IS THE EURO THE NEW YEN?

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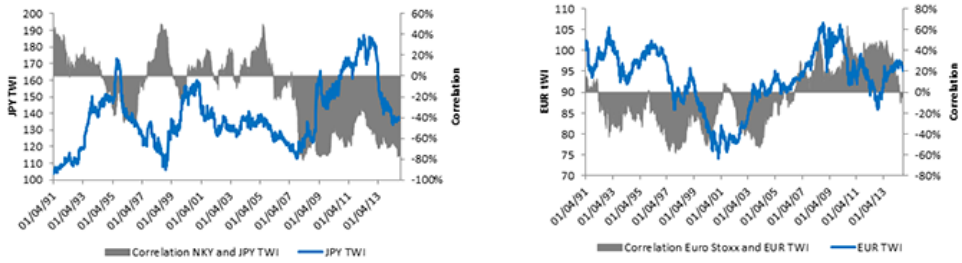
Currency-hedged equity strategies broke onto the exchange-traded fund (ETF) investment scene in late 2012 following significant weakening of the yen, which led to a wide disparity in performance between unhedged and currency-hedged Japanese ETFs. A key driver in the case of Japan was negative correlation, or an inverse relationship, between the performance of Japanese stocks and the yen. As the yen weakened, Japanese stocks performed well. The case for Japan's equity market in late 2012 and 2013 started when the central bank provided huge levels of monetary support to rid Japan of deflation. This action led to a much weaker yen, which in turn contributed to a surge in corporate profits. Today Japan looks like one of the lowest-priced markets because earnings were up more than stock prices.[1] There is recent evidence that Europe is becoming more Japan-like. First and foremost, Mario Draghi, head of the central bank, is instituting bolder monetary policies. In addition, we're seeing a negative correlation develop between the euro and European stocks. Now, this European negative correlation is not a new phenomenon. Much of the 1990s into the mid-2000s was characterized by a persistent negative correlation between the trade-weighted euro and European stocks.

Negative Correlations in Japan—A Historic Look Back Over the years, the Japanese yen has become increasingly negatively correlated to equities. While beginning in the '70s there was a run of approximately 25 years of positive correlation, 1995 marked a new regime. The new regime of negative yen and equity correlations in Japan coincided with a period of slow growth, deflation and zero-bound policy rates by the Bank of Japan (BOJ), and the negative correlation has been prevalent ever since. In many ways, this macroeconomic backdrop is similar to that of the Eurozone; since the beginning of 2014, both the euro and local equities have started to show increasingly negative correlation. What may be surprising to many is how often this was the case during the '90s—and how Europe has historically been more "Japan-like" in its negative correlation between equity markets and the European currencies.

Recent Negative Correlation between Euro Currency and Equities Reminiscent of Japan



Sources: WisdomTree, Bloomberg, as of 6/27/14. Past performance is not indicative of future results.

Euro Stoxx: Refers to the Euro Stoxx 50 Index, a market capitalization-weighted stock index of 50 large, blue-chip European companies operating in Eurozone nations.
NKY (Japan's Nikkei Index): Short for Japan's Nikkei 225 Stock Average, the leading and most respected index of Japanese stocks. It is a price-weighted index comprising Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.
EUR TWI: The trade-weighted euro is compiled as a weighted average of exchange rates of home versus foreign currencies, with the weight for each foreign country equal to its share in trade. This index is computed by the Bank of England.
JPY TWI: The trade-weighted yen is compiled as a weighted average of exchange rates of home versus foreign currencies, with the weight for each foreign country equal to its share in trade. This index is computed by the Bank of England.

Why Have Correlations Turned Negative and Japan-like? Is This a Replay of the '90s? There was a nine-year stretch between September 1, 1992, and May 31, 2001, when European currencies in the MSCI EMU Index depreciated 40.2% cumulatively versus the U.S. dollar, and EMU stocks in local currency terms had one of their best stretches ever, returning 19.8% per year. On a trade-weighted basis, European currencies declined 27.9% over the same period. This period alone suggests the European markets can perform well during times when the euro declines. More broadly, in the 1,226 rolling 52-week periods examined from January 1991 through June 2014, the Euro Stoxx 50 had a negative correlation to the European currencies, measured on a trade-weighted index, 59.4% of the time. The Nikkei 225 Index had a negative correlation to the yen only 56.1% of the time, albeit with very highly negative correlations that began showing up in late 2007. Below

are three rationales for the euro becoming more negatively correlated, as suggested by Valentin Marinov and his research team at Citi. • **Quantitative Easing (QE) to Buoy Equity Markets and Simultaneously Weaken EUR:** In light of the new policy measures announced at the June European Central Bank (ECB) meeting, many anticipate more policy action on the asset-purchase front, also referred to as QE. The expectation for more ECB action is underpinned by flat-lining growth expectations and mounting disinflation fears in the Eurozone. As was the case in Japan, this could lead to currency weakness and simultaneous stock-market outperformance, resulting in an even more negative correlation. • **Aggressive Policy Action to Encourage Currency-Hedging Activity:** Through verbal intervention, negative deposit rates and other liquidity infusions (targeted longer-term refinancing operations); the ECB could succeed in guiding markets toward a weaker euro. This could ultimately result in more currency-hedging activity from foreign investors, who are further encouraged by the miniscule cost of hedging at 0.1% annually.[2] Citi argues that increased currency hedging can lead to EUR underperformance, even if foreign inflows continue into the asset markets in Europe. As I argued here, it appears that Draghi is determined to cap the euro's upside potential, rendering the currency a source of unrewarded volatility. • **EUR the New Carry Currency:** As Japan returns to an environment of inflation and higher growth, the Eurozone might be fighting an uphill battle of lower-for-longer growth and persistent disinflation. Additionally, the ECB might only be in its early innings of policy easing, and its actions have thus far supported risky assets through lower bond yields and higher asset prices. The euro, as Citi suggests, is becoming the new funding currency, which should serve to further support European stocks while weakening the currency. **The Case for Euro Hedging** Given that many of the themes discussed above are likely to play out over the course of the next few years, negative correlations in the Eurozone may very well persist and become even more negative. WisdomTree believes currency-hedged investment strategies are growing in prominence due to shifting policy winds among global central banks. While the ECB has newly embarked on aggressive easing measures, the U.S. Federal Reserve is well on its way to ending QE late in 2014 and is largely expected to begin raising rates in the middle of 2015. This policy dichotomy could signal potential for a stronger dollar in the months ahead. From this standpoint, I believe we are in the very early stages of flows heading toward currency-hedged strategies—especially for Europe. [1]Sources: WisdomTree, Bloomberg, as of 6/30/14. [2]Source: Bloomberg, as of 5/31/14.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. ALPS is not affiliated with Citi.

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Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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

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.

Negative deposit rates : A new European Central Bank policy measure aimed at charging banks for parking their excess cash with the central banks.

Targeted longer-term refinancing operations (TLTRO II) : a periodic open market operation executed via tender offers which mature in June 2020.

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