TIME TO GET BULLISH ON THE EURO? WHY WE WOULD INCORPORATE A DYNAMIC APPROACH

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One of the big stories this year has been the weakness in the U.S dollar after a strong run in the second half of 2016. A confluence of factors is affecting the euro—from politics in the U.S. to monetary policy shifts that may occur later this year in the eurozone.

This has caused a shift in the attention of investors, from a focus on currency-hedged strategies that have the goal of isolating the equity market returns alone to "double decker" strategies that add currency risk on top of the equity returns.

Strategically, I believe there is a case to hold hedged strategies over the long run to reduce the uncertainty that comes with currencies. Sure, the euro is on a hot streak at the moment—but this is far from a sure sign to add value always and forever as unhedged strategies dictate. The euro's volatility over the last 20 years has been 10%—and the average annual move in either direction plus or minus 9%.[1]

Is now the time to turn more tactically bullish on the euro?

The increased flows to unhedged European stock exposures mean—whether intentionally or unintentionally—investors are taking on more euro risk. Instead of always being long the euro on top of equities, for those who wish to add in currency risk, WisdomTree has been advocating a dynamic factor model to determine how much risk to hedge or keep exposed.

Our currency factor model uses three factors to determine the hedge ratio: interest rate differentials, value and momentum.

- The interest rate differentials will suggest staying hedged the euro for some time—and would largely require the European Central Bank to hike rates to higher levels than the U.S. Federal Reserve (Fed). This will mandate that WisdomTree's dynamic hedged Indexes offer a minimum one-third hedge ratio on the euro for an extended period. Our research has shown that when you were paid to hedge like you are today, that interest rate differential on average offset any gains that came in the currencies—this was one of strongest factors in our research.
- Momentum: The reason that many have become more bullish on the euro is that it just started appreciating. Our momentum model evaluates the 10-day moving average of currencies compared with the 240-day moving average. This signal is currently unhedged with the euro's positive momentum and will remain there until the 10-day moving average crosses back below the 240-day moving average.
- Value: Our fair value model for the euro reduced the hedge ratio earlier this year. The euro crossed below our 20% undervalued threshold on a purchasing power parity basis and will remain unhedged on that model for some time.

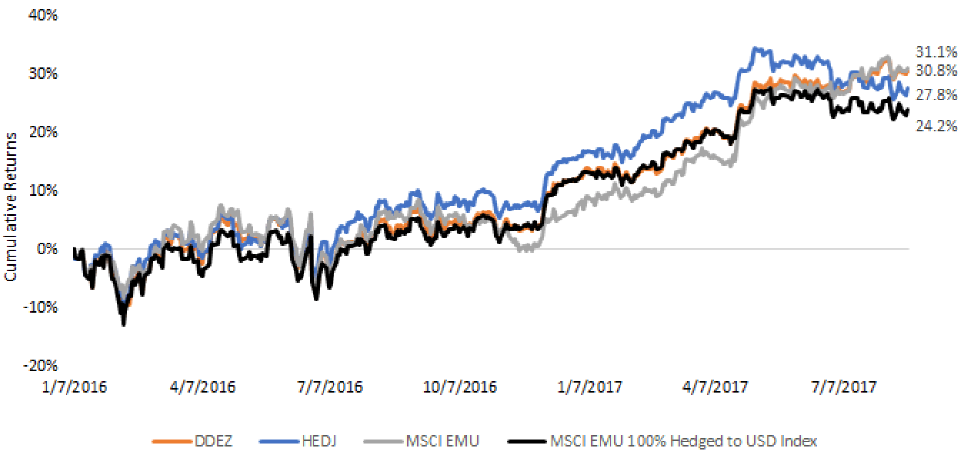
We launched the WisdomTree Dynamic Currency Hedged Europe Equity Fund (DDEZ), in January 2016. Over the ensuing period, it has outperformed both the fully hedged index from MSCI by approximately 660 basis points (bps) cumulatively and lagged the unhedged index by less than 40 bps cumulatively.

The WisdomTree Europe Hedged Equity Fund (HEDJ), which focuses on the exporters of Europe, was able to outperform the MSCI EMU (European Economic and Monetary Union) 100% Hedged to USD Index by 362 bps—this performance was due to its stock selection and weighting compared to a market cap index. While many have looked at this as a tactical play on Europe, we still advocate this as a core position of quality European stocks that have lower volatility than traditional unhedged European strategies.

