RISING RATES AND THE U.S. DOLLAR

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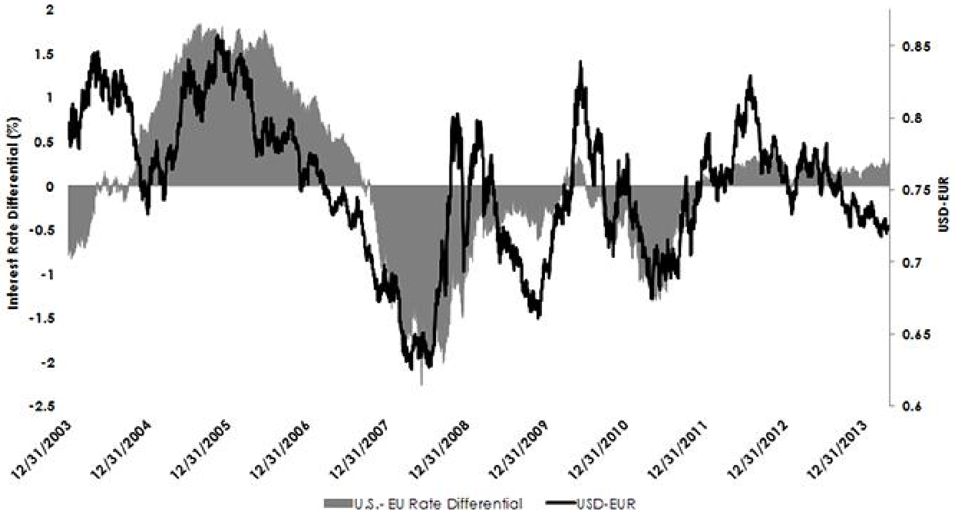
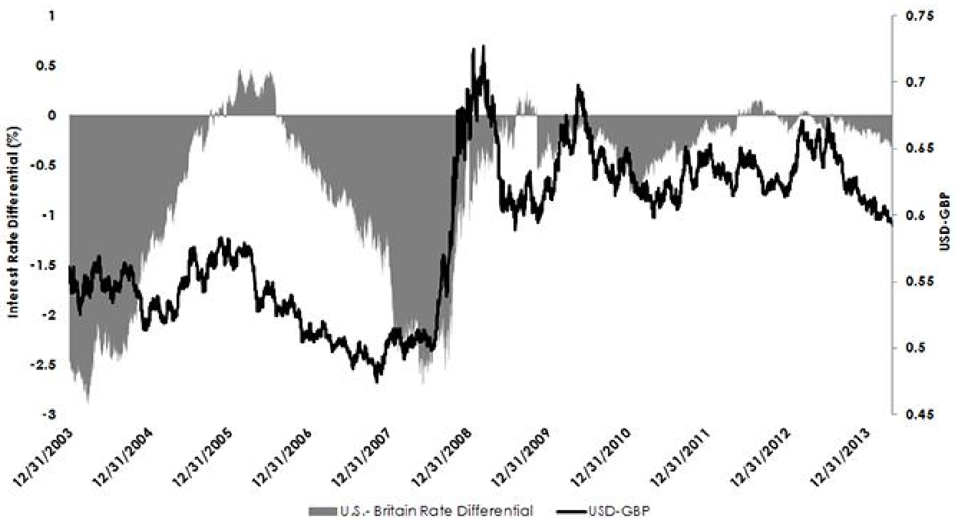
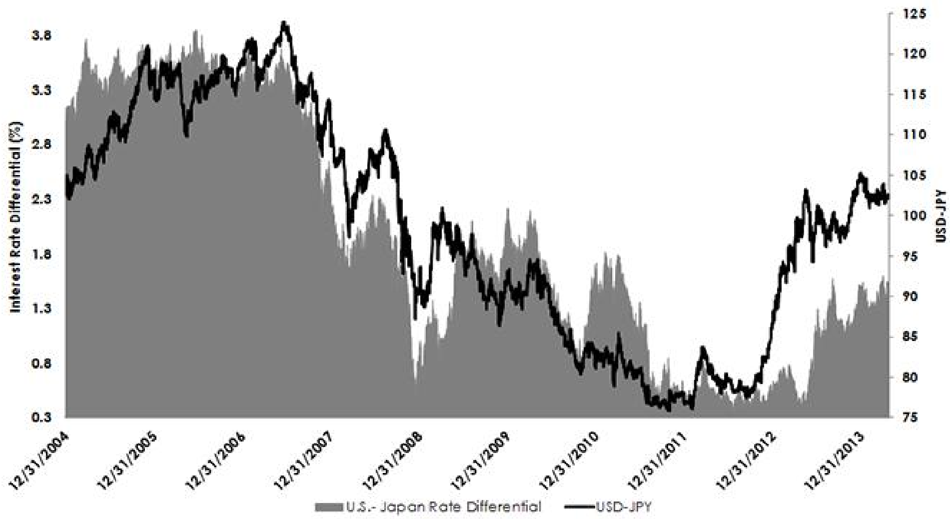
While interest rates in the U.S. have fallen so far year-to-date, we continue to believe that rates may be poised to rise in the second half of 2014. Over the last several weeks, we have seen increased interest from clients about how best to prepare their portfolios for an eventual rise in U.S. interest rates. While many investors understand the direct implications rising rates will have on their bond portfolios, one less-probed topic stems from what impact rising rates will have on the value of the U.S. dollar. With the increased popularity of currency-hedged equity strategies, the impact that currencies can have on investor total returns is beginning to crop up on more investors' radar. In the remainder of this piece, we will examine the historical relationship between interest rate differentials between countries and the impact on their exchange rates. Although interest rate differentials are only one potential determinant of the value of a currency, we believe that rising rates in the U.S. will ultimately lead to an appreciation of the U.S. dollar against a basket of low-yielding developed market currencies. As shown in the tables below, rising interest rates have tended to support currency appreciation compared to lower-yielding currencies. While the relationship is far from linear, the graphs do show that as interest rates (represented by the shaded portion) in the U.S. rise compared to foreign interest rates, the value of the dollar (represented by the black line) tends to appreciate. Interestingly, as rates have fallen so far this year, the dollar has also weakened marginally against a large number of foreign currencies, particularly in emerging markets. **Interest Rate Differentials and Exchange Rates, 12/31/03–5/31/14** **U.S. & Eurozone: 2-Year Interest Rate Differentials vs. Exchange Rates**



