FRENCH MINISTER WANTS EUROPE TO ENTER WORLD CURRENCY WAR

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"The euro is too strong and doesn't correspond to economic fundamentals." The European Central Bank ECB "should prepare to confront a new currency war in which the weakening of currencies becomes a political tool." – French Industry Minister, Arnaud Montebourg[1] In a recent blog we made the case for taking the euro out of Europe using currency-hedging strategies, based on our belief that currency hedging lowers the risk to investing in European equities. But there is another reason why hedging the euro may prove a useful strategy. A number of European politicians believe the euro is overvalued compared to other major currencies and is hurting their economies and local businesses. French politicians have been particularly vocal. In addition to Arnaud Montebourg, whom we quoted above, French president François Hollande recently stated that "A monetary zone must have an exchange rate policy. If not, it will be subjected to an exchange rate that does not reflect the real state of the economy."[2] Sebastian Mallaby, the Paul A. Volcker senior fellow for international economics at the Council of Foreign Relations, outlined the core of Europe's issues. If the ECB were to print money in order to achieve its stated goal of 2% inflation across the eurozone, countries such as Spain and Italy (with their high unemployment and slack in their economies) would likely experience 0% inflation, whereas countries such as Germany and the Netherlands would likely experience 3% to 4% inflation.[3] In essence, higher inflation in the core countries of Germany and the Netherlands can start to remove their structural competitive advantages over such peripheral countries as Spain and Italy, which are struggling to compete. **Will Germany Acquiesce?** In discussions of ECB policy, Germany carries significant weight. Regardless of whether Spain, Italy or France feels that a weaker currency could spur economic growth, Germany has been staunchly opposed to any ECB policy to weaken the euro. Germans remember the hyperinflation prior to World War II, and they feel that the profligate debt-fueled spending in the nations of peripheral Europe should not be rewarded by their acceptance of a weaker currency, which might end up increasing inflation in Germany. Ultimately, it may take a global economic surprise to inspire Germany to tone down the rhetoric against weakening the euro. **Global Economic Surprise of 2013: Sustained Yen Weakness** Since mid-November 2012, Japan's newly elected prime minister, Shinzo Abe, has made it a policy priority to reverse Japan's deflationary forces, which have hamstrung Japan's economic growth for some time. Currency markets have responded, and while many are focusing solely on the yen-to-U.S. dollar exchange rate, year-to-date through February 28, 2013, the yen has weakened 5.3% against the euro. Going back to November 13, 2012, through February 28, 2013, the yen has weakened 16.56% against the euro.[4] European companies—even German ones—are feeling this impact when their exports are competing in global markets with those from Japan. **European Exporters: Feeling the Pain and Taking Action** A number of European companies have joined the parade calling for policies to weaken the euro. • **LVMH Moët Henness - Louis Vuitton:** Louis Vuitton S.A.'s CEO Bernard Arnault has warned that a rising euro would have an impact on French exporters and specifically his firm.[5] • **L'Oréal:** The CEO of L'Oréal recently described the euro as "indisputably overvalued" and "effectively a handicap for European industry."[6] • **Airbus:** An appreciation by 10% of the euro shaves 1 billion euros from the

revenue of Airbus parent European Aeronautic Defence and Space Company N.V.—yet another example of a firm that is clearly impacted by continued euro strength.[7] LVMH illustrates what companies often do to combat the impact of currency movements on their revenues. During 2012, the firm garnered about 8% of its revenues from Japan—a significant amount. On February 15, 2013, the Louis Vuitton brand raised prices by 12% specifically for sales of its products in Japan.[8] Since the yen's significant weakening against the euro, sales of products in Japan—denominated in yen—were steadily losing value when converted back to euros—the currency of LVMH's home country, France. To mitigate this impact, LVMH is looking to collect 12% more yen on each Louis Vuitton sale in Japan. One open question is how Japanese consumers will respond to the higher prices—it must impact sales in some way. **Positioning for a Currency War** While the ECB has yet to embark publicly on a path to weaken the euro, recent euro strength especially against the Japanese yen is certainly bringing the subject into policy discussions. Investors can prepare for the euro to enter a currency war by focusing on two things: • Exposure to European firms characterized by global revenue streams—those companies that would stand to benefit the most from a weaker euro • Hedging of the euro currency to mitigate the impact of its depreciation on investment performance WisdomTree's Europe Hedged Equity Fund (HEDJ), which tracks the performance of the WisdomTree Europe Hedged Equity Index after costs, fees and expenses, provides the potential to accomplish both of these objectives. Constituents of this Index must derive at least 50% of their revenues from outside the eurozone, and the impact of the euro on returns is hedged against the U.S. dollar. *For current holdings in the WisdomTree Europe Hedged Equity Fund (HEDJ), click here.* **Take the euro out of Europe (Video)** [1]Tara Patel, "ECB Should Join 'Currency War' to Weaken Euro, Montebourg Says," Bloomberg, February 26, 2013. [2]Hugh Carnegy, Quentin Peel, Alice Ross, "Hollande Calls for Managed Exchange Rate," Financial Times, February 5, 2013. [3]Randall W. Forsyth, "The Euro's Fate," Barron's, July 16, 2012. [4]11/13/2012 marks the last date where the yen closed at below 80 to 1 U.S. dollar. Abe's candidacy for prime minister began to gain significant momentum approximately one month prior to his official election, so it was at that point that currency markets began reacting to his policy proposals. [5]"LVMH CEO Says Strong Euro Could Hurt Business in 2013," Reuters, January 31, 2013. [6]"European Companies Hit by Euro's Strength," Financial Times, February 24, 2013. [7]Patel, 2013. [8]Yuki Yamaguchi & Kenneth Maxwell, "LVMH Raises Vuitton Japan Prices Most Ever to Fight Weak Yen," Bloomberg, February 19, 2013.

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

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Hyperinflation : Extremely rapid, uncontrolled rise in price levels during a short period of time.