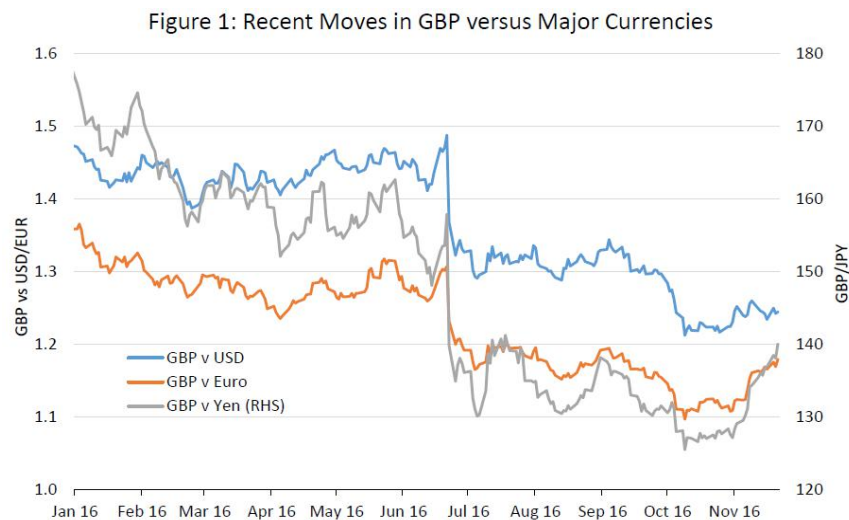


HOW TO HEDGE STERLING EQUITY EXPOSURES

Wisdomtree EU
07 Dec 2016

The recent sharp moves in Sterling – predominantly the weakness that we’ve seen since Brexit – has been beneficial for UK investors holding overseas assets. The declines have been particularly sharp against the USD, and, at its lowest point in mid-October it had fallen 18.5%, while its decline versus the Euro was more muted reflecting the weakness of the Euro. Still, even against a weakening Euro, Sterling fell 16.1%. Against the Yen – a currency that has seen reasonable strength – Sterling’s decline was even more pronounced at 20.5%. Sterling’s decline, combined with the strength of overseas equity markets, created a very positive return environment for many investors. This article outlines some of the benefits of currency hedging and how one might take advantage of Sterling’s recent weakness and rising overseas equity markets.



Source: WisdomTree, Bloomberg

Sterling – posting a modest recovery

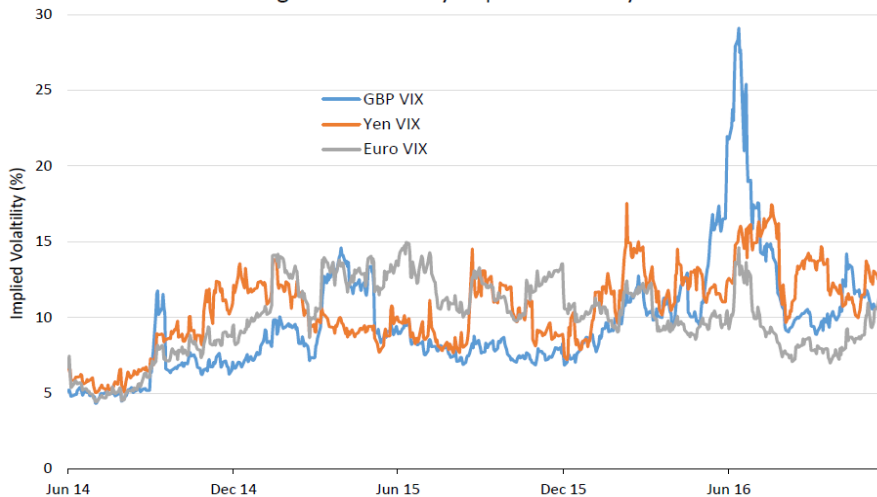
Since its recent low point, there has been a short-term recovery in Sterling driven by a number of factors, that we believe include the USD’s strength following the election and changes to the outlook of the impact of Brexit. In the same way investors have benefitted from Sterling’s weakness, there is every reason to explore using currency hedged ETFs to manage risk should Sterling experience a sustained recovery. Already during November Sterling has risen 10.6% versus the Yen and 6.4% versus the Euro. Against a substantially stronger Dollar the rise has been more muted rising by 2.1%.

