WHAT DOES THE UNDERVALUATION OF THE EURO MEAN FOR YOUR CURRENCY HEDGE?

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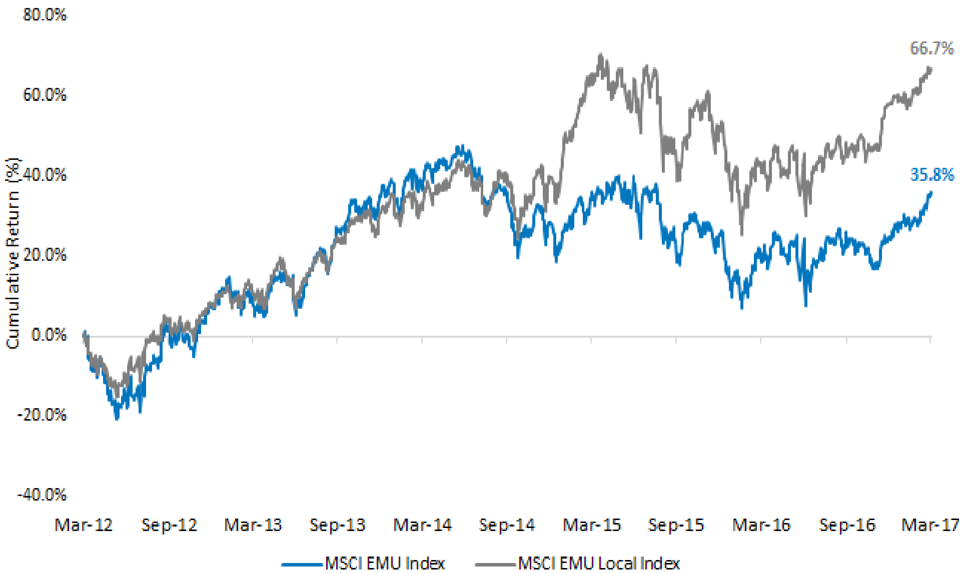
04/13/2017

In my last blog post on international investing, I suggested that currency hedging has a branding problem. I hypothesized that due to legacy naming issues, currency-hedged strategies seem like more exotic choices, whereas the unhedged options really are investments that contain two sources of risk: the equity markets risk and the currency risk. Currency-hedged strategies, despite having more exotic sounding names, really target just one source of risk and return: the local equity markets.

In European markets over the last five years, taking on the euro unhedged has been a losing bet: The euro has drifted downward from levels as high as 1.393 to the U.S. dollar in 2014 to low as 1.038 in late 2016. The euro has rallied a little from its bottom toward levels near 1.06 as of this publication.

For eurozone stocks over the last five years, the difference in returns was a drag from currency of more than 4 percentage points per year; on a cumulative basis, the drag from the currency bet losing turned a greater than 60% cumulative return into just a 30% plus cumulative return.

Cumulative Performance 3/23/12–3/24/17



Sources: WisdomTree, Bloomberg, with data from 3/23/12 to 3/24/17. Past performance is not indicative of future results. You cannot invest directly in an index. Shows most recent five years at the time of publication.

For European Equities Today: Is Now the Time to Be Bullish on the Euro?

But of course those are past returns. What about the future for the euro? Certainly, some people are saying the euro looks like a "value" proposition and is undervalued versus the U.S. dollar. In a further research piece, we will explore valuations of the euro for various European countries. While the euro may be too weak for countries like Germany, perhaps for countries like Portugal, Greece, Spain and Italy the euro is not weak enough. Moreover, valuations of currencies are not the best short-term timing indicator—any adjustments that come from currency deviations from a currency "fair value" can take a long time to mean revert.

For instance, for many of the years between 2003 and 2010 and all the way through 2014 the euro traded well above its fair value levels, and it took more than a decade from when it crossed above an OECD measure of fair value in 2003 before it started trading consistently below a fair value.[1] By that measure, it could be 2025 or later before the euro crosses back through a fair value territory.

On the other hand, we believe interest rate differentials are much more meaningful as short-term timing indicators. And by this score, while it is true that some are increasing odds that the European Central Bank (ECB) might act to taper its negative interest rate policy in 2017, the U.S. Federal Reserve (Fed) has hiked its short-term interest rates twice in the last three months and may be on a path to hike interest rates as many as four times in 2017. The differences in these short-term rates can be a powerful signal in terms of when it makes sense to hedge currencies, and therefore we have two signals pointing to opposite directions: Valuations suggest the euro is undervalued, while interest rates suggest a stronger dollar and weaker euro.

