HIGH CARRY: KING DOLLAR OR EMERGING MARKETS?

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WisdomTree launched our first currency (FX) funds back in 2008, at a time when short-term interest rates were still anemic on account of the global financial crisis. Now, short-term rates have risen to levels not seen since the mid-2000s, while longer-duration fixed income strategies have gone negative three years in a row.

For clients looking for alternatives to traditional fixed income, we believe two of our strategies could fill an interesting need in their portfolios depending on their view of the U.S. dollar.

Looking under the Hood: T-Bills + Rate Differentials

All of WisdomTree's currency funds are constructed exactly the same. For every dollar invested, $1 is invested in high-quality, U.S. dollar-denominated collateral such as U.S. Treasury bills. This position is combined with 1-month forward currency contracts that compensate investors for differences in short-term interest rates between markets as well as changes in the spot price of the currency. In essence, there are three sources of return: collateral, carry and moves in spot FX.

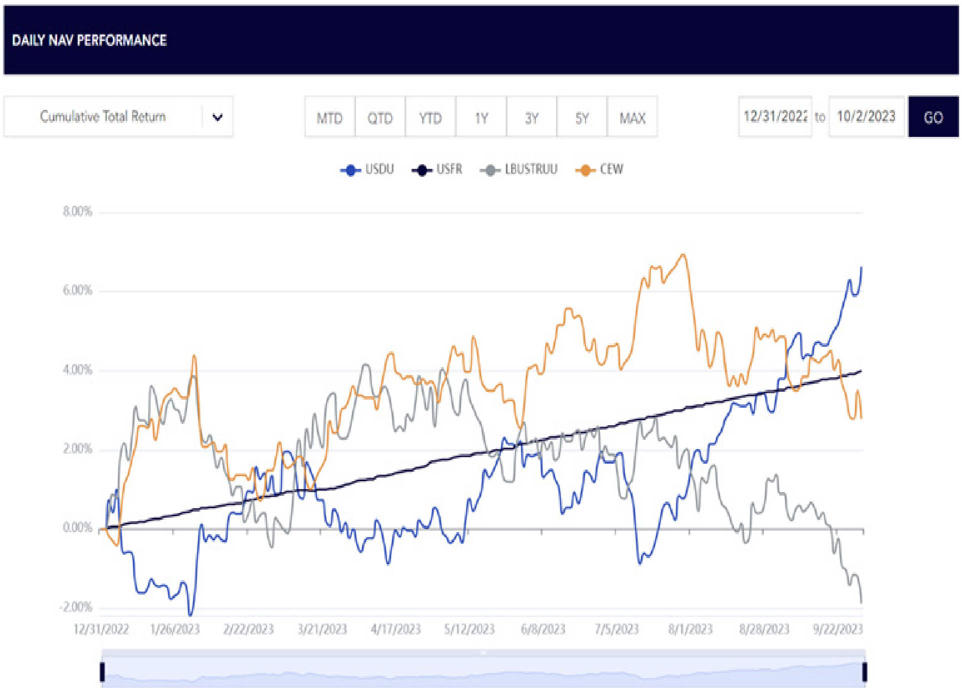
Long Dollar, Short Foreign FX

As we wrote about earlier, the spot prices of the U.S. dollar have risen dramatically over the last three months as expectations about a Fed pivot have been pushed further into the future. The WisdomTree U.S. Dollar Bullish Fund (USDU) is a direct exposure to this trend. USDU delivered returns of 7.6% versus a move in spot prices of 6.4%.

The 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 the most recent month-end performance for USDU, click here.

Short-term t-bills, represented by the WisdomTree U.S. Floating Rate Treasury Fund (USFR), had returns just north of 1% over this period, while the Bloomberg U.S. Aggregate (Agg) Index (LBUSTRUU Index) fell by 4.5% as longer-term U.S. interest rates rose.

Put another way, the dollar was one of the best hedges for rising rates over the period despite being one of the shortest in duration. Year to date, USDU is up 6.6%, while the Agg is down 1.9%. Additionally, our team has also previously written that a strong dollar is one of the bigger risks to U.S. corporate earnings, so there are further hedging characteristics that are attractive.



