WHY THE SUN IS STILL SET TO RISE IN JAPAN

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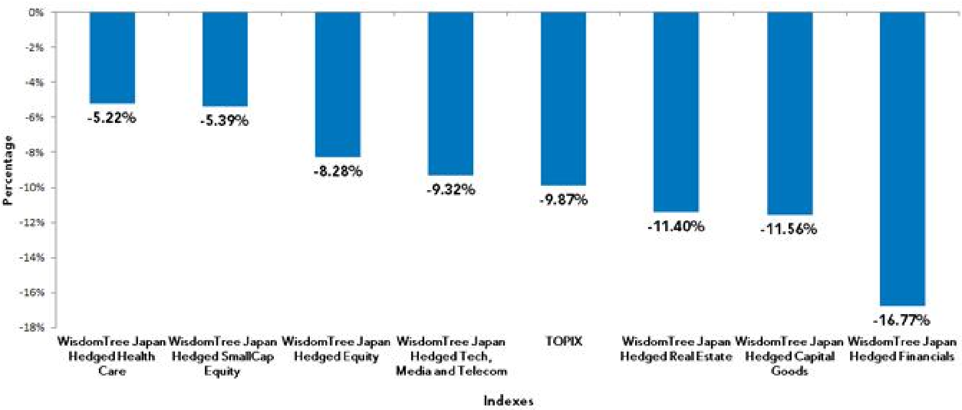
Among financial markets, 2013 was the year of Japan. Investors rushed into Japanese financial assets with great excitement, motivated by the policies of abenomics, which aim to end deflation and restore economic growth. These flows were manifested in positioning for a weakening of the yen that led to enthusiasm about Japan's stock market, which tends to trade inversely to the currency. However, since the beginning of 2014, the sun has been covered by clouds, and Japan has become a market that investors love to hate. But let's be clear: clouds cannot stop the sun from rising. Given the pullback in the first four months of 2014 and the underlying earnings growth, I believe Japan now offers a new attractive entry point. Much has been made of the implementation of a consumption tax hike from 5% to 8%. Yes, this is a short-term negative for Japan's local consumption. But Abe is trying to restructure the tax code and lower corporate tax rates to make Japan a more attractive place to do business. This should be good for corporate profits in the longer run. Expect more consumption tax hikes next year, pushing the rate to 10%, which will be offset by lowered corporate tax rates. Some have called for the Bank of Japan (BOJ) to provide additional monetary expansion. Make no mistake—the BOJ stands ready to take more action if its 2% inflation target is not met. But one should not overlook how aggressive its monetary programs already are. The Fed, for instance, has been tapering its accommodation program and is purchasing $45 billion of securities a month as of April 30. Japan, with an economy one-third the size of the U.S. economy, is expanding its balance sheet by about $75 billion a month—and not just in bonds but real estate and equities as well. The BOJ remains, by far, the most expansionary central bank in the world, providing plenty of liquidity to Japan and the global financial system.[1] We are still in the early innings of Abenomics, and many of those policies, such as reducing excess capacity, have a deflationary bend to them. Abe will be announcing more of his "third arrow" policies in June—this could be part of a catalyst to re-evaluate the negative sentiment that has gravitated to Japan in 2014, despite a continued growth in earnings. While prices have fallen, earnings expectations have actually increased over the period[2], so every dollar of earnings from Japan has gotten cheaper. The estimated price-to-earnings ratio is currently 11.7x and 12.9x for the WisdomTree Japan Hedged Equity Index (WTIDJH) and TOPIX, respectively. For perspective, the S&P 500 index is currently trading at 16.0x estimated earnings, over a 36% premium compared to WTIDJH and a 24% premium to the TOPIX. As investors look to capitalize on these discounted valuations, consider the following nuggets about Japanese market performance this year:

Japan Index Performance



Sources: WisdomTree, Bloomberg (12/31/13–04/30/14). Past performance is not indicative of future results. You cannot invest directly in an index.

- **Small Caps Lead:** I find it impressive that small caps were able to outperform their large-cap peers during the most recent pullback. Typically, one would expect small caps to have a higher beta exposure. Also, since the consumption tax hike is one of the most controversial policies this year, one might expect small-cap stocks—which are local to the economic performance—to be hit the most. But they have actually been the best performers, which might indicate that the consumption tax hike is not as big a deal as many claim. • **Yen-Sensitive Capital Goods Stocks Underperform:** The capital goods sector draws only 40% of its revenue from Japan, the rest coming from overseas.[3] This is a higher beta sector, and it did decline more than the TOPIX or WisdomTree's broad-based Japan Hedged Equity Index. This reflects, in my view, yen sensitivity and global growth concerns (i.e., China) more than concerns over Japan's local economic performance. • **A Large Divergence between Sectors:** The 10-percentage-point difference between the WisdomTree Japan Hedged Financials Index (WTJFH) and the WisdomTree Japan Hedged Health Care Index (WTJHCH) is quite large. The health care stocks, typically more defensive, have high dividend yields and have been focal points for some individual investors in the new tax-incentivized savings accounts being set up in Japan. The financials are the cheapest part of the market and could be a higher beta exposure for those who want to make a contrarian allocation in the "cheapest" part of Japan, as measured by the price-to-earnings ratios or price-to-book ratios. **Land of the Rising Sun** I believe 2013 marked the start of a multi-year bull market in equities, and this recent pullback offers an opportunity to increase under-weight allocations or add new positions. Japan is one of the lowest-priced regional markets on a price-to-earnings basis and the only market that actually had earnings outpace price gains over the most recent year.[4] I believe equity markets will remain supported as Abenomics continues to gain traction and especially as Abe makes more progress on his growth strategy for Japan (the third arrow of Abenomics). While broad-based approaches should continue to serve many investors well, I believe there is also a place for more finely honed precision tools, such as sector allocations or small caps, to express specific views regarding how Abenomics will play out. [1]Sources:WisdomTree, Bloomberg (04/30/14) [2]Period: (12/31/13-04/30/14) [3]Sources: WisdomTree, Bloomberg, as of 12/13/13 [4]Sources: WisdomTree, Bloomberg. Most recent year is 04/30/13–04/30/14

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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.

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

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

Inflation : Characterized by rising price levels.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Third arrow policies : The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.

WisdomTree Japan Hedged Equity Index : Index designed to provide exposure to Japanese equity markets while at the same time neutralizing exposure to fluctuations of the Japanese yen movements against the U.S. dollar. Constituents are dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. Weighting is by cash dividends paid.

TOPIX Small Index : 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 excluding the TOPIX 500 stocks and non-eligible stocks.

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.

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.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

WisdomTree Japan Hedged Financials Index : An index weighted by float-adjusted market capitalization, designed to provide exposure to Japanese financial companies while at the same time neutralizing exposure to fluctuations between the yen and the U.S. dollar.

WisdomTree Japan Hedged Health Care Index : An index weighted by float-adjusted market capitalization, designed to provide exposure to Japanese health care companies while at the same time neutralizing exposure to fluctuations between the yen and the U.S. dollar.