DECLINING PPIS PERPETUATE JAPAN'S TINA TRADE

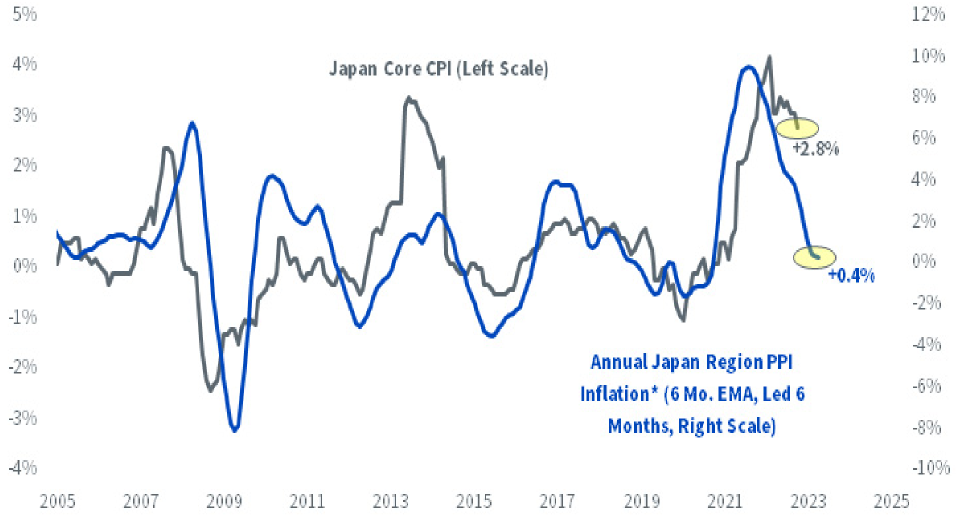
Jeff Weniger — Head of Equity Strategy
11/10/2023

Sometimes you just get a little lucky. That is increasingly looking like the case for not only the WisdomTree Japan Hedged Equity Fund (DXJ) but also for the Bank of Japan itself. Things were looking tough for the BoJ as recently as this summer, when the country's core CPI bolted north of 4%, far beyond the 2% inflation target that major central banks view as ideal.

At least for now, those CPI prints from a few months ago look like they marked the worst of it. Japan's core CPI has tapered down to a not outlandish +2.8% YoY growth rate. Trends in producer price inflation (PPI) suggest more downside could be coming.

Using Japan's own PPI, along with the PPIs of major trade partners China, Korea and the United States, factory gate prices from this collective are downright disinflationary. Using our smoothed series, the PPI basket is barely positive over the last year. We would not be surprised in the slightest if Japan witnesses sub-2% core CPI within the next few months.

Figure 1: Key PPIs Point to Japanese CPI Downside



PPI Basket Weights = 50% Japan, 25% China, and 12.5% each in U.S. and Korea. Sources: Refinitiv, U.S. BLS, Dept. of Labor, National Statistics Bureau China, Bank of Korea, Japan Statistics Bureau, Ministry of Internal Affairs & Communication. Data as of September 2023. EMA = exponential moving average.

The Bank of Japan is being reactive to an inflation threat that may very well be in the rearview mirror. For many years, its yield curve control (YCC) policy set a band of +/-25 basis points (bps) around zero percent for 10-year JGBs. As the global inflation scare sent debt yields spiraling higher in places like the U.S. and Germany, the BoJ's hand got pushed into widening the band to +/-50 bps around the zero bound. But if you pulled a quote on a random day in this year's first half, it was common to see the 10-year JGB yield in the 0.30%–0.40% range. It wasn't as if the 0.50% ceiling was being strongly threatened by bond vigilantes.

But then global bonds sold off even more, so the BoJ tightened policy once again. That policy move had the central bank putting emphasis not on a 0.50% yield but on a new 1% quasi-cap that it would seemingly defend if the bond market remained in bear mode.

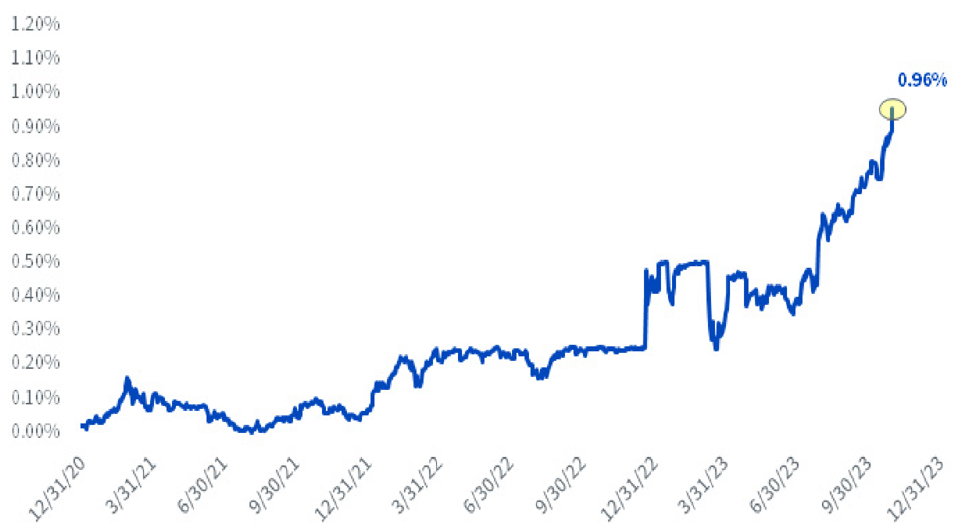
That was where things stood until late October, when the BoJ changed policy yet again. This most recent change is ambiguous and open to interpretation.