Source: WisdomTree, as of 10/7/23. **Past performance does not guarantee future results. One can not invest directly into an index.**

Long EM FX, Short USD

While the dollar has been on a tear recently, to start the year, we saw broad-based weakness. By contrast, the [WisdomTree Emerging Markets Currency Fund (CEW)] peaked on July 28 with returns of just under 7%. We contrast this to returns in core bonds of only 2%.

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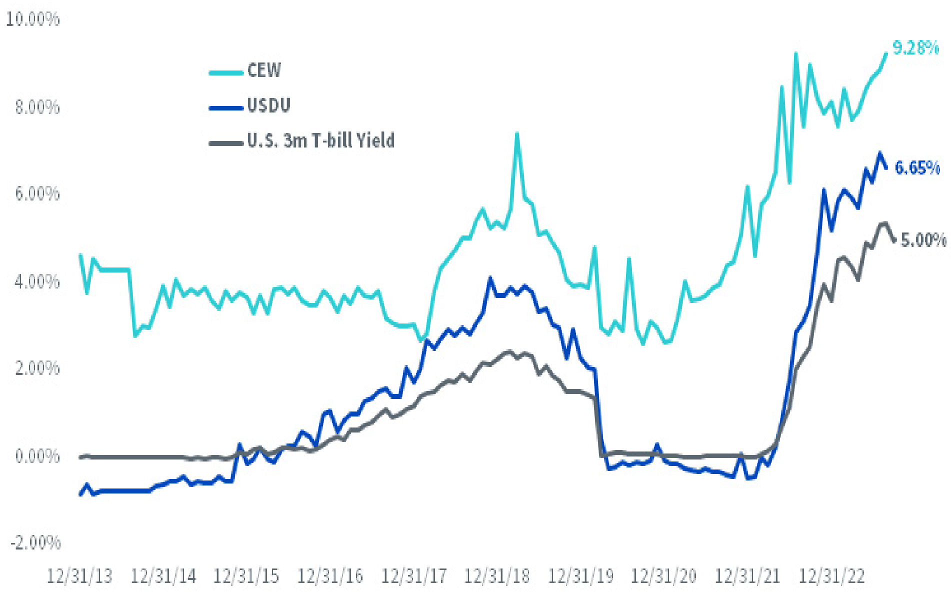
While spot prices could be seen as the primary driver of returns for the currency funds historically, investors should now be much more cognizant about the potential for returns from short-term U.S. collateral, as well as paying close attention to rate differentials.



Source: WisdomTree, as of 10/7/23. Each line represents implied yield. **Past performance does not guarantee future results. One can not invest directly into an index.**

Currency Fund Implied Yields

As shown in the chart above, we contrast the implied yield components of CEW and USDU after the launch of USDU in late 2013. Early in the period, CEW provided a significant yield pickup due to higher short-term rates in nearly all emerging market countries versus the U.S.

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After the Fed began its aggressive rate tightening cycle in 2022, implied yields in the U.S. increased versus foreign markets while at the same time providing meaningful levels of income on the underlying collateral that's invested in Treasury bills. A 9% implied yield on CEW—with no duration—is an interesting carry rate when compared with other alternative fixed income strategies that yield 9%, like high-yielding bonds.

Conclusion

When investors are thinking about positions other than core allocations like stocks and bonds, they should be thinking about strategies that offer "carry plus" or some other driver of return. With short-term rates close to 5.5%, this baseline for returns appears attractive in real terms should the Fed ultimately prove successful in achieving its dual mandate. In response, the value of the dollar is likely to be one of the primary beneficiaries or casualties, depending on the amount of time it takes. In the short run, we believe dollar strength offers the path of least resistance. In the long run, EM currencies may offer value from higher rates and appreciation due to their structurally higher levels of growth and inflation.

Important Risks Related to this Article

USDU/CEW: 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. The Fund focuses its investments in specific regions or countries, thereby increasing the impact of events and developments associated with the region or country, which can adversely affect performance. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

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You cannot invest directly in an index.

DEFINITIONS

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

The Global Financial Crisis : Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Forward currency contracts : A forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Implied yield : The annualized rate of return generated by a fund's investment in forward currency contracts. The calculation is intended to show the yield of forward currency contracts, assuming that foreign exchange rates remain constant.

Inflation : Characterized by rising price levels.