

Case for Currency Hedging: Weak Currency Benefits Europe and Japan

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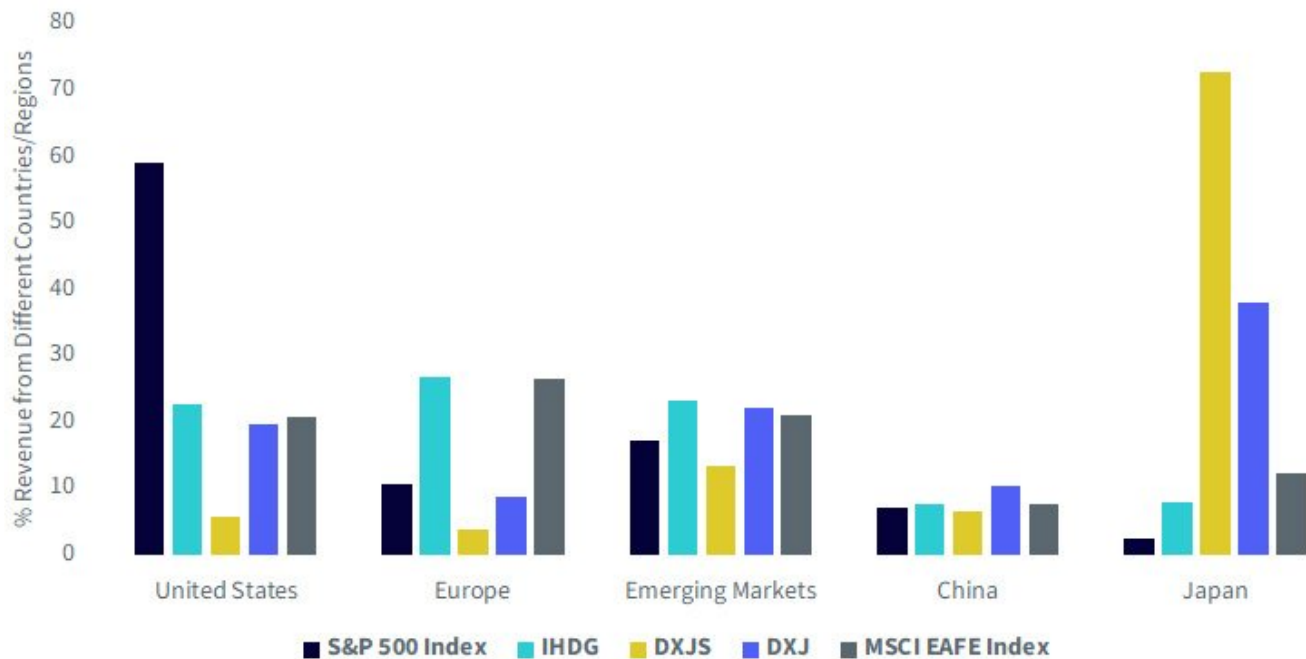
Key Takeaways

- Weak currencies can benefit Japanese and European companies with substantial overseas business operations, leading to limited incentives for the countries to significantly strengthen their currencies.
- The U.S. is more accepting of Japan and Europe maintaining weak currencies as a check on the rise of Chinese exports, benefiting its allies in their competition with China.
- Currency hedging, whether through dynamic or fully hedged strategies, has delivered risk reduction and return enhancements for many developed international portfolios.

In today's complex global economy, currency fluctuations play a crucial role in shaping investment outcomes. While we've previously emphasized the [importance of currency hedging in a U.S. investor's international portfolio](#), there's a subtle aspect that often goes unnoticed: the positive impact of weak currencies for Japanese and European companies and U.S. tolerance of it as a check on Chinese exports.

Headlines often focus on the unhappiness caused by currency devaluation and volatility, particularly in the Japanese yen. However, a weak yen can actually benefit Japanese companies because many of these companies have substantial overseas business operations. The same holds true for most European companies. As a result, Japan and Europe reap the rewards of weaker currencies, and the incentives for them to significantly strengthen their currencies are limited.

Figure 1: A Closer Look at Revenue Sources



Sources: FactSet, WisdomTree, as of 4/30/24. **Performance data quoted represents past performance and is no guarantee of future results. Investment return 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. Current performance may be lower or higher than the performance data quoted.**

For each Fund's full standardized and most recent month-end performance, please click the respective ticker: [DXJS](#), [DXJ](#), [IHDG](#).

Based on the chart above, the U.S. S&P 500 index is about 60% domestic, while developed international strategies are around 40% Europe and Japan.

