THE UNEXPECTED OPPORTUNITY FOR 2019: JAPAN

Christopher Gannatti — Global Head of Research
02/19/2019

There is a massive divergence in today's markets:

- We believe Japan is an interesting market, with many positive things occurring at the policy level and with very inexpensive and improving fundamentals.
- Market participants outside Japan often don't pay as much attention to Japan, because they think that the hype over Abenomics and the subsequent investment opportunity have both passed.

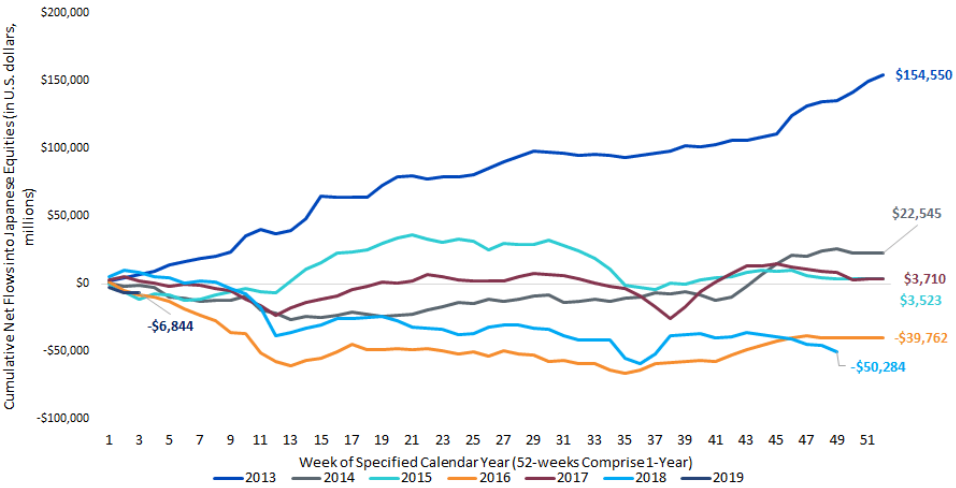
With Japan so far out of favor among investors, is it a *contrarian* opportunity, or are we continuing to be fooled by the false allure of Japan's potential?

Progression of Flows: Massive Excitement to Massive Pessimism

Going back to late 2012, it is true that Japan represented massive potential for reform and excitement that many viewed as almost certain to contribute to strong equity returns. Figure 1 indicates that:

- Non-Japanese investors plowed nearly $155 billion into Japan's equity market in 2013, based largely on the initial excitement of prime minister Shinzo Abe's election and agenda, as well as the initiation of Japan's own massive quantitative easing (QE) policy under the leadership of Bank of Japan (BOJ) governor Haruhiko Kuroda.
- Since 2013, the pattern of foreign investor flows has become progressively more volatile. 2018 was the worst year of Prime Minister Abe's tenure from an investor flow perspective, as foreign investors pulled more than $50 billion out of Japan's equity market.

Figure 1: Calendar Year Flows



Sources: Bloomberg, Japan Ministry of Finance. Data is for each specified year, starting January 1 and ending on the date of the last Friday in December. Past performance is not indicative of future results. You cannot invest directly in an index. Data is reported weekly and based on the annual calendar, so holidays may have an impact and cause the reporting of less than 52 datapoints during a given year.

Investors Assumptions May Differ from Reality

While we'd like to think that each investor is studying Japan's market, poring over financial data and becoming as excited as we are when Japan implements what we consider innovative tax and incentive policies (not to mention the central bank buying equities), the reality is different.

Investor Flows Frequently Follow Performance

Japan has had substantial volatility during the Abenomics period (which started in December 2012), meaning investors could have caught Japanese equity exposure at the wrong time. However, for comparative purposes, we frequently resign ourselves to using more standardized periods of time, such as calendar years. Figure 2 indicates:

- Last year, when more than $50 billion was taken out of Japan by foreign investors, we saw that Japan's equity returns were poor, ranking behind the United States, the eurozone, the United Kingdom and even emerging markets. As a result, outflows during that particular year made sense based on our behavioral assumption that poor performance correlates positively to investor outflows.
- If we extend the horizon and look at the full period of Abenomics, calendar year by calendar year, based on investors' sentiment about Japanese equities, we'd assume that Japanese stocks would be at the bottom of the pack. In 2016 and in 2018, Japanese equities were the worst performers of the regions we show. But, importantly, in 2013 and in 2015, they were the top performing, and in 2014 and 2017, they were in the middle of the pack. *Even the U.S. equity market, viewed frequently as possessing unassailable performance supremacy in recent years, only led the other regions in two of those years.*
- During the full period, only two markets achieved double-digit returns. The U.S. equity market was at the top of the range, which likely surprises no one. Japan came in second, beating the eurozone, the United Kingdom and emerging markets. *That*, we would predict, surprised almost everyone.

