WITH JAPAN MARKET SELL OFF, FOCUS ON THE FUNDAMENTALS

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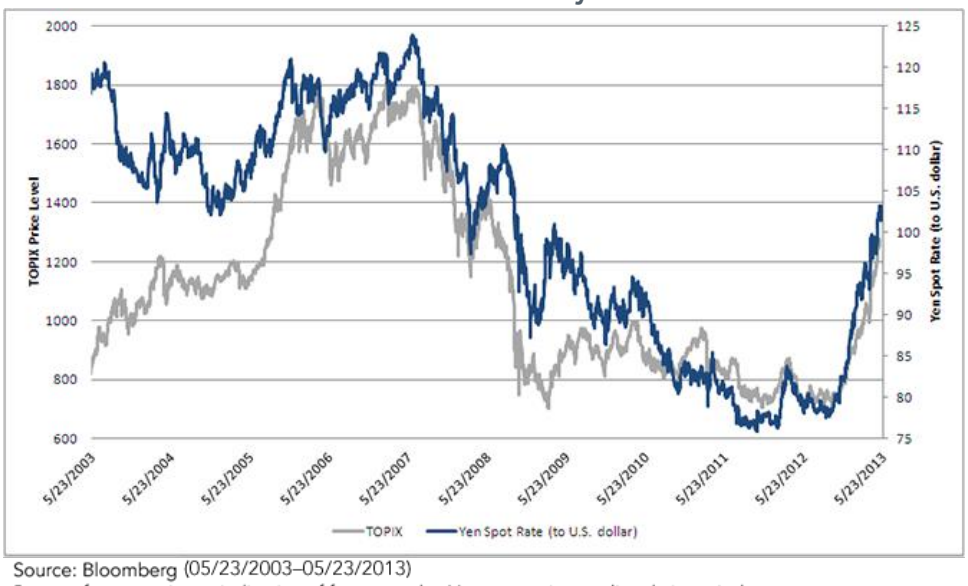
05/23/2013

The Japanese markets have been largely a one-way path higher in the last six months, as market participants focus on the bold actions of the Bank of Japan (BOJ) targeting 2% inflation through unprecedented monetary stimulus. One outcome of these bold policies has been a substantially weakening yen, which provides support to Japan's exporters. The steep sell-off was triggered by a worse than expected Chinese economic report. Will this be a psychology changing report that changes the tone of the market? I doubt it. Just recently the yen breached a critical 100 yen per U.S. dollar level that was a key psychological barrier for continued yen weakness. When one focuses on the fundamentals of Japanese companies, the earnings outlook has improved meaningfully as a result of this currency weakness (discussed below). With the equity market rising in conjunction with earnings expectations, I believe the case for Japan's equity markets is intact. A key variable to watch, of course, is the exchange rate, as much of the moves higher in equities are tied to weakness in the yen. From a historical perspective, I believe there is more room for weakness. **Longer-Term Perspective** Although the yen has weakened recently, both the yen and the TOPIX (Tokyo Stock Price Index) are still below their pre-financial crisis levels of mid-2007. The BOJ recently argued that the yen hadn't weakened against other currencies but rather begun to moderate from its excessive highs toward a more balanced level. Let's look at the 10-year history of both the TOPIX and the yen–to-dollar exchange rate in the chart below.

10-Year History: Yen-to-Dollar and TOPIX



Source: Bloomberg (05/23/2003–05/23/2013)
Past performance is not indicative of future results. You cannot invest directly in an index.

• **Recently Strong Trend –** The yen has weakened by more than 14.0% against the U.S. dollar, and the TOPIX has returned over 38% year-to-date. The yen has weakened over 25% since its 2011 highs against the dollar, and the TOPIX has gained over 70% since its 2012 lows. • **Still Below Recent Highs –** Although the yen has weakened substantially against the U.S. dollar and the TOPIX has surged, both are below their pre-crisis levels. The yen would need to depreciate another 22%, and the TOPIX would have to appreciate over 52% for them to return to the highs set in 2007. To put this in perspective, the S&P 500 Index is currently around 4% above its 2007 high. • **Current Levels –** Many experts expect the yen to weaken further against the dollar as a result of the Bank of Japan's monetary actions and 2% inflation target. Considering the price action over the past 10 years, I also think there is more room for the yen to

weaken if the Bank of Japan continues to stimulate the economy through monetary policy. **Yen Weakness May Provide Support to Earnings** The products that Japanese companies sell worldwide become cheaper to foreign buyers as the yen weakens against their domestic currencies. As these products become relatively cheaper across the globe, the demand increases, allowing Japanese companies to sell more. The companies eventually must bring the money back to Japan, and when they do, they are able to exchange the foreign currencies against more yen. This process has allowed many Japanese companies to report increases in sales and profits. Keeping valuation multiples constant, increases in company profitability potentially translate to higher equity prices. J.P. Morgan's Japan strategist Jesper Koll conducted an excellent analysis of how he expects earnings to fluctuate for various levels of the yen exchange rate.

Relationship between the Yen and Earnings per Share of TOPIX

$/¥	75	80	85	90	95	100	105	110
EPS[1]	55	65	71	76	80	84	88	93

Source: J.P. Morgan
[1]EPS: Earnings per share, 03/14 expectations.

• **Earnings Expectations Increase with Yen Weakness:** Given a 10-point move in the yen from ¥90 to ¥100, J.P. Morgan would expect a similar percentage increase in earnings from 76 to 84, or about a 10% increase in earnings. If the yen depreciated from ¥100 to ¥110, J.P. Morgan estimates another 10% increase in earnings, from 84 to 93. • My base case scenario is that the yen will continue to depreciate against the U.S. dollar and EPS should increase as a result. J.P. Morgan's model gives at least one guide for how aggregate Japan earnings might respond to this yen change. **Hedge Yourself Against Further Weakness** Although Japanese exporters may potentially benefit from further yen weakness, it does not help U.S. investors who are not hedged. When investing in foreign markets investors are exposed to movements in equity prices as well as movements in currency. Japanese equities are positive year-to-date, but the yen weakness (against the dollar) has detracted from the total return, unless the currency was hedged. It is, of course, impossible to know with certainty if the yen will weaken or strengthen against the dollar in the future, so hedging currency also helps mitigate the risk of currency impacting returns by isolating simply the equity exposure. The WisdomTree Japan Hedged Equity Index is 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. The Index consists of dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. By excluding companies that derive 80% or more of their revenue from Japan, the Index is potentially tilted toward export-oriented companies with a more significant global revenue base. *Time to invest in Japan?* (Video)

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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.

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

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