IS THE EURO THE NEW YEN? INCREASINGLY SO.

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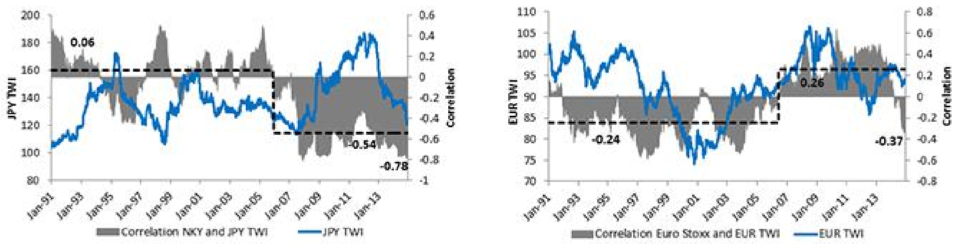
Currency-hedged equity strategies have become increasingly popular in the exchange-traded fund (ETF) investment scene, and it started with the significant weakening of the yen, which led to a wide disparity in performance between unhedged and currency-hedged Japanese ETFs. A key driver in the case of Japan was negative correlation, or an inverse relationship, between the performance of Japanese stocks and the yen. As the yen weakened, Japanese stocks performed well. There is recent evidence that Europe is becoming more Japan-like in displaying negative correlations between its equity markets and its currency moves. This negative correlation in Europe is not a new phenomenon: Much of the 1990s into the mid-2000s was characterized by a persistent negative correlation between the trade-weighted euro and the respective European stocks. The return of these stronger negative correlations is why I say the euro is increasingly the new yen. **Negative Correlations: A Historic Look Back** Over the years, the Japanese yen has become increasingly negatively correlated to equities. While beginning in the '70s there was a run of approximately 25 years of positive correlation, 1995 marked a new regime. The new regime of negative yen and equity correlations in Japan coincided with a period of slow growth, deflation and zero-bound policy rates by the Bank of Japan (BOJ); this negative correlation has been prevalent ever since. In many ways, this macroeconomic backdrop is similar to that of the eurozone; since the beginning of 2014, both the euro and local equities have started to show increasingly negative correlation. What may be surprising is how often this was the case during the '90s—and how Europe has historically been more "Japan-like" in its negative correlation between equity markets and the European currencies. **Recent Negative Correlation between Euro Currency and Equities Reminiscent of Japan**



Sources: WisdomTree, Bloomberg, as of 12/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.
Euro Stoxx: Refers to the Euro Stoxx 50 Index, a market capitalization-weighted stock index of 50 large, blue-chip European companies operating in eurozone nations.
NKY (Japan's Nikkei Index): Short for Japan's Nikkei 225 Stock Average, the leading and most respected index of Japanese stocks. It is a price-weighted index comprising Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.
EUR TWI: The trade-weighted euro is compiled as a weighted average of exchange rates of home versus foreign currencies, with the weight for each foreign country equal to its share in trade. This Index is computed by the Bank of England.
JPY TWI: The trade-weighted yen is compiled as a weighted average of exchange rates of home versus foreign currencies, with the weight for each foreign country equal to its share in trade. This Index is computed by the Bank of England.

Why Have Correlations Turned Negative and Japan-Like? Is This a Replay of the '90s? As the above chart shows, there was a nine-year stretch between September 1, 1992, and May 31, 2001, when European currencies in the MSCI EMU Index (EMU) depreciated 40.2% cumulatively versus the U.S. dollar, and EMU stocks in local currency terms had one of their best stretches ever, returning 19.8% per year. On a trade-weighted basis, European currencies declined 27.9% during the same period. This period alone suggests the European markets can perform well when the euro declines. Per the charts above, in the 1,252 rolling 52-week periods examined from January 1991 through December 2014, the Euro Stoxx 50 had a negative correlation to the European currencies, measured on a trade-weighted index, 60% of the time. The Nikkei 225 Index had a negative correlation to the yen only 57% of the time, albeit with very highly negative correlations that began showing up in late 2007. Below are two rationales for the euro becoming more negatively correlated: • **Quantitative Easing (QE) to Buoy Equity Markets and Simultaneously Weaken Euro:** In light of the new policy measures announced by the European Central Bank (ECB) in 2014—and the anticipation of new measures in 2015—many expect more policy action on the asset-purchase front, particularly with sovereign bond buying, corporate bond buying and outright QE. The anticipation of more ECB action is underpinned by declining growth expectations and mounting disinflation fears in the eurozone. This could lead to currency weakness and simultaneous risk-asset (equity) market outperformance, which can result in an even more negative correlation. • **Aggressive Policy Action to Encourage Currency-Hedging Activity:** In 2014 the ECB launched aggressive monetary policy easing, including verbal intervention, negative deposit rates and other liquidity infusions (targeted longer-term refinancing operations, TLTRO). As a result, the ECB has succeeded in guiding markets toward a weaker euro in 2014. We have already started to see an increase in asset flows to currency-hedged strategies for Europe in 2014 and expect this to continue if asset flows pick up for European investments[1]. **The Case for Euro Hedging** Given that many of the themes discussed above are likely to play out over the course of the next few years, negative correlations in the eurozone may very well persist and become even more negative. To illustrate the point, Goldman Sachs recently downgraded its EURUSD[2] forecast to 1.08 in 12 months, 1.00 (parity) by the end of 2016 and 0.90 by the end of 2017. WisdomTree believes currency-hedged investment strategies are growing in prominence due to shifting policy winds among global central banks. While the ECB and the BOJ have newly embarked on aggressive easing measures, the U.S. Federal Reserve is largely expected to begin raising rates in the middle of 2015. This policy dichotomy could signal potential for a stronger dollar in the months ahead. From this standpoint, I believe we are in the very early stages of flows heading toward currency-hedged strategies—especially for Europe.

[1]Source: Bloomberg, as of 12/31/14. [2] EURUSD: Measures USD per unit of EUR, as of 1/9/14.

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DEFINITIONS

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

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.

Negative correlation : Indicated by a tendency of two series of data to move in opposite directions. Shown in the chart (in the red box), the USD-to-GBP exchange rate is trending downward while the FTSE 100 Index is trending upward.

Deflation : The opposite of inflation, characterized by falling price levels.

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).

MSCI EMU Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.

Nikkei 225 Stock Average Index : A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

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.

Bond : A fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).

Disinflation : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

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.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Targeted longer-term refinancing operations (TLTRO II) : a periodic open market operation executed via tender offers which mature in June 2020.