

EUROPEAN EQUITY INVESTORS: HOW MUCH FAITH DO YOU HAVE IN EURO STRENGTH?

Jeremy Schwartz — Global Chief Investment Officer
01/30/2013

There is always a development in the global asset markets that has the potential to captivate a large share of the headlines. To me, one of the most interesting stories of late is taking place with respect to currencies. Japan's newly elected prime minister, Shinzo Abe, is engaging in a relentless attack on the strength of the yen against other currencies, and the market seems to believe that he is serious, since the yen is actually declining in value, most notably as measured against the U.S. dollar. I said in a previous blog that Abe has a large "bazooka" in his pocket and he is not afraid to use it if the currency markets shift toward supporting a stronger yen or the Bank of Japan (BOJ) does not follow a set of policy prescriptions that have the potential to weaken the yen's value against other currencies. Abe's rhetoric thus far has been very effective in getting the yen to weaken, and as a result a number of investors have embraced [currency hedged investments](#) for Japanese equities, as they see the weaker yen directly benefiting Japan's exporters. Japan may be the only country in the world that's currently exhibiting such a clear and sharply negative relationship between the returns of its currency and the returns of its equity markets—such that while the yen has been one of the weakest currencies, its equity markets have been among the strongest in the world.¹ All this is not to say that Japan is the only country whose currency value against other major currencies should be in question. There is a recession in Europe—and the countries on the periphery still exhibit very slow economic growth or even contraction, with many structural and competitive imbalances yet to be fully corrected. Last year, flows to European equities were substantial,² as bargain-hunting investors concluded that European stocks were attractively priced, even with all the uncertainty surrounding the economy. Practically all the investments went into funds that [assume European currency risks](#). Do these investors believe the euro is structurally better positioned than the U.S. dollar? I believe both the euro and the U.S. dollar have their fair share of potential weaknesses. Ultimately, the situation begs the question: Should investors trying to capture the relatively low prices of European stocks take on additional euro risk—namely positioning themselves so that their investments may decline from a weakening euro compared to the U.S. dollar—in doing so? It is widely understood that currency performance can add significant volatility to international equity returns, but the difficult question regards whether investors receive compensation, i.e., a potential increase in their returns, for taking on this additional risk. In some cases, depending upon both the market and the period in question, equity market returns and currency returns can exhibit correlations that are sharply negative—as we are currently witnessing in Japan.³ In fact, in the 1990s the European currencies had negative correlations between their returns measured in U.S. dollars and the MSCI EMU Local Currency Index. There was a nearly 10-year stretch (from September 30, 1992, to May 31, 2001) where the European currencies represented in the MSCI EMU Local Currency Index declined more than 40% on a cumulative basis, but the index returned 19.81% a year.⁴ The European stocks represented in this index reacted much like many of the Japanese stocks represented in the MSCI Japan Local Currency Index are reacting today. Over certain periods, of course, currencies can provide a tailwind that serves to strengthen returns for international investors who are not hedging their exposure (like the period from June 30, 2001, to March 31, 2008, where currency returns boosted the MSCI EMU Index by almost 10% per year⁵), but they can also be a big headwind for those who may be unhedged, as they have been for European equity investors since the euro peaked out at around \$1.60—it is now trading at around \$1.33.⁶ Currently, the default allocation for most investors in foreign equities is to take 100% exposure to currencies on an unhedged basis, regardless of one's outlook on the foreign currency's potential strength or weakness compared to the U.S. dollar. **I think investors should consider the following model for foreign equity investing:** 1) Investor has no conviction on currency direction: 50% hedged currency exposure, 50% currency exposure 2) High conviction that foreign currency will rise: 100% currency

exposure 2) High conviction that foreign currency will fall: 100% hedged currency exposure Of course there are many points in between these three baseline scenarios. I believe most investors have no real conviction on potential currency performance but still take on the full currency risk. To me, that is the wrong baseline. More investors should start with a 50% hedged currency position as a baseline and then dial up or down the currency exposure or currency hedge depending on their views and their level of conviction. The currency I have the most fundamental questions about—beyond the yen—is the euro. We have focused our research and index development on European equities that would benefit from a weaker euro, notably exporters such as Daimler Chrysler, BMW, Unilever, Bayer, Anheuser Busch InBev and other multinational corporations that have a global revenue base. Many of these exporters had very positive euro returns as the euro fell, even as the broader MSCI EMU Index declined after the euro peak (led by declining financials). While past performance is not indicative of future results, I expect these European exporters could potentially continue that positive performance if the euro were to weaken further versus the U.S. dollar. Bottom line: Investors should consider how much conviction they have in the potential performance of the euro against the U.S. dollar—and if the answer is that they have no idea as to its future direction, which I suspect is the case for many, they ought to consider hedging that risk, if they are truly trying to capture the equity opportunity. **Take the euro out of Europe (Video)** ¹Refers to the MSCI Japan Local Currency Index. As of 12/31/2012, the yen has been the weakest currency of the 12 represented in the MSCI EAFE Index compared to the U.S. dollar on a 1-month, 1-quarter and 1-year basis. Of the 22 market indexes represented in the MSCI EAFE Local Currency Index, the MSCI Japan Local Currency Index has ranked 1st, 2nd and 8th over these same periods. Source: MSCI. ²Based on an analysis of flows to European ETFs. Source: IndexUniverse. ³Refers to the negative correlation exhibited between the returns of the yen measured in U.S. dollar and the returns of the MSCI Japan Local Currency Index, with a specific negative 3-year correlation measured as of 12/31/2012. ⁴Source: MSCI. ⁵Source: MSCI. ⁶Bloomberg.

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.