THE DISCONNECT BETWEEN PRICES AND PROFIT GROWTH IN JAPAN

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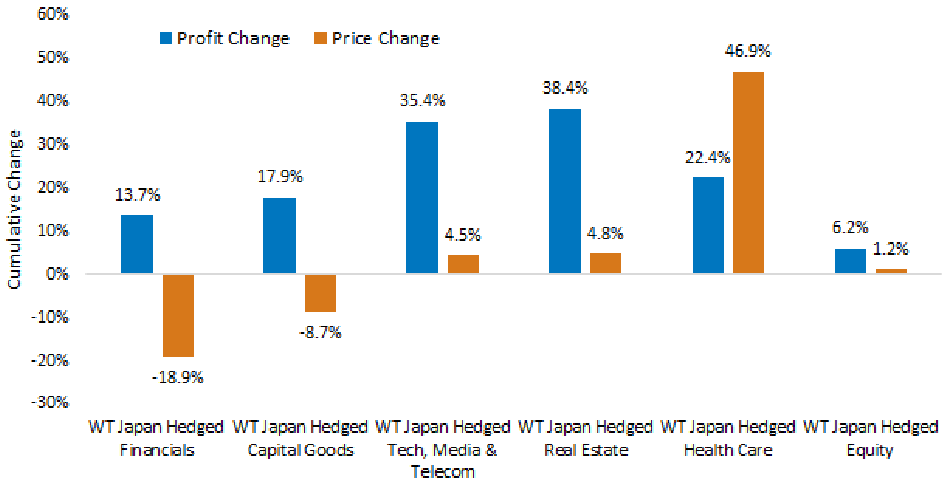
Despite the volatility and downdraft experienced over the last nine months, I believe Japan represents one of the best opportunities among global equity markets over the coming three to five years. The bull case for Japan stems from supporting equity market valuations: earnings yields in Japan are among the highest and most attractive compared to its developed market peers, while at the same time the bond yields in Japan are among the lowest, with the 10-year Japanese government bond being in negative territory. Since the end of 2013, the WisdomTree Japan Hedged Equity Index, has had only modest gains— just over 1%. But profits over the period were up 6%. With an expected P/E ratio of 13.2x as of March 31, 2016, the earnings yield was 7.6%. As a comparison and just to judge how equities compare to bonds in other major countries: the S&P 500 Index had an earnings yield of 5.7% over the same period, with an optimistic outlook for earnings giving a 17.5x P/E ratio; the 10-year bond in the U.S. was close to 1.8%. With a higher bond yield in the U.S., equities face more competition and have a lower premium earnings yield advantage. This also means that, at close to 8%, the earnings yield vs. bond yield spread for the WisdomTree Japan Hedged Equity Index is twice as high as it is for the S&P 500, which is closer to 4%. This earnings yield vs. bond yield spread is one key reason I believe institutions and individuals both within and outside Japan should add to Japanese equities in greater proportions, providing support for the market. Furthermore, Japan has perhaps the most aggressive central bank in terms of monetary policy stimulation—but there are still increasing calls for the Bank of Japan (BOJ) to boost stimulus later this year. And a big fiscal boost is likely in May, ahead of the G7 meetings, with the only real question being the size of the program. The coordinated activities should help increase sentiment toward Japanese equities and put renewed downward pressure on the yen, reversing the headwinds Japan has faced so far in 2016.



	WisdomTree Index					
	WT Japan Hedged Financials	WT Japan Hedged Capital Goods	WT Japan Hedged Tech, Media & Telecom	WT Japan Hedged Real Estate	WT Japan Hedged Health Care	WT Japan Hedged Equity
Profit Change	13.7%	17.9%	35.4%	38.4%	22.4%	6.2%
Price Change	-18.9%	-8.7%	4.5%	4.8%	46.9%	1.2%
P/E Start (12/31/2013)	12.0x	15.1x	21.5x	24.7x	21.3x	13.8x
P/E End (3/31/2016)	8.6x	11.7x	16.6x	18.7x	25.6x	13.2x
Change in P/E	-28.7%	-22.5%	-22.8%	-24.2%	20.0%	-4.7%
Earnings Yield (3/31/2016)	11.7%	8.5%	6.0%	5.3%	3.9%	7.6%

Sources: WisdomTree, Bloomberg, with data from 12/31/2013 to 3/31/2016. Subject to change.

There are a number of areas within Japan worth considering based on gaps between profit growth and price growth over the last three years: **Financials:** Japanese Financials has been the most battered sector over the last three years. The price of the WisdomTree Japan Hedged Financials Index has been down close to 19% since 12/31/2013, while expected profits for the sector have been up 13.7% over the period. The sector has been under pressure recently due to fears about the negative interest rate policy (NIRP) in Japan. But on April 12, the BOJ announced a technical change to NIRP that will reduce the portion of private bank reserve deposits to which negative rates apply. The net effect is a boost to private bank margins that could add back as much as 2% to 3% on operating profits. It is positive not just because of the boost to bank profits but because it confirms policy makers' flexibility and a shift to correct the BOJ's policies to be more "pro-market" and "pro-growth." **Details:** The BOJ raised the ratio used to calculate the macro add-on balance in the current account profit margin: financial ratio calculated as net income divided by revenue balances from zero to 2.5%. Changing the ratio will increase the portion of the current account balances to which zero interest rates apply and decreases the portion of bank balances to which the negative rate is applied. The change became effective with the start of the last reserve period on April 16. There is also expected to be increased support for banks through the application of negative lending rates at which banks can borrow from the BOJ, providing further support for banks. **Real Estate:** Prices for the WisdomTree Japan Hedged Real Estate Index have been up only 4% since 12/31/2013, but expected earnings were up 38.4%, the most of all the WisdomTree sector Indexes. This is the one sector that uniformly reacted most positively to the NIRP policy. Lowered borrowing costs and long-term interest rates are most beneficial to real estate, where capital expenditures and borrowing are the highest of any sector. The drop in mortgage rates—with the 10-year Japan mortgage now at 70 basis point (bps) per year[1]—is stimulating huge growth in mortgage refinancing and should also help provide a boost to real estate developers and construction companies. **Capital Goods:** The WisdomTree Japan Hedged Capital Goods Index has faced three severe headwinds: First, this is the sector most exposed to the global economy, so concerns around global growth, particularly China's, have hit this sector hard. Second, the decline in commodity prices has impacted many of these energy and resources companies, where big expenditures are made to purchase machinery. Finally, in 2016 these companies have been hit by the strong yen. Despite profits being up 18% in aggregate for the sector, prices were down 9% and the sector trades at one of the lowest P/E ratios and highest earnings yields in Japan. Given a stabilization in commodities and receding fears on China, these companies may be well positioned, particularly if the yen starts to weaken again. **Conclusion** In our view, Japan remains one of the better opportunities for global equity investors. Whether one takes broad exposure or targets specific sectors such as Financials or Real Estate, we see a number of opportunities to take advantage of the pessimism that has surrounded Japan recently.

Unless otherwise noted, data sources are WisdomTree and Bloomberg as of 3/31/2016. [1]Source: Bank of Japan, as of 3/31/2016.

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

Bullish : a position that benefits when asset prices rise.

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.

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.

G7 : The Group of 7 is a group consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Negative Interest Rate Policy (NIRP) : A monetary policy where by interest rates.

Profit margins : Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

Mortgage Rates : the interest rate charged for a mortgage.

Basis point : 1/100th of 1 percent.