middle of 2011 to the end of 2015, global investors generally shunned EM assets. As a consequence, EM currencies declined dramatically over this period. As shown in the chart below, EM currencies fell by more than 33% over this four-and-a-half-year period. While Asian currencies depreciated by far less, countries with significant exposure to commodities experienced the most significant devaluations. In the case of Russia, Brazil, South Africa and Turkey, these economic difficulties were exacerbated by geopolitics as well.

Dollar Strength vs. Weakness: 7/29/11–8/10/17



Cumulative Performance	
CNH	-3.6%
TWD	-4.7%
KRW	-7.7%
THB	-10.5%
PHP	-17.0%
PLN	-23.6%
CLP	-29.4%
Average	-29.9%
MYR	-30.8%
INR	-31.0%
MXN	-34.7%
IDR	-36.3%
COP	-40.7%
ZAR	-50.3%
BRL	-51.2%
TRY	-52.3%
RUB	-54.0%

Source: Bloomberg, as of 8/10/17. Past performance is not indicative of future results.

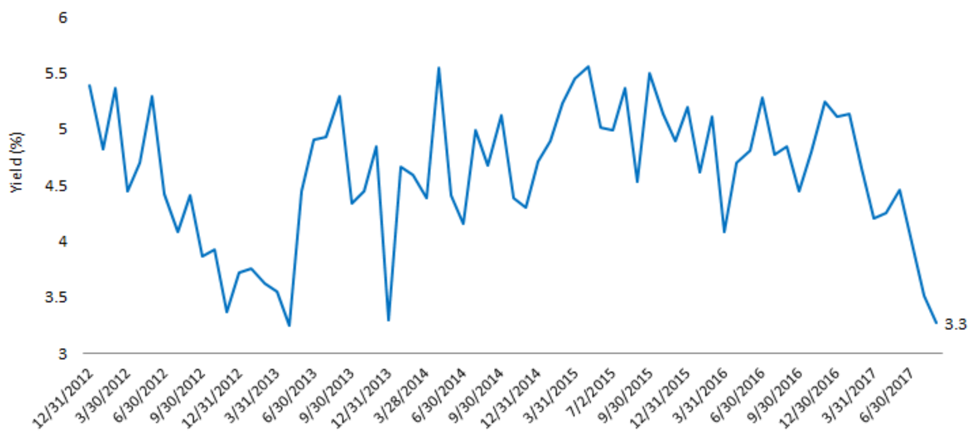
Since 2016, commodity prices have rebounded while volatility in most global markets has declined. Over this period, countries that experienced the most significant devaluation have seen their currencies rebound sharply. On average, EM FX has appreciated by over 5% against the U.S. dollar during this period. In our view, bifurcating these two periods can be instructive on two fronts. First, it provides investors with an idea of the pain that EM FX can provide during a weak EM FX, strong U.S. dollar market. But secondarily, it also shows that there can be fairly dramatic deviations across a group of economies that are anything but homogenous.

However, the most significant takeaway for us is to try to not get caught up on trying to identify specific turning points in the market. Given the carnage many investors experienced from mid-2011 through 2015 and the rebound that we've seen recently, the worst of EM FX depreciation in this dollar cycle looks to be behind us. For investors who are allocating to these markets, currencies are down by approximately 30% since the start of the dollar rally in July 2011—even when including recent gains. While there are no guarantees that EM FX will continue to outperform the U.S. dollar, investors considering long-term allocations to EM assets should view local FX performance more as a tailwind compared to a headwind.

Opportunities for Income

In addition to returns driven by changes in the value of currencies, exposure to EM FX can also provide investors with a meaningful amount of carry. Given that interest rates in most emerging markets tend to be higher than in the U.S., investors that go long a basket of EM currencies via currency forward contracts are usually compensated for bearing this risk. While the level of income depends on U.S. and foreign central bank monetary policy, these higher implied rates provide opportunities for income that can help dampen volatility that's often associated with investments in EM. As we show below, the embedded income yield component for CEW has averaged 4.6% since 2012.[4]

Embedded Income Yield (%)



Source: WisdomTree, as of 8/11/17. Past performance is not indicative of future results.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Please click here for CEW standardized performance.

In sum, EM FX can offer significant value relative to 2011 despite recent inflows and appreciation. There is also a strong carry component to the return, with short-term interest rates in these markets that average 3.3% today embedded in forward rates utilized to access these markets. Combining embedded income from forwards, with more positive sentiment to these foreign currencies, we see CEW as a useful tool to increase exposure to positive economic momentum that we see accelerating across the emerging markets.

[1]As measured by the MSCI Emerging Markets Index through 8/11/17.

[2]Compared to the MSCI EAFE Index.

[3]Compared to the S&P 500 Index.

[4]Source: WisdomTree, as of 8/4/17.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in specific regions or countries, thereby increasing the impact of events and developments associated with the region or country which can adversely affect performance. Investments in emerging or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile and these investments may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers the Fund can be adversely impacted by changes affecting such issuers. Unlike typical exchange-traded Funds, there are no indexes that the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objectives will depend on the effectiveness of the portfolio. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs.

Investments in commodities may be affected by overall market movements, changes in interest rates and other factors such as weather, disease, embargoes and international economic and political developments. **Commodities and futures are generally volatile and are not suitable for all investors**. Please read the Fund's prospectus for specific details regarding the Fund's risk profile

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.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

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.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

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.

Embedded Income Yield : Represents the annualized rate of return generated by a fund's investments in both fixed income securities and derivatives exclusive of interest rate changes and movement in foreign exchange spot rates. The calculation is intended to capture the Fund's potential to earn income return over the following year given current holdings and market conditions. The embedded income yield will differ from the portfolio's yield to maturity, due to the incorporation of derivatives in the embedded income yield. Embedded income yield and portfolio yield to maturity may differ from a Funds actual distribution and SEC yield and do not reflect Fund expenses.