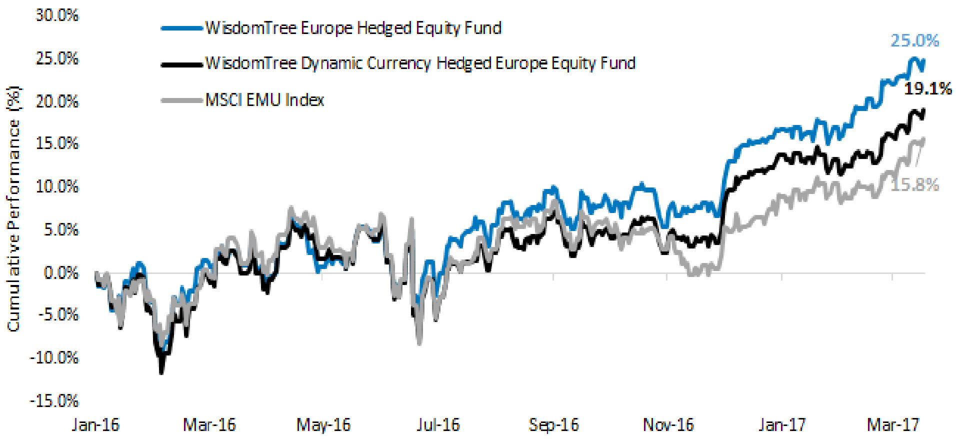
Using a Factor Model to Determine Currency Exposure

WisdomTree developed a dynamic hedged index and exchange-traded fund (ETF) family to try to help investors time their currency exposure when the factors suggest a stronger or weaker euro. The dynamic signals incorporate a three-factor approach to currency risk management: interest rate differentials (which suggest being hedged), valuations (which suggest not being hedged) and momentum (which suggests being hedged).

Our Dynamic Currency Hedged Europe Equity Fund (DDEZ) today has a two-thirds hedge ratio on, while investing in a broad basket of dividend-paying stocks. This ETF has 14.5 months of history and has seen its hedge ratio as low as 50% and high as 83.3% since its inception. If the momentum signal were to roll over, its hedge ratio would drop from two-thirds hedged to one-third hedged, as the interest rate differential signal would suggest staying hedged for some time—as long as the ECB has a lower short-term rate than the Fed.

Over the last 14.5 months, this dynamically hedged eurozone ETF has outperformed the unhedged MSCI EMU Index by more than 300 basis points (bps), while it lagged WisdomTree's flagship 100% currency-hedged European ETF of eurozone exporters, the WisdomTree Europe Hedged Equity Fund, HEDJ.[2]

Cumulative Performance 1/07/16–3/23/17



Sources: WisdomTree, Bloomberg, with data from 1/7/16 to 3/23/17. Past performance is not indicative of future results. You cannot invest directly in an index. 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.

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.

Click for standardized performance of the WisdomTree Europe Hedged Equity Fund and the WisdomTree Dynamic Currency Hedged Europe Equity Fund.

Exporter Tilt Paying Off for HEDJ

The exporter tilt has also paid off from a stock selection basis, so there is some outperformance of HEDJ over DDEZ from that perspective as well. On a local to local currency basis, the stocks in HEDJ outperformed the MSCI EMU Index by about 900 bps, and a predominance of that performance came from under-weighting eurozone Financials, which lagged; identifying strong performance Financials in Spain; and then over-weighting and tilting to outperforming Consumer Discretionary and Industrials stocks.

The Future of the Euro?

As investors contemplate the moves in the euro and think about what those moves mean for returns looking forward, we'd remind them that currency has added to volatility of European stocks, while not adding to expected returns. I call this a form of taking uncompensated risk. Why take this euro risk or bet unless you have a bullish tactical view of the euro?

While valuations might suggest that it is a better time to take on the euro than it was five years ago, our dynamic currency factor model, which we think can create a series of positive expected returns, suggests being two-thirds hedged.

Change Your Default Allocation

The only proposition for European equities I personally would not advocate for is being unhedged all the time. I can argue for fully hedging the euro for the volatility-reduction benefits or dynamic hedging to take euro bets when the odds are most in your favor. DDEZ could be a great option for those who don't want to have to rotate between hedged and unhedged on their own.

[1]Source: OECD, with 2003–2010 referring to data from 5/30/03 to 6/30/10 and 2014 as 10/31/14.

[2]Sources: WisdomTree, Bloomberg, with data from 1/7/16 to 3/23/17.

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. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

DDEZ 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.

As HEDJ 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. Please read each Fund's prospectus for specific details regarding each 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.

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You cannot invest directly in an index.

DEFINITIONS

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

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

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).

Bullish : a position that benefits when asset prices rise.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

Organization for Economic Cooperation and Developmnt (OECD) : the organization for economic co-operation and development aims to promote policies that will improve the economic and social well-being of people around the world.

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

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

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

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.

Momentum Factor : 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.

Hedge Ratio : The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.

Dividend : A portion of corporate profits paid out to shareholders.

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

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