Here is what we think the BoJ is now saying.

The central bank is "promising" to treat 1% as a target rate on 10-year JGBs, with a relatively hard vow to defend that level if trades start coming across around 1.10%, maybe 1.20%. I'm pulling those numbers from the sky because it is based on my Lasik-corrected vision focusing on an intentionally ambiguous bar chart that the BoJ just released. It's one of those things where they don't want to give you a hard-and-fast number, so we have to guess a little. I'm thinking their leeway for intervention is 10–20 bps beyond the 1% level.

Fortunately, because we anticipate downside in Japan's consumer price inflation, the bond market may luck into a situation where 1% yields are about as high as they get anytime soon. As of now, the 1% bound has not been breached, or even threatened for that matter. The yield is still 0.96%, and we will call that roughly three-and-a-half percentage points south of the yield on same-maturity U.S. Treasuries in any given session, give or take (figure 2).

Figure 2: 10-Year Japanese Government Bond Yield (%)



Source: Refinitiv, as of 10/31/23.

The S&P 500 is facing more competition from rising bond yields; until recently, much of the late summer and autumn was characterized by the bears pouncing on the death of the USD TINA trade. TINA said we should buy stocks because "There Is No Alternative" in a world where bonds yield nothing.

In the U.S., Canada and Europe, TINA should really be renamed TWNA, as we change "is" to "was." The zero-yielding world is long gone. There was no alternative to buying so-called risk assets…until the bond market rolled over and started giving us a viable asset class once again.

Some are now questioning U.S. equity valuations when they can clip something in the mid-5s in the money markets. I started calling this TAMMY, which stands for "there are money market yields." The acronym applies to money markets, but there are plenty of people using some variation of TAMMY as it applies to intermediate and long-term bonds too.

If TINA is dead in the United States, it remains alive and well in Japan. Using dividend yields, the 4.84% on offer in 10-Year T-notes is 317 bps north of the S&P 500's proverbial "coupon." That is a complete upending of the TINA trade that persisted since the days of Ben Bernanke's Lehman-era firehose.

In contrast, Japan's TINA situation may not be as robust as it was before the JGB sell-off, but the picture is much rosier than it is elsewhere. The Topix throws off an admittedly non-exciting 2.35%, but the alternative is 0.96% in JGBs, so the spread is 139 bps in favor of stocks. That is a far cry from the three percentage point gap in the other direction in the U.S.

Figure 3: The TINA Trade, United States vs. Japan

The Topix is cap-weighted, so it doesn't have the screen for dividends that you find in many of our mandates. For DXJ, we rebalance in November, so there is a refresh on valuations as I write.

DXJ sells consistently around 11 to 12 times earnings, which corresponds to an 8%–9% earnings yield. This is a substantial premium to government bond yields, presenting a much better margin of safety than that which exists in U.S. markets.

DXJ's SEC 30-day Yield = 2.30% as of 11/9/23. The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance, please click here.

As for the yen, many think the currency is cheap—and there are plenty of fair value measures that suggest upside in the yen. But remember this: since the Bank of Japan keeps interest rates pegged below the zero bound, there is a substantial carry of nearly 6% that is earned by Americans when they hedge the yen. We think the case is strong: the stocks are cheap and the carry is sizeable.

I'll speak about Japanese stock market catalysts on our *Office Hours* webinars in the coming weeks and months, so please make sure to check out the calendar, which you can find here.

Unless otherwise stated, all data as of October 31, 2023.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk, interest rate fluctuations, derivative investments which can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

+ 2023 Japan Index Rebalances

Related Funds

+ WisdomTree Japan Hedged Equity Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Producer Price Index : weighted index of prices measured at the wholesale, or producer level.

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.

Yield curve control (YCC) : Involves targeting a longer-term interest rate by a central bank, then buying or selling as many bonds as necessary to hit that rate target.

Basis point : 1/100th of 1 percent.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

TINA : TINA is an acronym for "there is no alternative."

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.