

What Are Technicals Saying About Currency Markets?

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While factor investing in equities appears to be gaining traction, investors ignoring momentum in the foreign exchange (FX) market may be exposing themselves to undue risk. Below, we examine the trends in technicals for the U.S. dollar, euro, Japanese yen and British pound to find clues for where FX markets could head next.

Methodology

Through our research on currency markets, we identified three distinct factors that help explain movements in FX markets over the short, medium and long term. In the short run, momentum can be a powerful predictor of future FX returns. This idea is based on currencies that recently have appreciated tend to do so until those moves are exhausted. In the medium term, carry (or interest rate differentials between countries) can also influence relative exchange rates. The idea that higher interest rates attract foreign capital causing the exchange rate to appreciate is widely cited in academic research. Finally, in the long-run, the concept of purchasing power parity also helps explain exchange rates. Over time, currencies cycle from being overvalued to fairly valued to undervalued. It stands to reason that currencies that are overvalued should be hedged.

While we have shown that all three factors can be combined to improve currency hedging decisions, this analysis focuses on the short-term drivers of exchange rates: momentum. In this case, should the 10-day moving average cross above the 240-day moving average, that currency is likely to continue to appreciate. Below, we highlight broad-based positioning in the dollar as well as the euro, the yen and the pound.

Broad Dollar

After an impressive run from 2011 to mid-2015, the dollar¹ generally has been in a corrective phase. This appears to have changed at the end of 2017. In May 2018, the 10-day moving average crossed the 240-day moving average, signaling a move higher for the dollar. In our view, looking at broad-based measures of the dollar against other major markets and trading partners can help signal broader trends. Interestingly, from 2011 to mid-2015, virtually no foreign currency appreciated against the dollar. With the exception of the Mexican peso, no other foreign currency has appreciated against the U.S. dollar since it broke out on May 10, the day the momentum signal was triggered. In our view, investors should continue to reassess currency risk in the current strong dollar environment.

BBDXY Technicals (10- & 240-Day Moving Average)



Source: Bloomberg, as of 8/21/18. Past performance is not indicative of future results. You cannot invest directly in an index .

For definitions of terms in the chart, please visit our [glossary](#).

European Euro (EUR)

While the euro remains much weaker than it was in 2014, both 2016 and 2017 saw a fairly strong resurgence against the dollar. On May 15, 2018, the euro broke below the 240-day moving average, signaling the potential for further weakness against the dollar in the coming weeks. In our view, as long as the euro continues to trade under 1.1929, any rebounds should be sold tactically.

EUR Technicals (10- & 240-Day Moving Average)

