U.S. RATES ARE RISING AND JAPANESE EXPORTERS ARE ROARING

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Just when clients seemed to tire of hearing about Japan and Abenomics, and the foreign investor outflow—nearly $50 billion in 2016[1]—seemed like it could only move in one direction, we learned yet again to expect the unexpected.

The Trump Election Victory Was a Critical Catalyst

Before the victory of President-elect Donald Trump, 2016 looked as if it would go down as the year of yen strength. One could have pointed to all manner of central bank policies from qualitative and quantitative easing to buying equities and real estate to negative interest rates, and yet, with each passing day, the yen would move closer and closer to 100 relative to the dollar (and remember, it started the year at 120).[2] Even the innovative policy of yield curve targeting, announced by the Bank of Japan (BOJ) on September 21, 2016,[3] did not seem to have an impact.

But then came the surprise Trump election victory:

1. The first and very noticeable impact—likely because of expectations of increased economic growth and increased deficit spending—was that the U.S. 10-Year Treasury note interest rate spiked from a 1.70% to 1.80% range to a 2.30% to2.40% range.[4] This was a *massive* move, and massive moves in today's markets have global repercussions.
2. As U.S. equities soared to new highs and the Russell 2000 Index notched 15 days in a row of gains,[5] across the Pacific Ocean, the yen—which had initially spiked down in its typical "risk-off" nature toward 100 to the dollar on the news of the Trump victory—started to depreciate. As of this writing on November 30, 2016, it has depreciated to levels above 114.
3. The massive rise in U.S. interest rates truly put the BOJ's yield curve targeting policy to an important test. On November 17, 2016, the BOJ affirmed its commitment to buying as much of the 10-year Japanese government bonds as needed to maintain a yield of 0% or below.[6] Japanese investors would therefore see a U.S. 10-Year bond yielding 2.30% to 2.40% and see their own government bond yielding zero, and market forces would lead to buying U.S. Treasuries. They would need to sell yen and buy dollars to do so, encouraging a weaker yen in the process.
4. As of this writing, the U.S. Fed Funds Futures market is also pricing in a 100% chance of a U.S. Federal Reserve interest rate hike at the December 2016 meeting.[7] That, combined with the U.S. 10-Year yield already rising, further encourages 1) a stronger U.S. dollar generally and 2) Japanese investors to not hedge their dollar exposure when buying U.S. assets, because it would be more expensive to do so. This is another important factor encouraging a weaker yen.

A Weakening Yen Is the Key That Unlocks the Valuations of Japan's Exporters

When the yen weakens, companies such as Toyota, Honda, Nissan, Panasonic, Sony, etc., become more competitive as their products see their relative prices drop in global markets, including the United States. Sales volumes tend to increase along with an important positive impact from translating the foreign currencies acquired through foreign sales back into yen for reporting on their home country's (in this case, Japan's) financial statements. During the start of 2016, because of the yen's strength, there was a rather large headwind blowing in the face of these companies. That headwind appears to have been, for the moment, removed.

Japan's Exporters as a Rising Interest Rate Solution

One of the single most compelling charts of 2016, in our opinion—and we've shown it before—displays the difference in Japan's performance during the fall in the U.S. 10-Year Treasury Note interest rate, from December 31, 2015, to July 8, 2016, and during the rise in the U.S. 10-Year Treasury Note interest rate from July 8, 2016, to November 29, 2016. Coincidentally, the near-term bottom in the U.S. 10-Year yield happened on the same date that Prime Minister Shinzo Abe saw a significant Liberal Democratic Party (LDP) victory in the upper house of Japan's legislature, giving him a super majority for future reform efforts.

Japan's Equities During Rising and Falling U.S. Interest Rates

Japan Equities

- **The Falling Rate Period:** WisdomTree's Japan Hedged Equity Index requires all constituents to garner less than 80% of their revenue from within Japan, thereby tilting toward exporters. The two largest sector exposures of this approach have tended to be Consumer Discretionary and Industrials. Given that the yen was strengthening as U.S. interest rates fell—in fact, the strongest performing currency by far in the G10 complex vs. the dollar—it is not surprising that these sectors suffered the most as their products and services became more and more expensive.
- **The Rising Rate Period:** As conditions changed and the strengthening of the yen first took a pause and then began weakening, Japan's equity market shifted. The formerly poor-performing Consumer Discretionary and Industrials sectors became the two top contributors to the outperformance of the WisdomTree Japan Hedged Equity Index versus the MSCI Japan 100% Hedged to USD Index .

The bottom line: For investors looking to add to their rising rate toolkit, we encourage them to broaden the search beyond U.S. borders and to consider Japan in this context. Recent performance has been so strong that the WisdomTree Japan Hedged Equity Index is now outperforming the MSCI Japan 100% Hedged to USD Index by 168 basis points year-to-date.[8] If rising rates and a weakening yen are here to stay, this gap could widen further, as the majority of its generation came after the Trump victory.

[1]Sources: Bloomberg, Japan Ministry of Finance. Data current as of 11/18/16.

[2]Source: Bloomberg, with start of year corresponding to 12/31/15.

[3]Source: "New Framework for Strengthening Monetary Easing: 'Quantitative and Qualitative Monetary Easing with Yield Curve Control,'" Bank of Japan, 9/21/16.

[4]Source: Bloomberg.

[5]Source: Lu Wang, "U.S. Stocks Rise to Record as Trump Rally Goes on for Third Week," Bloomberg, 11/25/16.

[6]Source: Reuters, "Bank of Japan Just Fired a Warning Shot to Markets," Fortune, 11/17/16.

[7]Source: Bloomberg, as of 11/30/2016.

[8]Year-to-date refers to the period 12/31/15 to 11/30/16.

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DEFINITIONS

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.

Quantitative and qualitative monetary easing (QQE) : A central bank 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.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

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

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

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.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

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.

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.

MSCI Japan 100% Hedged to USD Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.The Index seeks to neutralize the impact of the yen vs. U.S. dollar exchange rate on returns.

Basis point : 1/100th of 1 percent.