FROM OUR JAPAN STRATEGIST ROUNDTABLE: A FOCUS ON ECONOMIC ISSUES WITH JESPER KOLL

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WisdomTree has compiled a Japan Strategist roundtable—a compilation of views from three of the most widely followed Japan investment strategists. In separate one-on-one interviews, we asked these strategists to share their views on Japan's equity markets, the economy, government initiatives and the currency. Below is part of our discussion with **Jesper Koll of J.P. Morgan Japan** and his take on the economy, labor market issues, Bank of Japan policies and factors impacting the yen. ***Jesper Koll believes resource constraints are spurring wage growth and that this is central to his focus on a theme of "domestic demand." Jesper, please talk about this.*** **Jesper Koll:** Let me give you a thesis for Japan: I think Japan is going to be the one society where a new middle class is emerging, because you'll find that the domestic service sectors, which is predominantly merchandising and individual services, over the last 20 years have seen wages decline by an average 1.5%. That, because of the greater shortage of workers, is now going to inflect up. The low-end employees at smaller companies, the mom and pop shops, as well as employees in the merchandising and domestic service sectors, wages are actually going up. ***This is why you think the consumption tax in April is really a non-event?*** **Jesper Koll:** Yes, absolutely. People look at wage growth, and they focus on the base pay negotiation. Well, I'm terribly sorry. The base pay negotiation applies to companies that are in the manufacturing sector and only employ 17% of the people. In the national income statistics and the gross domestic product (GDP) statistics, workers' compensation currently is rising already at a rate of about 2.5%. ***Moreover, on demographics, Jesper thinks there are important changes in the works.*** **Jesper Koll:** The baby boom drag—the baby boomers moving to retirement—is over, and the children of the baby boomers for the first time in their employed lives are actually seeing greater stability of jobs. More people are going to be hired on a full-time basis. Once that happens, you start to have a family. As the certainty of lifetime income improves, you get greater household formation, marriage rates go up, and then before long, you're going to have another baby boom. ***Jesper, you've said the Bank of Japan (BOJ) is not "pushing on a string" and that a surprise for 2014 will be that inflation exceeds 2% by mid-year, keeps on rising, and by end-2014, the BOJ policy board forecasts 3.1% inflation for 2015. What drives this?*** **Jesper Koll:** Yes. I think the most important thing in Japan is that you are hitting resource constraints. The labor market is shrinking. Every year, there are about 750,000 people leaving the Japanese workforce. Before long, a labor shortage puts real upward pressure on wages and puts pressure on inflation. Japan for 2013 and 2014 is in a sweet spot where productivity is rising faster than wage growth. But, eventually you're going to have unit labor costs actually beginning to increase. ***Labor market reform is a big topic, given the declining labor force. What do you think Abe should be doing?*** **Jesper Koll:** The one reform that needs to happen: a more open immigration policy. Let me be very clear. That's not Mr. Abe's fault. That is not the fault of the visa rules and regulations—it's a function of corporate governance really being very closed to outsiders and whether these outsiders are non-Japanese or whether they are females. You can't change this management style legislatively; corporations have to change. There are some examples of this occurring. Lawson, the second-largest convenience store operator in Japan, three years ago started a policy: Every third person they hired here in Japan is a non-Japanese. The CEO is globally educated, and the moment he became the CEO, he forced the HR department to open the doors to employ non-Japanese. ***What will drive this change going forward?*** **Jesper Koll:** The scarcity of labor is becoming acute, and it will be a necessity. When you look at the logistics business, shipping parcels, base pay is rising at a rate of 9% compared to a year ago. In the construction industry, base pay is increasing at a rate of between 12% and 15%. Literally, a lot more money right now cannot buy you an additional construction worker. At the top end of the economy there's still excess. There's still an excess of utility workers, government bureaucrats and public sector employees. To some extent, there's an excess of employment in manufacturing, where more robots are being used. But at the lower end there is a shortage, and this is putting wage pressures and could cause Japan's companies to open up. ***Another important factor for Japan is the current account situation. Please discuss this.*** **Jesper Koll:** Japan is no longer a creditor country, it's a debtor country. You've seen the current account data now showing a structural current account deficit. This has very, very big implications for the macro of the country. It makes it likely that the yen is going to be a weak rather than a strong currency. ***How much of this is the oil imports, and how much is buying ahead of the consumption tax?*** **Jesper Koll:** One-third of the deterioration of current account is due to the terms of trade and the higher fossil fuel imports that Japan is doing because it's gone ex-nuke. But exports are not picking up, because more than two-thirds of production has shifted overseas. Five years ago, it was only 45%. No matter how weak the yen, Japan's official exports are unlikely to be accelerating from here. But importantly, you and I as investors don't really care. In fact, every time a Japanese company announced that they are buying another global company or that they're building another offshore factory, I hop up and down in joy because profit margins on offshore factories are typically two-and-a-half to three times higher than they are on Japanese factories. This is good for profits. ***When you look at the yen's impact on the big exporters, given this offshoring phenomenon, how does a weak yen increase profits like it has for big companies like Toyota[1]?*** **Jesper Koll:** The year-on-year increase in dollar earnings translates into higher yen revenue (with the yen weakening). You're increasing your dollar costs as well. It's obviously not a one-for-one relationship. Given the fact that the profit margins are in Toyota's case about 3.5 times higher for the American operations, the impact is a significant positive. In general terms, for the listed company, a 10% depreciation of the yen against the dollar basically adds back about 10% to corporate earnings from current levels. **We very much thank Jesper Koll for his participation in our roundtable. You can read the full commentary with more comments from Jesper Koll and other Japan strategists here.** [1]As of 12/31/2013, the WisdomTree Japan Hedged Equity Fund (DXJ) held 4.78% in Toyota, the WisdomTree Japan Hedged SmallCap Equity Fund (DXJS) held 0.00% in Toyota, and the WisdomTree Japan SmallCap Dividend Fund (DFJ) held 0.00% in Toyota. For a full list of current holdings of the WisdomTree ETFs, please visit wisdomtree.com.

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Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Current account : The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

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.