BREAKING THROUGH 3.05% ON U.S. 10-YEAR NOTES COULD SPELL OPPORTUNITY IN JAPAN

Christopher Gannatti — Global Head of Research
05/24/2018

So, it has happened. As of this writing, the U.S. 10-Year Treasury note has seen its yield break through the much-discussed 3.05% resistance level—something we haven't seen since 2011.

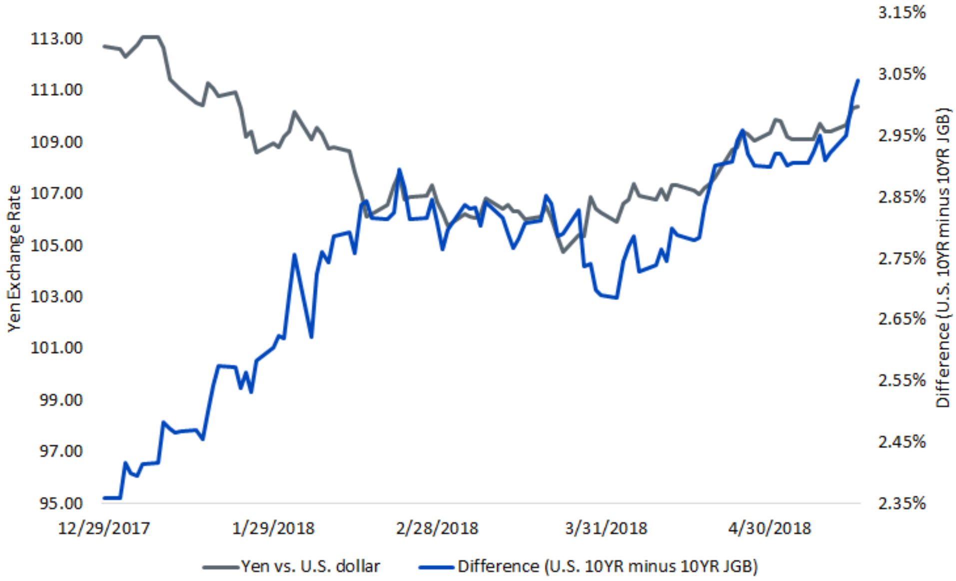
What does that mean for equities globally?

Japan as a Play on Rising U.S. Interest Rates

Over the years, we have written often on the concept of using Japanese equities as a play on rising U.S. interest rates. In the current regime, this makes a lot of sense because:

- The Bank of Japan (BOJ) is holding the 10-year Japanese government bond (JGB) interest rate close to 0%. In normal circumstances, global interest rates would move in some relationship to U.S. interest rates, but clearly this wouldn't occur today.
- This leads to a transmission mechanism for the move that would otherwise occur in Japan's government bond market to occur in Japan's currency market versus the U.S. dollar. Rising U.S. rates—all other things being equal—should encourage Japan's currency to weaken against the U.S. dollar.

The 2018 Experience: Have 10-Year Interest Rate Differentials Affected Currency Moves?

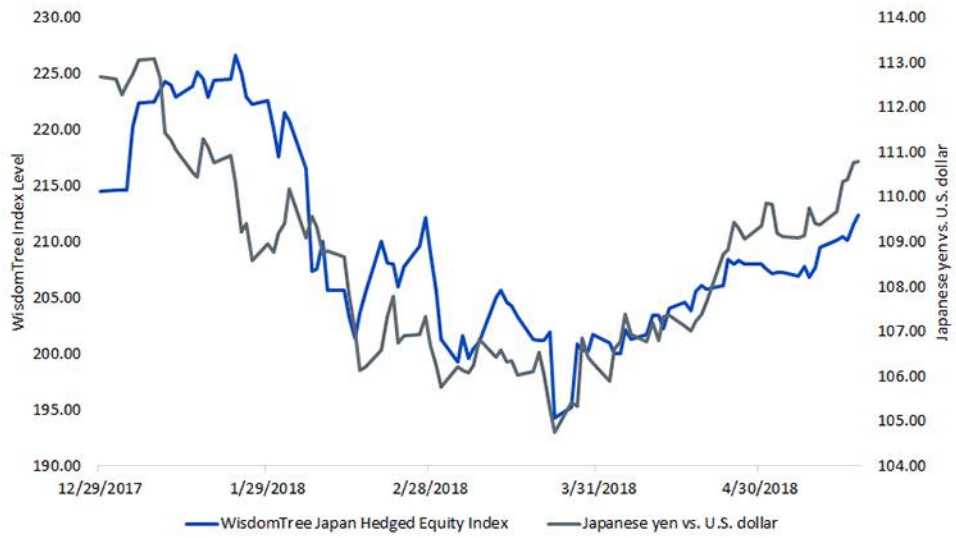


Source: Bloomberg. Data for the period 12/31/17–5/16/18. Past performance is not indicative of future results.

