

Bullish German exporters, bearish euro? How UK investors can implement a GBP currency hedged equity strategy in one trade

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WisdomTree's German Equity UCITS ETF – GBP Hedged (DXGP) offers UK investors German equity market exposure and potentially achieve DAX equivalent performance in GBP terms. An Export-tilted German equity portfolio that is hedged in GBP efficiently positions the UK investor around euro devaluation. The weakness and/or volatility of the euro may remain a recurring risk in the face of Eurozone's macro uncertainty and the interest rate premium UK Gilts offer over German Bunds. In a macro environment where divergent monetary policies place persistent pressure on a foreign currency to which local investors have an undesired exposure - when all that is desired is the return on the underlying asset - it is worth paying attention to hedging the currency risk.

In the face of UK's improving growth conditions and rising interest rate expectations that contrast a lacklustre performing Eurozone economy requiring low borrowing costs, UK investors investing in Eurozone assets remain subject to potentially significant devaluation risk of the euro relative to the pound. Especially when seeking to benefit from the sentiment boost Europe's export-led equity markets typically enjoy when the euro devalues, a currency hedged equity strategy wrapped in an ETF may be an efficient way for UK investors to isolate the potential positive returns in equity markets from the potential negative returns in FX markets.

Chart 1 shows the since inception performance of the WisdomTree's Germany Equity UCITS ETF – GBP Hedged total return index in GBP, together with the EUR/GBP spot rate as well as vs the DAX 30 (expressed in EUR and GBP terms).

Over the period shown, UK investors would have incurred a significant currency risk when buying into German equities at a time when the euro was depreciating relative to the pound. In fact, the euro depreciated 7.4% this year relative to the pound, having weakened by 15% since the inception of the index (30 April 2014). This implies that while the DAX is up 18% this year and up 2.6% in 2014 in euro terms, it would be up only 10.1% this year and down 3.9% in 2014 when converted into GBP. However, when investing in an export biased basket of German stocks that is also currency hedged, UK investors are given the opportunity to efficiently take advantage of that segment of the German equity market that is likely to be most sensitive to currency fluctuations.

In the face of QE in the Eurozone, whereby the ECB is now also looking to accelerate the asset purchases ahead of a low-liquidity summer period, the pressure that the program may put on the euro could be another boost to the top (and bottom) line projections of German exporter stocks, and potentially provide more support for their stock prices. Over time, the extra performance reaped by neutralising the depreciating

effects of QE- induced inflationary expectations on the currency that are detrimental to the in GBP converted performance for UK investors exposed to German exporter stock basket can be substantial. As shown in the chart, the performance gap between the hedged vs the unhedged exposure to the German equity market has grown considerably on the back of QE. However, an export tilted German stock portfolio where the GBP/EUR FX risk is hedged, UK investors may reap the benefit of generating German equity market like returns in sterling. The index of the WisdomTree's Germany equity UCITS ETF that is GBP hedged has been able to closely follow the performance of the DAX 30. Hence, UK investors are able to get DAX 30 equivalent returns in one simple trade ETF.

In spite of the substantial depreciation of the euro relative to the pound in recent years, the risks of the euro devaluing further should not be ignored. QE is expected to last until 2016, which until it is unwound will keep the lid on Eurozone's suppressed bond yields that, in the face the uncertainty overhanging Greece's future in the Eurozone, makes the Eurozone by and large an unattractive investment destination for investors seeking competitive income yield. In particular when compared to the UK, where improved growth expectations have widened UK's long term interest rate differential with Germany to well over 100 bps, as shown in chart 2 (previous page). The risk of depreciation and considerably volatility to which the euro-pound exchange rate could become subject may be a prudent reason to hedge currency risk. Not least because when gauged by the strong performance of Germany's equity market, the currency hedge may well be worth it.

Investors sharing this sentiment may consider the following UCITS ETF:

- **WisdomTree Germany Equity UCITS ETF - GBP Hedged (DXGP)**

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

Important Risks Related to this Article

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