UK EQUITIES AND THE BRITISH POUND BECOMING INVERSELY RELATED

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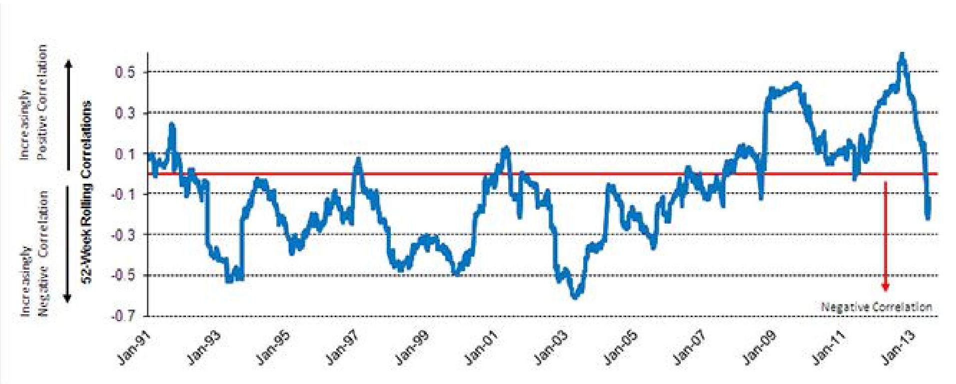
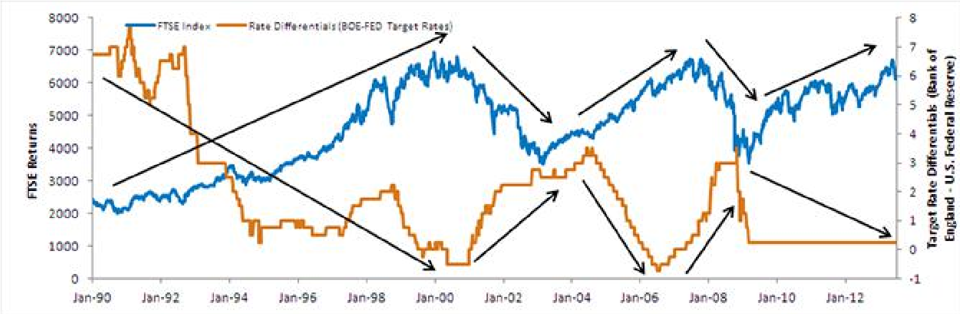
WisdomTree has focused on currency-hedging investment strategies this year. One might say the ideal situation for a currency-hedged strategy is when there is a relationship like we see in Japan today: when currency and equities move in opposite directions (referred to as a "negative correlation") and investors expect the currency to weaken further. It is thus noteworthy that we've seen a significant decline in correlation between UK equities[1] and the British pound (GBP) since September of 2012. The correlation has even broken into negative territory recently. This was not the first time UK equities and the GBP were inversely correlated—this negative correlation was characteristic of the markets for much of the 1990s and early 2000s. One explanation for the negative correlation of the GBP and UK equities in the '90s can be attributed to the global revenue base of many UK companies. The United States was viewed as an engine of growth during this period, and when the U.S. dollar strengthened versus the GBP, it coincided with a strong UK equity market. There was also a general environment of worldwide economic expansion.[2] This period was characterized by narrowing interest rate s differentials between the UK and U.S.[3] The decline in UK interest rates throughout the '90s was supportive for equities, while the currency weakened due to the reduction in interest rate spreads and debilitating macroeconomic factors pertaining to the UK but not the global economy where companies operated. This contributed to the persistent negative correlation during this period. In contrast, we saw spikes in correlation between the GBP and UK equities in 2000 (dotcom crisis), 2008 (global financial crisis) and more recently in 2010–12 (euro debt crisis). In these particular periods, correlation jumped into positive territory and hit a high of 0.6 at the height of the euro crisis in September of 2012. Correlation tends to spike in periods of severe economic uncertainty as investors sell out of non-U.S. dollar-denominated assets, such as currencies and equities, and funds are reallocated into the long-standing perceived safe haven-heaven, the United States. **Chart 1: 52-Week Rolling Correlation between the FTSE 100 Index and British Pound (GBP) Currency (vs. USD) 01/04/1991–06/28/2013[4]**



Sources: WisdomTree, Bloomberg.

The 52-week correlations have shown that the broad market[5] and the currency tend to be negatively correlated for most of the '90s and into 2007. **Interest Rate Differentials and UK Equities** The interest rate differentials between the United States and the United Kingdom play a large role in explaining the inverse correlation between the UK's equities and its currency. While interest rate differentials between the UK and the U.S. are negatively correlated with the FTSE 100 Index (chart 2), the interest rate differentials are positively correlated to the GBP exchange rate versus the U.S. dollar. These two relationships contribute to the overall negative correlation between UK equities and the GBP. **Chart 2: The FTSE 100 Index and Rate Differentials Imply an Inverse Relationship 01/05/1990–06/28/2013**



Sources: WisdomTree, Bloomberg

• Since 2009, interest rate differentials between the UK and the U.S. have been relatively flat. However, equities have been flirting with record highs as the FTSE has attracted many global leaders that have a multinational revenue base.[6] While the currency has weakened to reflect general concerns regarding poor UK growth and twin deficits, equities, on the other hand, have appreciated in line with stronger global growth post the global financial crisis. This explains the significant drop in correlation since 2012. • As severe economic tail risks becomes less of a focus—the spike in correlation that is typical of extreme uncertainty becomes less likely. Barring another crisis situation, we could see correlations become even more negative. • The differentials in interest rate policies of the UK and the U.S. have an impact on both the currency markets and the equity markets. It is thus interesting to contrast the initial stages of U.S. discussions to slow down the Fed's extraordinary monetary accommodation with the first meeting of the new head of the UK's central bank, Mark Carney, where he brought a new measure of communication to the Bank of England by stating that its interest rates were going to stay low for an extended period. If interest rates in the U.S. increase due to better economic growth while UK rates stay low, this could be negative for the British currency but positive for UK equities. **Conclusion** In light of the lackluster growth prospects for the UK and the potential for aggressive policy easing by the newly elected Bank of England governor, Mark Carney, we believe that equities can continue to climb while the British pound weakens to address competitiveness issues. In other words, the negative correlation between UK equities and the British pound can persist and even increase. During such an environment for currency and equities, just as we have seen with Japan, currency-hedged equity strategies become of greater importance. [1]UK equities: Universe is the FTSE 100 Index. [2]Source: The World Bank, Economic Growth in the 1990s: Learning from a Decade of Reform. March 2005. [3]Interest rate differentials: Measured by the difference between the Bank of England and the U.S. Federal Reserve target rates. [4]WisdomTree, Bloomberg. We use 52-week rolling correlations on returns, as this provides a longer-term perspective on how equity and currency returns relate to one another. [5]Broad market: Measured by FTSE 100 Index. [6]Source: Turcan Connell,"Think Global", May 2011.

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DEFINITIONS

Negative correlation : Indicated by a tendency of two series of data to move in opposite directions. Shown in the chart (in the red box), the USD-to-GBP exchange rate is trending downward while the FTSE 100 Index is trending upward.

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.

FTSE 100 Index : A market capitalization-weighted index measuring the performance of the 100 largest companies listed on the London Stock Exchange.