FX volatility remains at above average levels

The recent move in currency markets also resulted in increased volatility – with implied

volatility for the Euro moving sharply higher. Without necessarily having a view on the direction of currencies, implied volatility can provide investors with a useful measure of expected risk in FX movements. A good example of this shift is in mid-June 2014 when all three major currencies had implied volatility of 5% versus the USD. Leading up to Brexit this reached a peak level of 28.33% for sterling. Overall there has been a shift in the currency risk environment. In the case of Sterling, current levels of close to 11% represent a considerable premium to monthly average levels one year ago which were around 7%. Similarly, the Euro currently has implied volatility of close to 12% compared to close to 8% at the end of September.

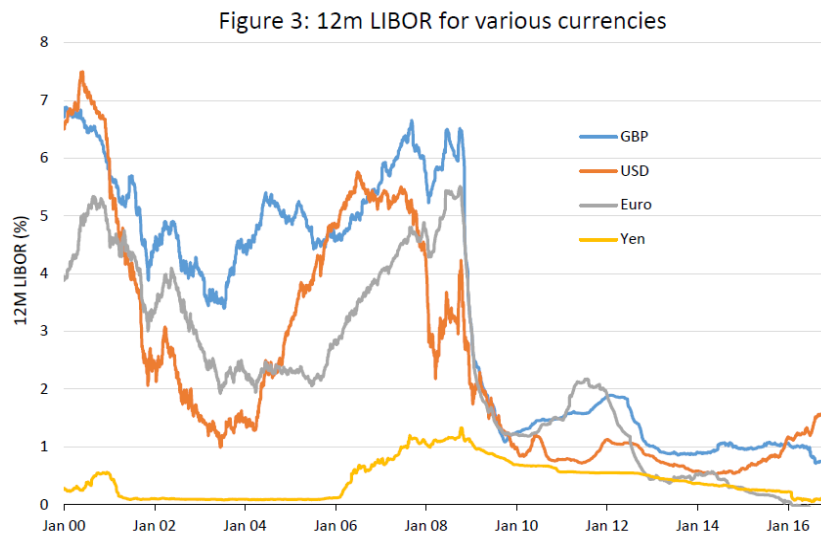
Figure 2: Currency Implied Volatility



Source: WisdomTree, Bloomberg

Divergent interest rate trends

While the USD’s strength has been due to macroeconomic outlook changes and dynamics post the result of the US Election, there has also been a considerable divergence in interest rates. Both existing and expected interest rates for the USD versus other currencies have become a key point of differentiation. If one considers 12-month LIBOR rates for the main currencies one can observe that since 2014, when they were broadly similar, the level and direction of interest rates has diverged, as shown in the chart below. Critically US rates have been on a rising path and this has contributed to a strong USD environment. In a new post US election macro scenario, we expect US rates will continue to rise, while the Eurozone’s weak domestic economy is likely to leave rates lower and for longer. In addition, there are European political risks around key events in the short to medium term, starting with the Italian referendum in December and elections in France and Germany in 2017. While Sterling interest rates have declined since Brexit it is unclear whether there is scope for further declines.



Source: WisdomTree, Bloomberg

The benefits of currency hedging

The recent weakness in Sterling combined with rising overseas equity markets has created an ideal environment, we believe, for investors. However, if equity markets retain their bullish outlook but Sterling strengthens, investors' gains may be capped or eradicated. In this context we believe that investors may wish to consider WisdomTree's range of Sterling currency hedged ETFs. These products offer broad exposure to US income strategies, Japan exporters and Eurozone export oriented multinational large caps, while additional granularity is provided with a German exporter-focused ETF.

If one considers a global benchmark such as FTSE world or MSCI world, these WisdomTree ETFs aim to provide a Sterling hedged exposure for between 75% and 80% of the benchmarks respectively. In the context of a benchmark that excludes the UK – which is typical for domestic UK investors – our hedged coverage aim rises to 79.5% and 85% respectively for FTSE and MSCI. Naturally investors may wish to position themselves in similar exposures that are unhedged and WisdomTree's ETFs provide an efficient solution with unhedged share classes available for the same exposures.

Overall, investors looking to manage risk in the current equity environment would be well placed to consider Sterling hedged ETFs as a cost-effective solution.

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