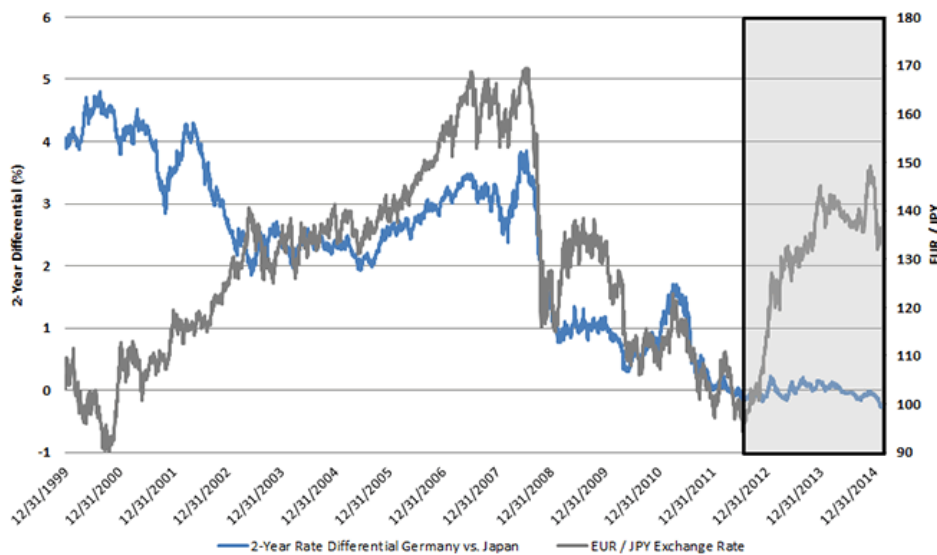


# WHAT'S REALLY DRIVING THE VALUE OF THE EURO AND YEN?

Bradley Krom — Head of U.S. Research  
03/02/2015

With a majority of developed markets rallying strongly over the last several years, we think the single biggest determinant for investors actually being able to capture those returns has hinged on their ability to manage [currency risk](#). Owning foreign assets in any currency other than the U.S. dollar has generally resulted in a painful combination: being on the right side of the trade, but seeing profits eroded from weakening foreign currencies. As we [noted last summer](#), relative [short-term interest rates](#) can significantly impact the value of one currency versus another. However, relative rates may not always give the full story. Case in point: What's driving the value of the euro and the yen now that short-term interest rates in both Europe and Japan are hovering around 0%? As we show in the remainder of this piece, the relationship between the euro and the yen is being driven by the markets' perception about the effectiveness of central bank policy. So far in 2015, an overwhelming majority of analysts and traders are forecasting another year of dollar strength. While consensus views often make investors nervous, we believe that the drivers of a longer-term trend in the dollar remain firmly intact. Most notably, anticipated divergence between the U.S. Federal Reserve (Fed) and foreign central banks becoming a reality will likely help accelerate this trend. However, as shown in the chart below, with short-term interest rates anchored around zero in Europe and Japan for the last two years, interest rate differentials did little to explain the dramatic weakening in the value of the yen compared to the euro. So what can explain this dramatic rise? To put it simply, [quantitative easing \(QE\)](#).

**Exchange Rates vs. Short-Term Interest Rates (12/31/1999–2/20/2015)**  
Germany & Japan: 2-Year Rate Differential vs. EUR / JPY (RHS)

