CAUSE AND EFFECT: BANK OF JAPAN BECOMES GOVERNMENT'S LARGEST LENDER

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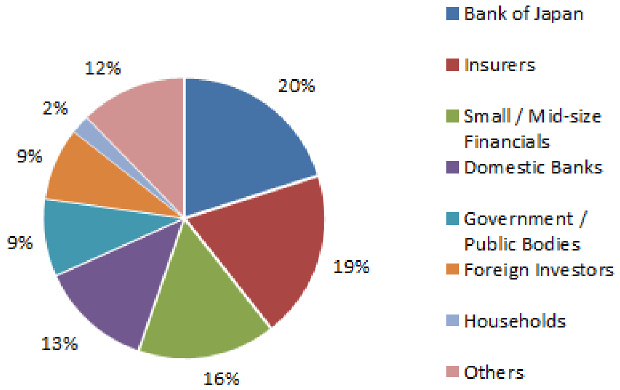
On June 18, the Bank of Japan (BOJ) announced holdings of more than ¥201 trillion ($1.97 trillion), making it the largest single holder of Japanese government bonds (JGBs) in the world. Accounting for 20.1% of total debt outstanding, the BOJ overtook the country's insurance industry in the top spot for the first time in history.[1] Although central banks often use their holdings of government debt to affect monetary policy, the meteoric rise in the expansion of the BOJ's balance sheet is unprecedented. Since June 2012, the BOJ has nearly doubled its holdings of JGBs, rising from 10.2% over the period.[2] With the BOJ continuing to signal its willingness to aggressively stimulate the economy, we highlight below what we believe are the most significant implications of these policies. **Japanese Government Bond (JGB) Holders, as of 3/31/2014**



Source: Bank of Japan, released 6/18/14. Subject to change.

1. Warehousing of Japanese Interest Rate Risk With 10-year JGB yields hovering at just over 0.58%[3], the BOJ is willing to accept 0.06% per unit of interest rate risk. By comparison, at a ratio of 0.39 we currently view the Barclay's U.S. Aggregate Bond as a poor risk/reward trade-off.[4] With risks so heavily skewed in the Japanese market, the BOJ is willing to assume the other side of the Ministry of Finance's interest rate risk. In buying longer-maturity bonds, the BOJ is hoping to stimulate bank lending by lowering costs for borrowers, but also attempting to reduce uncertainty for banks. Whereas investors buy bonds for income or asset & liability matching, the BOJ's objectives are purely to stimulate the economy through lower borrowing costs and greater liquidity. As such, the central bank is much less sensitive to fluctuations in interest rates if it intends to hold the bonds until maturity. In this regard, we believe that this will have the impact of continuing to push traditional buyers of JGBs into riskier assets such as foreign bonds or equities. Additionally, in order to increase its holdings of JGBs, the BOJ has recently come to dominate the new issuance market. Since April 2013, the central bank has purchased over 70% of the government's debt issuance.[5] With potential gaps in liquidity forming in the market, we believe this will have the effect of increasing volatility as well. **2. Catalyst for a Shift in Investor Behavior** As we highlighted above, by forcing traditional JGB investors into riskier assets, we believe that volatility in Japanese interest rates may begin to increase. As investor preferences gradually change, the mix of JGB holders becomes more concentrated. With fewer natural buyers or holders of longer-term Japanese debt, it will increasingly be up to the BOJ to keep rates constrained. At the same time, it has also been reported that the two largest pension funds are poised to dramatically reduce their exposure to JGBs. This fall, the Government Pension Investment Fund (GPIF) [6] is expected to reduce JGB exposure from 60% to 40% and increase exposure to Japanese equities from 12% to 20%.[7] While we believe this will serve as a positive catalyst for the Japanese equity market, it could also cause JGB yields to rise, absent an increase in demand from elsewhere in the market. As the BOJ continues to increase its holdings, it does so at the expense of other market participants. So far, we have seen the most significant drop in the holdings of Japanese banks and overseas investors. Should this trend continue, we believe that rates would also begin to rise as a consequence of this shift in buyer preferences. Compared to quantitative easing in the U.S., where the Federal Reserve held approximately 14% of the government's debt outstanding, the Japanese central bank has shown a strong willingness to hold significant portions of the Japanese government bond market. With Japanese bond yields still near all-time lows, we continue to believe that a sea change in interest rates could be just around the corner. With the evolution of government policy continuing to skew risks in favor of rising rates, we believe that the WisdomTree Japan Interest Rate Strategy Fund (JGBB) could provide an attractive means of betting on the ultimate success of Abenomics. [1]Source: Bank of Japan, 6/18/14. [2]Source: Bank of Japan, 6/18/14. [3]Source: Source: Bloomberg, as of 5/31/14. [4]Source: Source: Barclays, as of 5/31/14. [5]Source: Bank of Japan, as of 6/18/14. [6]Source: The Government Pension Investment Fund (GPIF) is the pension fund for Japanese government employees. [7]Source: J.P. Morgan, "Japan: New Growth Strategy Focus on Corporate Governance," 6/20/14.

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

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.