

CRASH TESTING ABENOMICS

Jesper Koll — Senior Advisor
01/14/2016

We remain convinced that Japanese risk assets—equities and real estate—are on track for a multi-year [bull](#) market. Our conviction is based on two essential pillars. The first one is our view that Japan's private sector has begun to focus on capital efficiency as a principal driver of corporate strategic focus. The second one is that Japanese policy makers are relentlessly focused on ending [deflation](#) and creating a pro-growth domestic macro-economic backdrop. Both pillars remain firmly in place, and we expect a decisive and united policy response from "Team Abe" to the deflationary threat posed by current global and domestic developments. The Bank of Japan (BOJ) is back in play to [ease](#) on January 28/29. While Japan's corporate governance revolution is unlikely to be derailed by the current pullback in global markets, the current threat to [Abenomics](#) is very significant, in our view. Personally, I think Abenomics is now facing the most challenging "crash test" since its inception three years ago, because any national growth agenda is ultimately only as good as its success in building endogenous domestic forces strong enough to withstand a global deflationary shock.

Rising Deflation Risks The current "crash test" consists of two major hurdles: economics and portfolio. The economics is straightforward. It is the compounding deflationary pull from: • Falling global demand in general, China in particular; • Imported deflation from both yen strength and falling commodity prices; and • Domestic demand deflation forced by the negative wealth effect from falling asset prices. Note here that on January 12 [TOPIX](#) was down 17.7% from its August 2015 peak, while the [S&P 500](#) was down "only" 9.9% from its May 2015 peak. While it is difficult to model the exact impact of these compounding deflationary forces on Japan's [inflation](#) and growth outlook, sensitivity analysis suggests that the 5% appreciation of the yen and the fall in commodity prices alone have the power to push the [Consumer Price Index \(CPI\)](#) back into outright deflation (last reading of the national CPI was +0.3% year-over-year). It goes without saying that these are just the immediate first-round effects. Sustained global deflation momentum and yen appreciation would, before long, begin to cut into domestic employment and business investment plans. Clearly, downside risks to achieving any inflation target are rising.

Rising Portfolio Risks—Negative Returns for Abenomics Portfolio This Fiscal Year The portfolio risks are even more significant, in my view. This is because the entire portfolio reallocation agenda of Abenomics—cut domestic bonds, raise domestic equities and non-yen exposure—is being undermined. Specifically, yen equities are now down 9.1% since the start of the Japanese fiscal year (April 1, 2015); in other words, we are on track for the first negative fiscal year for yen equities since 2011. It would also be the first year of yen appreciation since fiscal 2011. And to add insult to injury, the negative returns of risk assets is offset by a sharp rally in the perceived "risk-free" [Japanese government bonds \(JGBs\)](#), with 10-year [yields](#) falling from 40 [basis points \(bps\)](#) at the start of the fiscal year to 23 bps on January 12.

Asset Performance from a Japanese Perspective—Negative Abenomics

Index	12-Month Peak	% Change from Peak	% Change Since Start of Japan FY2015
TOPIX	1703 (August 2015)	-17.7	-9.1
JPY/USD	125.9 (June 2015)	-6.7	-2.2
S&P 500 (JPY)	265 (July 2015)	-14.7	-8.9
S&P 500 (USD)	2135 (May 2015)	-9.9	-7.0
JGB 10-Year (bps)	55 (June 2015)	-58.2	-42.5 (yields fall from 40bps to 23bps - strong rally)

Portfolio This Fiscal Year? Source: Bloomberg, as of Jan 12, 2016, Tokyo close. FY2015 ends March 31, 2016.

The message is loud and clear: Portfolio rebalancing has been a key part the Abenomics strategy, with the BOJ, the [Government Pension Investment Fund \(GPIF\)](#) and Japan Post all advocating and implementing significant increases in risk assets to "lead by example" and for private asset managers and retail investors to follow suit. If these new "national model portfolios" do indeed show negative returns in the current fiscal year—which concludes March 31, 2016—there are bound to be significant negative repercussions. After all, Team Abe has often insisted that the transmission of a new virtuous cycle from portfolio rebalancing into the real economy, fiscal sustainability, corporate innovation and positive

wealth for consumers remains at the core of why Abenomics will work. Failure to perform risks incurring the wrath of critics from both the conservative side and the opposition. **Policy Response Coming—BOJ in Focus on January 28/29** In short, the current threat to Abenomics is very real, in our view. The good news is that Team Abe is not complacent. A strong and unified reflation policy response is likely to come soon. A key focus falls on the BOJ. We had originally expected added easing to come at the March 14 or the April 27 policy board meeting; but given the growing sense of urgency forced by the combination of accelerating global and domestic deflation risks and growing pressure on Team Abe to renew its pro-growth credentials, added BOJ stimulus is now in the cards for as early as the January 28/29 meeting. Indeed, assuming global and domestic asset price volatility remains high, failure to act decisively and proactively now could severely endanger Team Abe's pro-growth credibility, in our view.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Bullish : a position that benefits when asset prices rise.

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

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

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.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

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.

Inflation : Characterized by rising price levels.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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.

Basis point : 1/100th of 1 percent.

Government Pension Investment Fund (GPIF) : Japan's largest public pension fund.