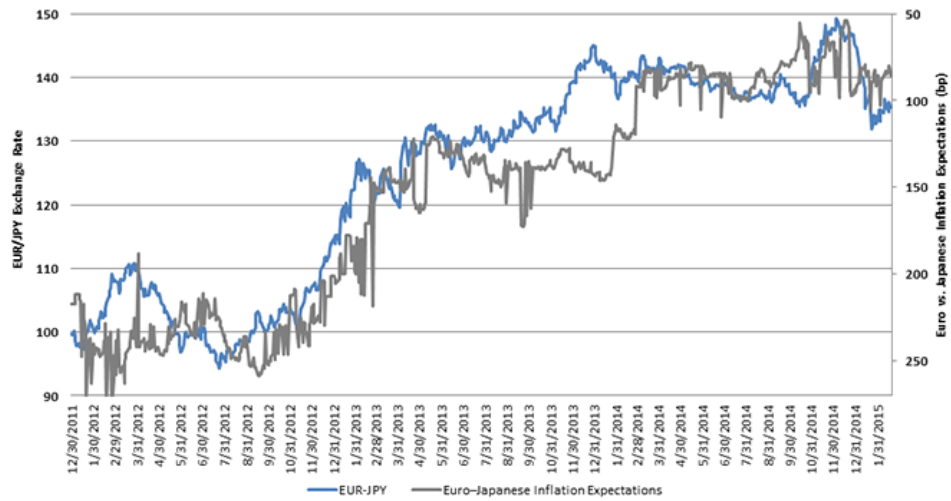


Source: Bloomberg, as of 2/20/15.

With few other policy tools available to central banks with policy rates near zero, the Bank of Japan (BOJ) has unleashed a series of aggressive [asset purchase programs](#) in order to provide a shock to the Japanese economy. In doing so, how can the BOJ manage the effectiveness of its policies other than through the prices of the Japanese stock market? While the prices of risky assets are one way, a more nuanced approach would be to measure investors' thoughts on future [inflation](#). Since a primary goal of QE is to reverse [deflationary](#) tendencies, an uptick in inflationary expectations provides one barometer for QE efficacy. For the last 20 years in Japan, deflation has stifled domestic consumption and made investment unattractive. Since the

end of 2012, the yen has declined by more than 15% against the euro. As shown in the table below, the markets' perception of inflation expectations can explain a significant portion of the decline in value of the yen versus the euro.

**Exchange Rates vs. 5-Year, 5-Year Forward Inflation Expectations Euro/Yen Exchange Rate vs. 5-Year Inflation**



Source: Bloomberg, as of 2/20/15.

**Expectations (RHS)**

**Here**

**Come the Europeans** Perhaps noting the initial success of the BOJ, the European Central Bank (ECB) announced details of its own plan for aggressive asset purchase on January 22, 2015.<sup>1</sup> While the euro initially fell against the yen on the announcement, we have yet to see any meaningful change in relative inflation expectations. This can primarily be explained by the slight delay until March for actual asset purchases in Europe to begin. In our view, if the ECB is able to have a similar impact on the markets' perception of inflation, the Bank of Japan may need to announce additional measures to keep the euro from depreciating compared to the yen. **Portfolio Implications** While it is possible that currency markets may look to other factors to drive relative [valuations](#), QE in Japan and Europe represents clear positives for [risk](#) assets around the world. As the U.S. seeks to tighten [monetary policy](#), the combination of stimulus efforts from the BOJ and the ECB should continue to lift markets. Additionally, with global economic momentum possibly turning the corner in the second half of 2015, investors should consider [hedging](#) currency risk in order to protect returns from fluctuations in currency markets. **Unless otherwise noted, source for data is Bloomberg.** <sup>1</sup>Source: ECB, as of 1/22/15.

**Important Risks Related to this Article**

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

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](http://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, Kara Marciscano, 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

**Currency risk** : the risk that an investment will decline in value due to a change in foreign exchange rates.

**Short-term rates** : the rate of interest on a debt instrument maturing in two years or less.

**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.

**Asset purchases** : The Fed purchases longer-term securities issued by the U.S. government and longer-term securities issued or guaranteed by government-sponsored agencies such as Fannie Mae or Freddie Mac.

**Inflation** : Characterized by rising price levels.

**Deflation** : The opposite of inflation, characterized by falling price levels.

**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.

**Risk** : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

**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.

**Hedge** : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.