

2018: TEN SURPRISES FOR JAPAN

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INTRODUCTION

It is the time of year when economists and strategists present their forecasts and baseline scenarios for the year ahead. Quantitative forecasts are based on probability models that cannot help but assume the future will be correlated to the past; and qualitative scenarios are based on, well, a combination of experience and common sense. Either way, most methodologies leave little room for a discussion of true outliers and true surprises.

I wrote this list, "2018: Ten Surprises for Japan," to address this deficiency. Here are the outlier scenarios that I worry about for Japan investment implications. By definition, these 10 surprises lie outside the consensus. Their primary purpose is to make the reader think. Improbable as they may appear, any movement toward their far-out direction could cause an about-face in market consensus. Enjoy, and best wishes for a successful and happy 2018.

1. PRIME MINISTER SHINZO ABE GOES TO PYONGYANG AND SECURES A \$1 TRILLION JAPAN-LED INFRASTRUCTURE UPGRADE FOR NORTH KOREA

At the end of 2017, it may not be prudent to expect a reversal of fortunes regarding the issue of North Korea. However, as long as cool heads prevail, the path toward a constructive endgame is not impossible to foresee. From an economic development perspective, North Korea and Japan are a match made in heaven: an ample supply of natural resources and labor meets world-leading technology and capital. PM Abe has an outstanding track record as a champion promoter of Japan-led infrastructure projects. Engaging North Korea constructively would not just boost Japan's economic fortunes but surely create a historic legacy for Abe worthy of the Nobel Peace Prize. This is unlikely, unfortunately, but so is a peaceful endgame solution without stepped-up economic engagement. Sooner or later this will happen, in my view.

2. ACCELERATED YEN DEPRECIATION TOWARD ¥150/\$ FORCES CHINA TO DEVALUE THE CHINESE YUAN BY 30%

Desynchronized monetary policy cycles raise the probability of desynchronized asset price movements in general, and foreign exchange¹ markets overshoots in particular. In my view, this leaves the yen very vulnerable for 2018. I know, in both 2016 and 2017, the Bank of Japan (BoJ)–Fed² cycle did not desync as much as anticipated, but this does not mean it won't do so in 2018. After all, U.S. fiscal policy has changed. More importantly, when the next cycle of U.S. dollar strength accelerates, the circuit breaker I am most worried about is China. Japan and China now compete head-to-head in many

¹ Foreign Exchange (FOREX, FX): The exchange of one currency for another, or the conversion of one currency into another currency.

² Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States.

markets, including high tech and bullet trains, so yen depreciation is now more of a worry for China's factories than for U.S. ones. The weaker the yen gets, the greater the risks of a Chinese yuan devaluation. When the yen slips past ¥140 against the U.S. dollar, I fear a 30% Chinese yuan devaluation more than a potential backlash from the U.S.

3. THE NEW FEDERAL RESERVE CHAIRMAN IMPORTS THE BOJ OPERATIONAL MODEL AND FIXES THE U.S. 10-YEAR YIELD AT 2.5%

If Trump gets his wish and the U.S. economy speeds up to a sustained 3.5% to 4% growth rate, U.S. bond yields³ could come under substantial upward pressure, possibly as high as 6% or more for the 10-Year bond. After all, real GDP⁴ growth of 3.5% to 4% implies nominal growth of at least 5.5% to 6% and, historically, it has been rare for bond yields to stay much below the sustained nominal GDP growth rate. In any event, rising U.S. bond yields will start to put downward pressure on U.S. risk assets in general and equities, real estate and credit in particular. Before long, rising bond yields will be followed by a genuine down cycle. To pre-empt this, a professional real estate developer and very unorthodox president may find it hard to resist temptation by getting the Federal Reserve to import the BoJ operational model: fix the U.S. long bond at an agreeable level, say 2.5%, and let the economy go into overdrive for the next election cycle.

4. TOYOTA BUYS TESLA AND TURNS THE NEWLY INTEGRATED U.S.-BASED FACTORIES INTO THE MOST PRODUCTIVE CAR FACTORIES EVER

Toyota and Tesla appear to be perfectly complementary. The Japanese carmaker is the undisputed global champion of top-quality massive-scale manufacturing, which is exactly what Tesla is still struggling to create. Meanwhile, Tesla offers a turbocharged on-ramp to the future of transportation, which is exactly where Toyota wants to go. At the operational level, one can easily imagine Toyota-led production expertise delivering the world's most productive car factories for Tesla. Of course, combining the two corporate cultures may prove impossible, but nothing would prove the ambitions of the new Japan better than a successful Japanese takeover of a U.S. Silicon Valley superstar. This would be a huge surprise, given that the more likely strategy is for Toyota to come from behind and beat Tesla at its own game. Out-producing and out-designing a first mover like Tesla is, after all, Japan's proven core competence.