We wanted to test this hypothesis in relation to whether there was any discernible relationship between the difference in 10-year interest rates in the U.S. and Japan and the behavior of the yen.

- During the month of January, the difference between the U.S. 10-Year note and the Japanese 10-year JGB was widening. At the same time, the yen was strengthening. Clearly, our hypothesis of widening interest rate differentials and weakening yen was challenged during this period.
- In February 2018, the relationship changed. Yes, the yen continued to strengthen, but the difference between the U.S. 10-Year note and Japanese 10-year JGB interest rates actually began to fall. March 23, 2018, saw the strongest level of the yen that we've observed thus far in 2018. After that point, the yen weakened, and it is clear that the gap between the U.S. and Japanese government rates was also widening.

In 2018, the Yen (Like in Other Years) Heavily Influenced the Equity Experience



Source: Bloomberg. Data for the period 12/31/17–5/16/18. Past performance is not indicative of future results. You cannot invest directly in an index.

- Japanese equities are well known for the negative correlation of their returns to movements in exchange rate between the yen and the U.S. dollar. We can see here that, from the beginning of 2018 until approximately March 23, the yen was getting stronger and the WisdomTree Japan Hedged Equity Index was dropping. From March 23 to the present, the yen has been getting weaker and Japan's equities have been appreciating.
- With the U.S. 10-Year Treasury seeing its yield break through the 3.05% resistance level, and assuming the BOJ continues its current policy for the foreseeable future, a widening differential could support continued depreciation of the yen. If this relationship holds, this can be quite positive for Japan's equities.

Valuations Support Japan's Exporters Very Strongly

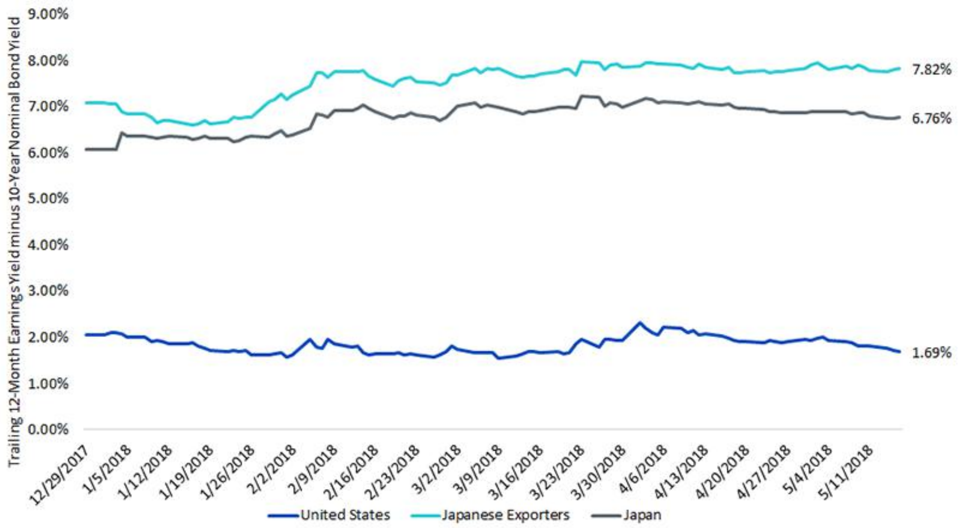
While Japan's equity market is generally characterized by a negative correlation between its returns and those of the yen, there are differences across sectors. Utilities and Telecommunication Services, for example, are very domestically driven—meaning their revenues and earnings are less dependent on the yen's moves, whereas Industrials and Consumer Discretionary companies are major exporters.

For those looking at Japan over the past six years, their "yen experience" has varied massively.

- In 2012 prior to the December 16 election of Prime Minister Shinzo Abe, the exchange rate was around ¥80 to the dollar. Our current levels of ¥110–111 to the dollar clearly are much weaker.
- In July 2015, the rate hit levels of ¥125–126 to the dollar; looking from this perspective, the yen has strengthened significantly.
- 2016 was interesting, in that we saw the rate go from about ¥120 to ¥99 and change, and then back almost all the way to ¥120.

The bottom line: While it would have been a great story to see the rate move in a straight line from levels around ¥80 to levels above ¥120 and beyond, this hasn't happened. The result is that, without a crystal-clear direction on the currency, export-oriented stocks within Japan have tended to trade at less-expensive valuations than Japan's broad market.

Japan's Exporters: Valuation Advantage over Japan's Market as Well as U.S. Equities



Source: Bloomberg. Data for the period 12/29/17–5/16/18. Past performance is not indicative of future results.

Conclusion: Low Expectations and Yen Weakness Could Open the Door for Japan's Exporters to Break Out in

2018

My colleague Jesper Koll has written about expectations of company earnings in Japan being fairly low and headed for a potential break out. If this is combined with a global macroeconomic backdrop that encourages the yen to continue to weaken, Japan's exporters could see a very strong second half to 2018.

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.

For more investing insights, check out our Economic & Market Outlook

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

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

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

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.