JAPANESE 10 YEAR RATES DOUBLE IN 2015, RISE ABOVE GERMAN BUNDS

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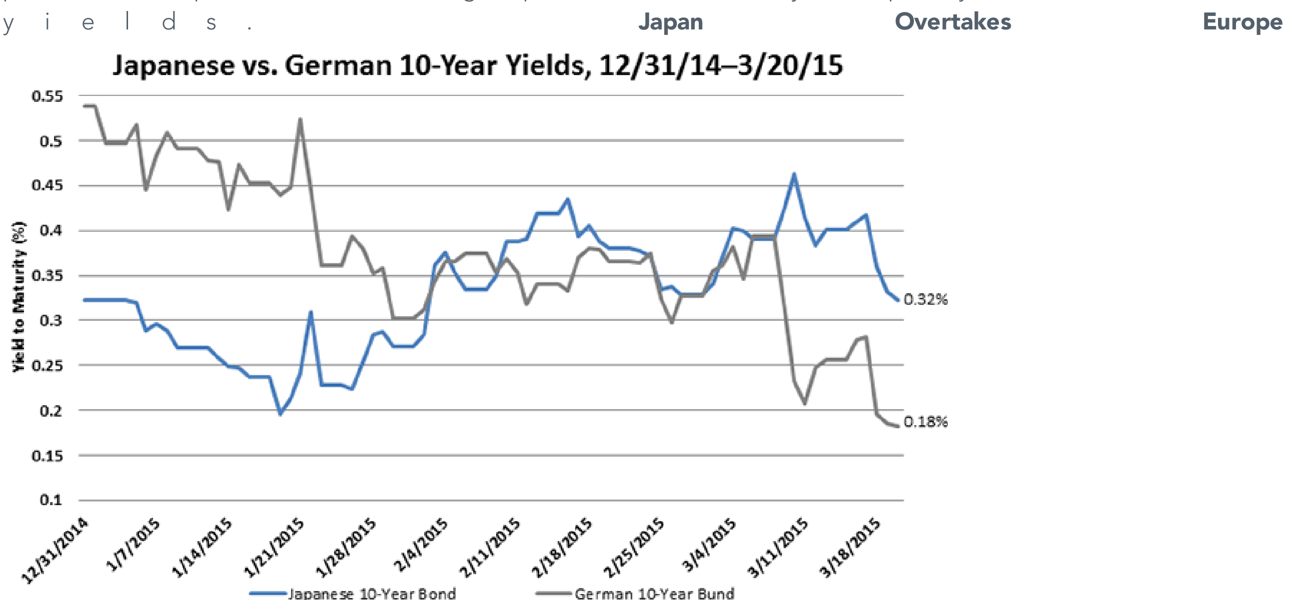
03/27/2015

In an earlier blog post, WisdomTree's research team asked, "Is the euro the new yen?" While the focus of that piece was on the relationship between each country's equity and currency markets, another interesting development is occurring in the Japanese and German bond markets. Since reaching historic lows in mid-January, Japanese government bond (JGB) yields had doubled over the last several weeks before retracing.[1] In the process, they have eclipsed German 10-year bund yields for the first time in over 20 years. While we believe this recent development has several interesting implications, the most relevant one for investors focuses on what could be driving this trend. Quite simply, bond purchases by the Bank of Japan (BOJ) are currently the single most important determinant of Japanese bond yields. Should the BOJ decrease its preference for JGBs as the primary tool for affecting monetary policy in the coming months, bond yields may continue to rise. **Rising vs. Falling** While here we primarily focus on the Japanese side of the equation, changes in European policy have also had a significant impact on the markets. While yields have drifted higher in Japan, they have fallen in precipitously Germany. In our view, one of the primary reasons why the European Central Bank (ECB) is choosing to go down the path of quantitative easing is to hopefully avoid the "lost decades" that Japan has experienced since the 1990s: weak growth, deflation, wage stagnation and a mounting debt burden. However, while Japan has arguably had the most aggressive central bank over the last few years, it is also purchasing assets other than bonds. A perceived shift in preference and a meaningful uptick in inflation will likely be the primary contributors to a rise in JGB yields. **Japan Overtakes Europe**



Source: Bloomberg, as of 3/20/15. Past performance is not indicative of future results.

For definitions of terms in the chart, please visit our glossary. As illustrated in the chart above, on February 3 the yield on the 10-year Japanese government bond was higher than the yield on the German 10-year bund for the first time in 20 years. The date stands out as it coincided with the announcement of tepid results for a 10-year JGB auction.[2] Auctions have been a preferred means of access for the BOJ, given that they allow it to put large amounts of money to work with minimal secondary market impact. In a few subsequent auctions, investors (including the BOJ) generally demanded a higher interest rate to

buy JGBs. While auction demand has recently stabilized, a key takeaway may be that JGB volatitlity may be poised to rise. With yields still at very low levels and some critics wondering about the future sustainability of bond purchases, an attractively skewed trade could include a short position in JGBs along with a short position in the Japanese yen.

[1]Source: Bloomberg, as of 3/20/15. [2]Source: Bloomberg, 2/3/15.

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DEFINITIONS

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.

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.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.

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.

Deflation : The opposite of inflation, characterized by falling price levels.

Inflation : Characterized by rising price levels.

Auction : a public offering of newly issued debt securities in which pricing is determined via an investor bidding process.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.

Nominal interest rate : Interest rate that does not account for the impact of inflation.