³ Bond yield: Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

⁴ Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

5. PM ABE INTRODUCES "ASIA-COIN," THE WORLD'S FIRST BLOCKCHAIN CYBER-CURRENCY BACKED BY A CENTRAL BANK

The race is on for national governments and central banks to sponsor and promote an official cyber-coin standard. Japan has the potential to take the lead here by introducing a BoJ-backed "Asia-Coin," a blockchain-based currency system created by a consortium of Japan's mega-banks and the BoJ. As a new national policy initiative, it should be easy to get Japan's leading companies to adopt this Asia-Coin as their settlement and transactions system for all their Asian/global business, which in turn creates a virtuous cycle of trust, liquidity and, well, a head start for Japan to set the global standard for the future of banking. This surely would be a surprise, but Japan's ambitions to rebuild Tokyo as a leading financial center are real. The creation of a Japanese government-backed Asia-Coin would put Japanese banks and financial institutions in an undisputed global leadership position. And the race really is on: while concerted Japanese leadership would be a positive surprise, a China government-led cyber-currency is bound to be launched before long.

6. JAPAN INTRODUCES "FINANCIAL MEANS TESTING" TO CUT PUBLIC BENEFITS AND NATIONAL HEALTHCARE FOR WEALTHY INDIVIDUALS

Cutting public benefits and entitlements is unpopular and difficult in any country, but in Japan, it is still popular to tax the rich and redistribute wealth. As pressure to cut the runaway fiscal deficit keeps rising, creative and unorthodox policy proposals to cut entitlements are starting to be discussed. Introducing financial means testing could be one option, where, for example, anybody with net financial assets greater than, say, ¥10 million and with no mortgage debt is no longer eligible for the public pension or Japan's national healthcare. Controversial for markets, but popular with voters? At the very least, nobody should be surprised by the creativity of Japanese policy makers.

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⁴ Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

7. JAPAN JOINS THE CHINA-LED ASIAN INFRASTRUCTURE DEVELOPMENT BANK

Over the past five years or so, the Japan-China relationship has developed from complementary to competitive. This is true on the economic front as well as on the political and strategic one. When China set up its version of the U.S.-led Asia Development Bank, the Asian Infrastructure Development Bank (AIDB), it was inevitable that Japan would follow the U.S. lead and not join. Now that Japan is urged by the U.S. to show greater independence, a change of national strategy may be in order. Both Japan and China have emerged as Asia's champions for multilateralism. Joining forces to lead by example makes more and more sense. Japan joining the China-led AIDB would be symbolic of both Japan's growing independence as well as its commitment to multilateralism. An even bigger surprise would be a truly grand strategy: in exchange for Japan joining the AIDB, China joins the Japan-led Trans-Pacific Partnership free-trade initiative. Concrete progress on Japan-China cooperation would certainly change Asia's dynamics for the better for investors.

8. TOKYO REAL ESTATE PRICES SURGE PAST 1990 BUBBLE-PEAK LEVELS

Tokyo real estate prices have begun to recover but still remain a good 40% to 50% below the bubble peak levels recorded in 1990. However, real estate developers recently have become more aggressive. Here and there, high-end luxury apartments for \$5 million or \$6 million are coming onto the market, which is more than double the price of top deals done three years ago. Demand is fueled by a rising new group of Japanese entrepreneurs, easy credit availability and Asian/foreign buyers. It won't be long before we see a new historic high for a residential real estate purchase. Before 2020 is a reasonable forecast, in my view, but in 2018 would be a positive surprise—a high-profile confirmation that deflation is over.

9. BIOTECH, FINTECH AND ARTIFICIAL INTELLIGENCE (AI) STARTUPS LEAD A WAVE OF IPOs THAT ESTABLISH TOKYO AS ASIA'S PREMIER APPLIED INNOVATION HUB

Nothing succeeds like success. For years now, the Japanese government has been focusing on the need for more entrepreneurship, innovation and corporate creativity. The time has come to actually show concrete success. A wave of IPOs⁵ would do wonders to prove Abenomics⁶ is working and that Japan is back on track to become the innovation power hub in Asia. In my view, Japan has plenty of entrepreneurial activity and creativity, particularly in biotechnology, fintech and applied AI and robotics. To see a more aggressive and visible monetization and commercialization of these would be the best positive surprise possible to prove a Japan optimist right.

⁵ Initial public offering (IPO): The first sale of stock by a private company to the public

⁶ Abenomics: Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

10. JAPAN BEATS GERMANY TO BECOME THE NEW SOCCER WORLD CHAMPION IN THE 2018 WORLD CUP

On July 15, 2018, the FIFA World Cup final will take place. Japan winning the title would be a major surprise, particularly to me. After all, I am German and every four years when the World Cup is held, I cannot help but turn massively biased. Team Germany not making it to a World Cup final will be not just a surprise, but a real shock. May the best team win in 2018!

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