U.S. & Britain: 2-Year Interest Rate Differentials vs. Exchange Rates



U.S. & Japan: 5-Year Interest Rate Differentials vs. Exchange Rates



Sources: Bloomberg, WisdomTree, as of 5/31/14. Past performance is not indicative of future results.

This phenomenon can largely be explained by the change in the relative costs associated with holding foreign currencies against the dollar. In countries where the interest rate differential is positive, these currencies tend to attract capital to take advantage of higher interest rates compared to lower-yielding alternatives. As we have noted previously on our blog, the costs associated with hedging a foreign currency are primarily driven by these relative interest rate differentials.

Swings in the Central Bank Policy Pendulum

While relative interest rates can often explain a large percentage of relative moves in currencies, these differences are clearly not the only determinant over time. As various pieces of economic or trade data are released, traders attempt to adjust their positioning and prices to account for new information. Currencies react to supply and demand. Recently, the currency markets had to digest a great deal of posturing by central bankers. On June 5, European Central Bank (ECB) president Mario Draghi announced new initiatives to inject liquidity into the eurozone via negative deposit rates. As a result, the euro weakened against the U.S. dollar. In Great Britain, Bank of England (BOE) governor Mark Carney warned that rates may rise “sooner than markets currently expect.” As a result, the British pound rose in value compared to the U.S. dollar. In both instances, potential changes in the economic outlook and the outlook for monetary policy had a strong impact on the value of the currencies against one another. In our view, the Federal Reserve and BOE are in a dead heat for who will hike rates first in 2015. In the case of Europe, we believe that a primary objective of ECB policy going forward will be to weaken the euro in order to help the European economy grow via cheaper exports. Ultimately, we believe investors will continue to take a greater interest in the role that currency plays on their increasingly global portfolios. As this awareness increases, we believe that many will seek to express these views through currency and currency-hedged equity exchange-traded funds.

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Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

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.