WHAT DO CHANGES IN INFLATION MEAN FOR JAPANESE BOND MARKETS?

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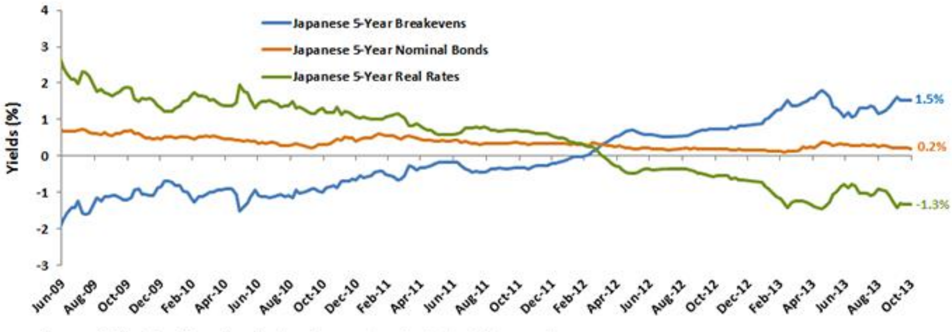
In several periods over the past decade, many sophisticated investors sought to profit from a rise in Japanese interest rates. Given the perpetually slow growth, combined with an ever-increasing long-term debt burden, they believed that the economic fundamentals did not support the lowest borrowing rates in the world. However, very few of these investors were ever able to profit from their economic thesis. Today, we believe that if Shinzo Abe's plan for the reflation of the Japanese economy is successful, the value of the yen will weaken materially, and interest rates may begin to rise in response to his policies. As a result, we believe there are several factors that may contribute to a rise in Japanese interest rates. Most notably, a rise in inflation and inflation expectations may finally spur the Japanese economy while at the same time supporting an increase in longer-term Japanese interest rates. **Why Should Investors Settle for a Decline in Purchasing Power?** Decades of deflation in Japan had the effect of incentivizing savings over consumption. If investors believed that prices would continue to drop in the future, their incentive to make a purchase today was lowered. This had the impact of not only causing a drag on economic growth, it also kept government borrowing costs low. However, this multi-year trend has recently been reversed. In our view, this byproduct of Abenomics may not only be positive for Japan's economic growth but also result in a significant shift in investors' asset allocation decisions. As shown in the chart below, deflation has the effect of boosting real interest rates, rewarding savings and disincentivizing consumption. Recently, the Bank of Japan has been successful in generating positive rates of inflation. As a result of this change, the real rates of Japanese five-year bonds have actually turned negative, implying that investors are actually losing future purchasing power by holding Japanese five-year bonds. **Drastic Change in Inflation Expectations in Japan**



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results.
Period chosen to give the reader a historical perspective and subject to data limitations on Bloomberg.

(05/31/2009–10/31/2013)

For definitions of terms in the chart, please visit our Glossary. The Japanese five-year breakevens (blue line) are a representation of investors' longer-term inflation outlook. While the blue line has spent much of the decade in negative (deflationary) territory, it broke into positive (inflationary) territory in February of 2012. This move in expectations coincides with the Bank of Japan's (BOJ) first announcement of a 1% inflation target. • The five-year breakevens imply that markets are expecting inflation to average 1.5% per year over the next five years. • Five-year nominal yields in Japan have remained relatively range bound since June of 2009. The nominal yield is simply the annual income one would receive from holding a five-year Japanese government bond (JGB). In fact, nominal yields have tended to decline during this period. • The five-year real yields are estimated by deducting inflation expectations from the nominal yields. In February of 2012, these real yields started trending into negative territory and have firmly remained there since. Currently, the real yield on five-year inflation-linked bonds rests at –1.34%. As a result of the BOJ's efforts to achieve a

2% inflation target by the end of 2014, at some point in the future Japanese bond investors will demand greater compensation (via higher yields) in order to preserve future purchasing power and offset inflation. In a recent speech appearance at the Council on Foreign Relations, the BOJ's new governor, Haruhiko Kuroda, said that Japanese bond yields may "eventually" climb if policy makers are able to boost expectations for price increases. He added that "'If we successfully raise inflation expectations to 2%,' it is 'irrational' for bondholders to 'accept' such low interest rates."[1] While inflation in Japan is a relatively recent phenomenon, we believe investors may wish to see a longer-term trend before significantly altering their asset mix. However, with bond returns no longer being boosted by deflation, we believe Japanese investors will eventually transition a portion of their portfolios into riskier assets, such as equities or foreign bonds, as they seek to boost returns. Read the full research here. [1]Caroline Salas Gage, "Kuroda Says BOJ Prepared to Do What's Necessary on Deflation," Bloomberg, 10/10/13.

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DEFINITIONS

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

Reflationary : Characterized by an environment of rising price levels.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

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

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.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Nominal yield : the annual interest rate that an investor demands for holding a bond to maturity, not including the impact of inflation.

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.

Real yield : the annual interest rate that an investor demands for holding a bond to maturity including the impact of inflation.