

IF THE BOND MARKET GETS SMACKED, JAPANESE EQUITIES ARE THE PLAY

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Here's your 2.03%. Take it or leave it.

That's probably what the [Bloomberg Barclays U.S. Aggregate Bond Index](#) would say if it could talk.

We think the classic "60/40" asset allocation—60% equities, 40% bonds—has a problem.

Aggregate bonds returned 5% annually in the 20 years through 2019. A repeat is mathematically impossible, unless [interest rates](#) plunge not only into negative territory but several percentage points deep into it, which I imagine would be virtually impossible due to the appeal of zero-yield physical cash in such a scenario. Even Swiss 30-year bond [yields](#) were stopped in their tracks at "only" -0.67%.

Something more reasonable—2%-ish bond market returns—assumes rates will not move much this decade, and that something like today's 1.59% rate on [10-year Treasuries](#) will maintain down the road.

And then there is the other scenario.

What will this industry do if the bond market turns disagreeable and so does the bulk of "the 60," U.S. equities?

I think there is a [hedge](#) for [rising rates](#), but it requires stepping out of the oh-so-common U.S.-centric holdings that populate so many portfolios. It's Japanese equities.

Global Reflation: The Bond Market's Nemesis Is Japan's Friend

With "Phase Two" of the Sino-U.S. trade deal in tow, the bond market is stepping in the direction of reflation, although the coronavirus has capped yields for now.

The 1.59% 10-year [T-note](#) yield is up a tad from 1.46% in September, but it was challenging the 2% level in the weeks before the virus grabbed attention. If the epidemiologists bring the situation under control, a case for another challenge of 2% may make the rounds.

Also, the meme in recent years was that globalization is dying and countries are turning inward. Pay no attention to the fact that Chinese exports to the U.S. are higher now than they were when Trump was elected; that doesn't sell newspapers. For investors who want to fade the deglobalization theory, it's not just China that stands to benefit (figure 1).

Figure 1: Foreign Market Share of Top 30 Brands by Category and Market (2017%)

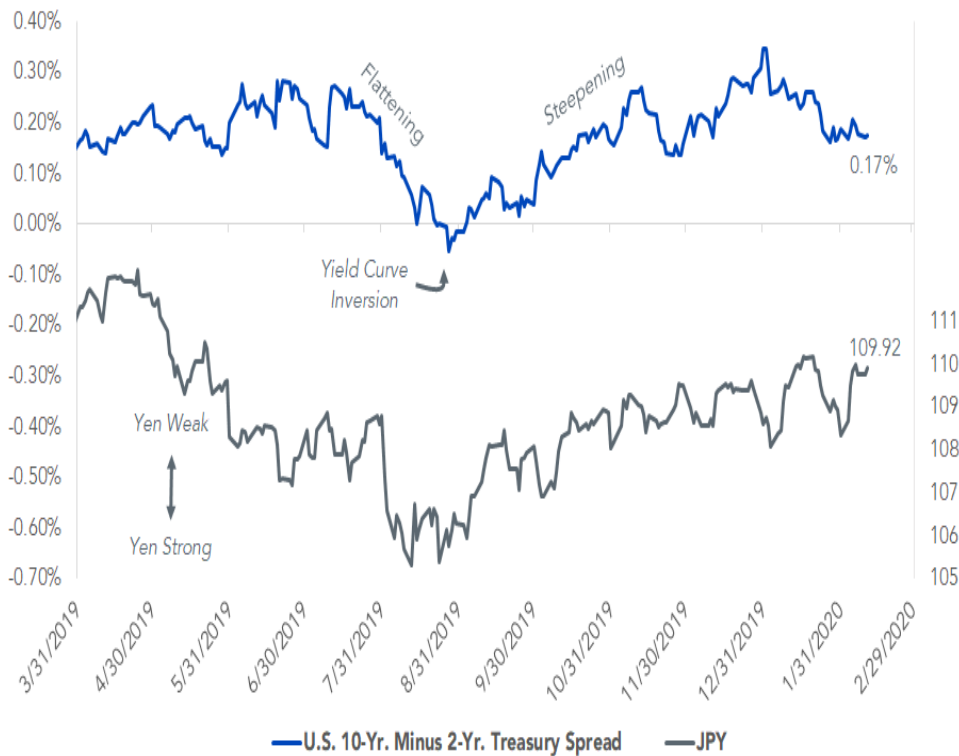
Category	China	United States	Japan
Apparel and footwear	49	9	37
Beauty and personal care	73	39	29
Consumer appliances	19	18	34
Consumer electronics	21	47	58
Home care	37	18	42
Health and wellness	38	16	29
Packaged food	45	13	52
Personal accessories	42	54	76
Toys and games	47	13	35
Soft drinks	31	38	12
Average	40	26	40

Sources: Euromonitor, McKinsey Global Institute Analysis, *China and the world: Inside the dynamics of a changing relationship*, July 2019.

Japanese stocks have lagged the U.S. considerably this century. The 3,334 level on the [S&P 500 Index](#) marked a quintupling for U.S. stocks from the global financial crisis low. Even going back 20 years to capture that [bear market](#) and the dot-com blowup, the index has still returned more than 6%. In contrast, the [MSCI Japan Index](#), whether in USD or in yen, is up less than 2% a year in the two decades through 2019.

What about the yen? If the spread between long and short rates widens—the yield curve steepens—it would seem hedging the yen in equity exposures is prudent (figure 2).

Figure 2: The Yen’s Driver



Sources: Bloomberg, WisdomTree, 3/31/19–2/11/20. Past performance is not indicative of future results.

Figure 3 shows U.S. and Japanese equity performance during the four rising rate environments of the last five years. Japanese equities performed poorly in the time frame as a whole, really only getting any mojo in the rising rate cycles.

Figure 3: U.S. and Japanese Equities Performance, Rising Rates

Start	Finish	10-Year U.S. Treasury Yield			Return During Rate Rise			
		Begin	End	Change (bps)	S&P 500	MSCI Japan (JPY)	MSCI Japan (USD)	WisdomTree Japan Hedged Equity Index
1/30/2015	6/10/2015	1.54%	2.49%	94	6.38%	15.75%	10.84%	17.12%
7/8/2016	12/15/2016	1.36%	2.60%	124	7.20%	29.11%	9.48%	38.03%
9/7/2017	11/8/2018	2.04%	3.24%	120	16.41%	8.77%	3.65%	8.10%
9/3/2019	11/8/2019	1.46%	1.94%	49	6.80%	13.70%	10.26%	16.62%
Total Period (All Rising AND Falling Rates)								
1/30/2015	2/11/2020	1.64%	1.59%	-5	13.15%	5.98%	7.42%	5.45%

Sources: WisdomTree, Bloomberg, 1/30/15–2/11/20. Past performance is not indicative of future results.

That could all change if bond yields turn around.

Unless otherwise stated, all data from Bloomberg, through 2/11/20

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Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

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

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.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Treasury notes : A debt obligation issued by the United States government that matures in less than 30 year.

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.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.