Cumulative Returns (1/7/16–8/22/17)

Funds/Index	Cumulative Total Return	Average Annual Return
DDEZ	30.8%	17.9%
HEDJ	27.8%	16.3%
MSCI EMU	31.1%	18.1%
MSCI EMU 100% Hedged to USD	24.2%	14.3%

European Equity Returns (1/7/2016 - 8/22/2017)



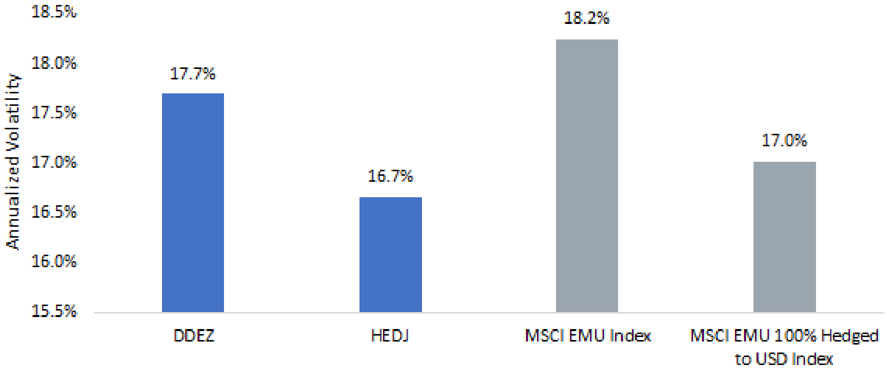
Sources: WisdomTree, MSCI, with data for the period 1/7/16–8/22/17. Net added value returns for ETFs and net total return for indexes. Past performance is not indicative of future results.

Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

For definitions of terms in the chart, visit our glossary.

From a volatility perspective, the hedged indexes, which are more like a pure equity strategy compared to the "double decker" equity plus currency strategies, will show lower volatility. Looking at annualized daily volatility levels, because we have a short period of the live dynamic hedged index, you can see the differentials in volatility.

Annualized Volatility (1/7/16 - 8/22/17)



Sources: WisdomTree, MSCI, as of 8/22/17. You cannot invest directly in an index.

Click here for DDEZ and HEDJ standardized performances.

The euro has contributed to returns for international investors this year, but this may not always be the case. I remember when many contrarians looked at the flows going to hedged strategies and suggested smarter investors should "go the other way." I'd argue that to lean against the vast tide today would be to move back toward hedged indexes for the eurozone and not in the double-decker funds. But if you think one can add value in rotating the hedge ratios and do not want to make a subjective determination, WisdomTree believes its quantitative and rules-based factor model will likely add value over time compared to both hedged and unhedged offerings.

[1]Volatility measured as the standard deviation of daily returns for the period 4/30/1998–8/22/2017. Average annual move measured for the period 12/31/1998–12/30/2016.

Important Risks Related to this Article

Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.

HEDJ: 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. 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 those issuers. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs.

DDEZ: 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 invests in derivatives in seeking to obtain a dynamic currency hedge exposure. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions. Derivatives used by the Fund may not perform as intended. A Fund that has exposure to one or more sectors may be more vulnerable to any single economic or regulatory development. This may result in greater share price volatility. The composition of the Index underlying the Fund is heavily dependent on quantitative models and data from one or more third parties, and the Index may not perform as intended. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index or take defensive positions in declining markets. 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.

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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.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

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

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Bullish : a position that benefits when asset prices rise.

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

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.

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.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Moving Average : is a calculation to analyze data points by creating a series of averages of different subsets of the full data set.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

Basis point : 1/100th of 1 percent.

MSCI EMU 100% Hedged to USD Index : represents a close estimation of the performance that can be achieved by hedging the currency exposure of its parent index, the MSCI EMU Index, to USD, the “home” currency for the hedged index. The index is 100% hedged to USD by selling the EUR forward at the one-month forward rate. The parent index is composed of large and mid-cap stocks across 10 Developed Market countries.

Market Capitalization : 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.