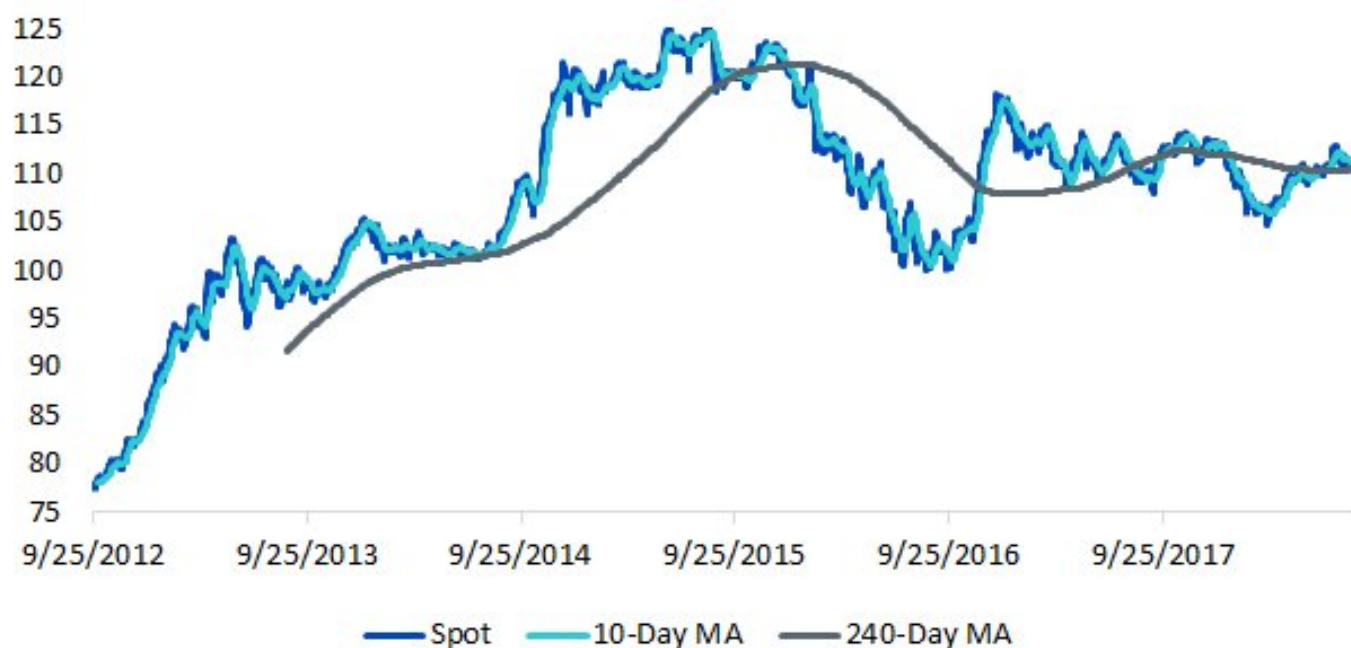


Source: Bloomberg, as of 8/21/18. Past performance is not indicative of future results. EUR spot currency values

Japanese Yen (JPY)

With few exceptions, the yen experienced a period of trend depreciation for over three years. Since that time, it has entered a period of consolidation. However, as of June 20, 2018, the technical position shifted to signal a potential period of yen weakness. In our view, as long as the yen remains above 110.4, it appears as though the market is signaling a strong dollar, weak yen pattern.

JPY Technicals (10- & 240-Day Moving Average)



Source: Bloomberg, as of 8/21/18. Past performance is not indicative of future results.

British Pound (GBP)

While the pound had been weakening well in advance of Brexit, depreciation accelerated rapidly after the June 23, 2016, referendum. Falling to 1.20 versus the dollar, the pound had also entered a corrective phase. However, on May 24, the technical picture began to improve for dollar strength after breaking through 1.3475. While the British government continues its negotiations with the European Union, it seems that risks for the pound remain skewed to the downside.

GBP Technicals (10- & 240-Day Moving Average)



Source: Bloomberg, as of 8/21/18. Past performance is not indicative of future results.

Summary

In our view, one of the broadest measures of the dollar appears to be breaking out while some of the most liquidly traded currencies are breaking down. In response, we believe investors should continue to be vigilant in managing the foreign currency risk of their portfolios. Our list of solutions runs the gamut of fully hedged strategies such as [WisdomTree Europe Hedged Equity Fund \(HEDJ\)](#), [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#) and [WisdomTree International Hedged Quality Dividend Growth Fund \(IHDG\)](#) to dynamically hedged strategies that rely on the three-factor methodology above. For the dynamic approaches, [WisdomTree Dynamic Currency Hedged International Equity Fund \(DDWM\)](#) and [WisdomTree Dynamic Currency Hedged International SmallCap Equity Fund \(DDLX\)](#) are currently 75% hedged across the currencies of the MSCI EAFE Index. In our most recently launched strategy, [WisdomTree International Multifactor Fund \(DWMF\)](#) was 84% hedged as of this writing.

1As proxied by the Bloomberg Dollar Spot Index (BBDXY).

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. 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. Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar. As the Funds can have a high concentration in some issuers, these Funds can be adversely impacted by changes affecting those issuers. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.