2017 OUTLOOK: ROUNDTABLE DISCUSSION ON THE DOLLAR AND EUROPE

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WisdomTree's Chief Investment Strategist, Luciano Siracusano (L.S.), its Director of Research, Jeremy Schwartz (J.S.), and its Director of Research in Europe, Viktor Nossek (V.N.), sat down in mid-December to reflect on 2016 and discuss the forces that could impact global financial markets in 2017. Below is an excerpt from the discussion focused on currencies. You can access the full roundtable piece below.

Let's start off with a discussion on global monetary policy.

V.N.: The European Central Bank's decision to prolong and at the same time also cut debt purchases signals a bare minimum stance of monetary support for the eurozone. The timing of the tapering in particular is poor, if not outright risky, given the looming general elections in Europe in 2017 and the Fed's hawkish stance on U.S. monetary policy.

Trying to prevent bond yields in Europe from rising at the same time that U.S. Treasury yields are rising may prove to be very difficult, especially with the European Central Bank (ECB) reducing its high-grade debt purchases by €20 billion per month. There is the real risk that the widening interest rate gap between the U.S. and Europe could force the ECB to increase quantitative easing to contain the selling pressure in European government bonds. By risking its credibility as an effective intervener in bond markets, the ECB has made itself prone to enticing speculators back into the fore to bet against the eurozone's weakest sovereigns and the euro for 2017.

L.S.: That sounds to me like a scenario where the euro continues to weaken against the U.S. dollar in 2017. At a minimum, pending elections mean the volatility of the euro is a risk that needs to be managed. Unhedged European stocks have not been in favor for U.S. investors, ending 2016 essentially flat, factoring in the 3% decline in the euro. But at the end of 2016, we have noticed some relative strength developing among European exporters, on a currency-hedged basis. The WisdomTree Europe Hedged Equity Index, for example, rallied 8% since November 8, ending up 10% for the year. Last year at this time, I said we would see about 5% appreciation in the dollar versus a broad basket of developed and emerging stocks in 2016. The Bloomberg Dollar Spot Index appreciated 3% in 2016. I am bullish on the dollar again for 2017 and would not be surprised to see that same Index appreciate an additional 5% from current levels in the coming 12 months. If we agree that interest rates and the dollar have further room to run, then that also means the Japanese yen may well depreciate even further from current levels.

J.S.: Forecasting currencies is one of the most difficult exercises. This is one reason why we have suggested to investors to adopt strategic currency hedges when investing in developed markets—so as to not be forced into expressing bullish views on currencies like the euro, yen and pound as unhedged strategies do. We believe it makes more sense to remove or reduce currency exposure as a source of uncompensated risk when investing overseas. WisdomTree developed its systematic and dynamic currency-hedging strategy to incorporate a rules-based framework for hedging currencies based on factors we found to be most influential in affecting the hedging decision. In aggregate, for what it is worth, the total hedge ratio in our broad-based international equity strategy was

approximately 70% hedged. The three currencies that make up over three-quarters of the developed international markets are the euro, yen and British pound. In our dynamic hedging model, the British pound and yen were hedged at 83.3% going into 2017, while the euro was 66.7% hedged due to its value signal reaching a threshold where the one-third of hedge ratio that accounts for the "value" of a currency came off (indicating the euro showed a level of "inexpensiveness"). Of course, other factors come into play, and the interest rate differentials and the momentum of the euro are still pointing to be more than two-thirds hedged there.

L.S.: That strategy paid off in 2016. The WisdomTree Dynamic Currency Hedged International Equity Index ended the year up about 8%, beating both the unhedged and hedged versions of the MSCI EAFE Index. We believe this strategy has broad application within core developed world allocations for U.S.-based investors and is a particularly timely one headed into 2017.

L.S.: Victor, what is your take on the political pulse in Europe? You have several major elections coming up in 2017.

V.N.: The rise of Euroskepticism across the continent presents the biggest risk for Europe's financial markets. Putting the EU and the euro to a referendum, such as is demanded by the Five Star Movement in Italy or the National Front in France, depends on such anti-euro movements winning the general elections. It need not get that far if Europe's mainstream parties on the left and right harden their stance against fiscal tightening and immigration in an effort to blunt the message of extremist fringe parties. But time has started to run out. Mainstream parties have only half-heartedly adopted popular rhetoric. And reluctance on the part of eurozone member finance ministers to resist fiscal restraint and bail-in rules may mean it's just "too little, too late" to sway public support and preserve political unity. At the EU level too, officials are reluctant to unleash an aggressive fiscal stimulus package, or a "Donald Trump-equivalent" investment-infrastructure plan, to boost jobs and restore confidence in the European project. The language of the European Commission suggests an uncompromising focus on budgetary restraint. In its latest assessment of the draft budgets for 2017 submitted by eurozone members, it identified eight members (Italy, Spain, Portugal, Belgium, Finland, Slovenia, Lithuania and Cyprus) as in danger of being noncompliant with fiscal rules for next year, to which the Eurogroup—an informal group of finance ministers of eurozone members—has broadly concurred.

Summarizing Thoughts

The investing implications are never clear from this type of political uncertainty. We saw after the Brexit vote, the currency fell, but equity markets in the UK were actually quite strong in 2016, assuming you were either a local investor in the UK or you hedged your British pound risk as a foreign investor in the UK. There could be more political upheaval that results in a still weaker euro, but European equity markets could perform well. Political uncertainty is what might create opportunity as valuations stay reasonable due to depressed sentiment. Our asset allocation team, while under-weight European markets, from a global allocation perspective still would allocate roughly 20% there (inclusive of the UK). However, we maintain less than a 10% euro exposure through currency hedging.

To read the full 2017 Outlook roundtable discussion, click here.

Important Risks Related to this Article

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Sovereign : A national government.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Bloomberg Dollar Spot Index (BBDXY) : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.

Bullish : a position that benefits when asset prices rise.

Hedge Ratio : The specified percentage of currency exposure being hedged, with 0% indicating that none of the currency exposure is being hedged and 100% indicating that all of the currency exposure is being hedged.

Interest Rate Differentials : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.