- **S&P 500 Index:**

- Approximately 40% of revenue for U.S. S&P 500 Index companies is derived from outside the U.S.
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- **Japanese Companies:**

- In the dividend-weighted large/mid-cap [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#), only 38.2% of revenue comes from Japan.
- The smaller-cap, dividend-weighted [WisdomTree Japan Hedged SmallCap Equity Fund \(DXJS\)](#) relies on Japan for 72.9% of its revenue.
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- **The MSCI EAFE Index:**

- Combining revenue from European and Japanese companies accounts for about 40% of the MSCI EAFE.
- Consequently, the incentives for Japan and Europe to significantly appreciate their currencies remain limited. For U.S. investors, this underscores the benefits of currency hedging, especially when U.S. interest rates are higher.
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- Consequently, the incentives for Japan and Europe to significantly appreciate their currencies remain limited. For U.S. investors, this underscores the benefits of currency hedging, especially when U.S. interest rates are higher.
- **WisdomTree International Hedged Quality Dividend Growth Fund (IHDG):**
 - The Fund is benchmarked to the MSCI EAFE Index, with about 35% of revenue from Europe and Japan combined. Weak currencies generally help companies that have sizable overseas revenue.
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Geopolitical Considerations

Beyond economic factors, geopolitical dynamics also shape currency outcomes:

- **Strong Dollar vs. U.S. Companies:**

- While a strong dollar can hinder U.S. companies' earnings growth, it benefits Europe and Japan—both U.S. allies in the competition with China.
- Weak European and Japanese currencies enhance the competitiveness of their products relative to Chinese counterparts.
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- **Tolerance for Weak Yen and Euro:**

- Given its economy, the U.S. is more accepting of Japan and Europe maintaining weak currencies. This approach serves as an additional check on the rise of Chinese exports.
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Lastly, let's address the impact of interest rate differentials:

- **Rate Cuts:**

- When the U.S. begins cutting rates, the U.S. dollar will be under pressure.
- However, what truly matters for currency movements is the interest rate differential, not the absolute U.S. rate.
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- **Europe's Response:**

- There's a high likelihood that Europe will either match or outpace U.S. rate cuts, ensuring that the USD-euro interest rate differential remains significant.
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Currency hedging, whether through dynamic currency hedging or fully hedged strategies, has delivered risk reduction and return enhancements for many developed international portfolios.

In summary, the incentives and U.S. tolerance for a weak yen and euro are important factors to consider in the current geopolitical environment. Thus, for a U.S. dollar-based investor, having some currency hedge could be a benefit.

Figure 2: Performance and Volatility of Various Ways of Hedging Currencies

Performance as of 5/28/24						
Ticker	Name	Average Annual Total Returns				
		1-Year	3-Year	5-Year	10-Year	Common Period (1/7/16–5/28/24)
DDWM	WisdomTree Dynamic Currency Hedged International Equity Fund	17.87%	8.85%	8.41%		8.50%
DWM	WisdomTree International Equity Fund	18.01%	4.56%	6.24%	3.64%	6.54%
DDLS	WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund	17.75%	4.59%	7.67%		8.00%
DLS	WisdomTree International SmallCap Dividend Fund	16.74%	-0.17%	4.54%	3.88%	5.81%
IHDG	WisdomTree International Hedged Quality Dividend Growth Fund	17.03%	8.22%	12.17%	9.52%	10.70%
MXEA	MSCI EAFE Index	16.66%	3.32%	7.69%	4.67%	7.48%

Performance as of 5/28/24						
Ticker	Name	Average Annual Volatility				
		1-Year	3-Year	5-Year	10-Year	Common Period (1/31/16–4/30/24)
DDWM	WisdomTree Dynamic Currency Hedged International Equity Fund	10.90%	11.87%	14.51%		12.69%
DWM	WisdomTree International Equity Fund	13.88%	15.42%	17.05%	14.55%	14.83%
DDLS	WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund	12.34%	12.54%	16.33%		14.43%
DLS	WisdomTree International SmallCap Dividend Fund	15.89%	16.42%	19.19%	16.13%	16.78%
IHDG	WisdomTree International Hedged Quality Dividend Growth Fund	11.01%	13.86%	13.99%		12.53%
MXEA	MSCI EAFE Index	14.80%	16.64%	17.80%	15.08%	15.37%

Sources: WisdomTree, FactSet, as of 5/28/24. Performance data quoted represents past performance and is no guarantee of future results. Investment return 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. Current performance may be lower or higher than the performance data quoted.

For each Fund's full standardized and most recent month-end performance, please click the respective ticker: [DDWM](#), [DWM](#), [DDLS](#), [DLS](#), [IHDG](#).

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty.

IHDG: To the extent the Fund invests a significant portion of its assets in the securities of companies of a single country or region, it is likely to be impacted by the events or conditions affecting that country or region. Dividends are not guaranteed and a company currently paying dividends may cease paying dividends at any time. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile and these investments may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. 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. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DXJS: Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk, interest rate fluctuations and derivative investments, which can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund 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 the Fund's prospectus for specific details regarding the Fund's risk profile.

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DDWM: The Fund 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DWM: Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DDLS: The Fund 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. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DLS: Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.