Figure 2: Japanese Equities Have Done Reasonably Well during the Abenomics Period

Regional Exposure	2013	2014	2015	2016	2017	2018	Avg. Ann. Return
United States	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	12.1%
Japan	54.6%	9.5%	9.9%	-0.7%	19.7%	-15.1%	11.1%
Eurozone	23.4%	4.3%	9.8%	4.3%	12.6%	-12.7%	6.4%
United Kingdom	18.4%	0.5%	-2.2%	19.2%	11.7%	-8.8%	5.9%
Emerging Markets	3.4%	5.2%	-5.8%	9.7%	30.6%	-10.1%	4.7%

Source: Bloomberg, with data for each specified calendar year beginning on December 31 of the prior year and ending on December 31 of the specified year. Past performance is not indicative of future results. You cannot invest directly in an index. Average Annual Returns are measured from December 31, 2012, to December 31, 2018. Returns are measured in local currency, so as not to be impacted either positively or negatively by currency performance. United States refers to the S&P 500 Index. Japan refers to the MSCI Japan Index. Eurozone refers to the MSCI EMU Index. United Kingdom refers to the MSCI United Kingdom Index. Emerging Markets refers to the MSCI Emerging Markets Index.

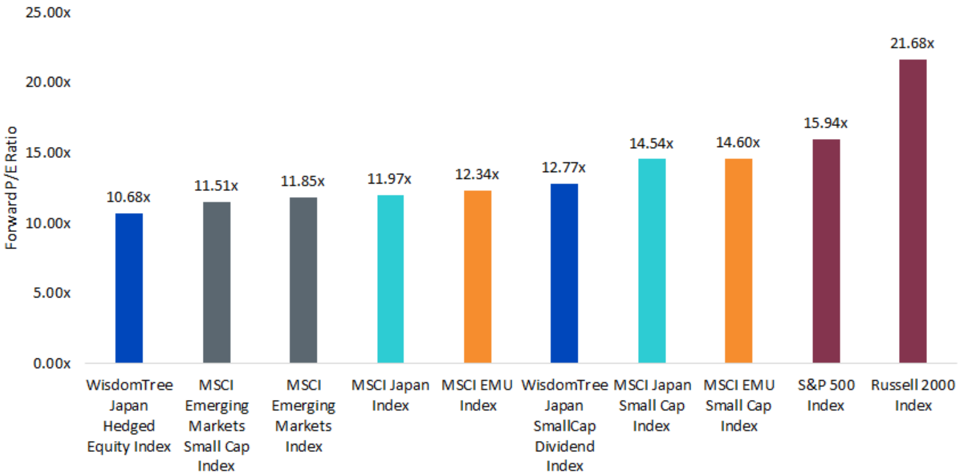
The Case for Japan as a Contrarian Investment

Of course. But the possibility would be true for any contrarian investment. In a way, the definition implies that the consensus view would be for further negative returns.

One of WisdomTree's core principles is that *valuation matters*. Unfortunately, the data doesn't suggest that valuation always matters equally across all markets, because nothing in investing is that simple. On the other hand, trying to say "valuation doesn't matter" leaves one back in the U.S. tech sector in 1999 and 2000, when suddenly it did matter in a big way.

In figure 3, we see that the risk of Japan's largest and most global companies could be close to being "priced in," likely due to uncertainty surrounding global trade tensions and a challenging domestic market environment. As a result, Japan's forward P/E ratio is at about two-thirds that of the S&P 500 Index. The risks of emerging markets, for example, are widely known, yet these businesses are trading at even lower valuations.

Figure 3: Japan's Global Companies Are Trading at Very Low Valuations



Source: Bloomberg, with data as of January 31, 2018. Past performance is not indicative of future results. You cannot invest directly in an index.

Sometimes the Strongest Returns Are Those That Surprise the Consensus

There is no question that Japan and Japanese equities are hard allocations to position today.

There is also no question that most investors are not focusing on Japan right now.

This tells us that there is an opportunity for a surprise in 2019. And surprises to the consensus have historically been some of the best return opportunities.

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, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch 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

Fundamentals : Attributes related to a company’s actual operations and production as opposed to changes in share price.

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 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.

Volatility : A measure of the dispersion of actual returns around a particular average level.

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.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

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.