

# JAPAN LOOKS CHEAP AND “YEN HEADWIND” MAY RECEDE ON ELECTION PROSPECTS

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Japan is an equity market that intrigues me and a handful of notable value investors such as David Herro, Morningstar's International Stock Fund Manager of the Decade, and James Hunt of Tocqueville Asset Management.<sup>1</sup> Earlier this year, I published a [research piece](#) based on historical dividend yield analysis that described what I saw as bullish prospects for Japan's equity markets based on its relatively low prices. Japan has been plagued by a perpetual bear market for much of the last 25 years. The last five years have been especially difficult—from the global recession and financial crisis to the earthquake and tsunami of 2011—and were compounded by an ever-rising yen that made Japanese exports less competitive in the global marketplace. In a research piece entitled “The Sun Also Rises?” Hunt spoke of a “quadruple whammy” of negative factors plaguing Japan, including: • A slowdown in Japan's [GDP](#) • A slowdown in China's GDP (one of Japan's largest export markets) • A territorial dispute between China and Japan • An ever-rising yen This fourth whammy—the rising yen—is the one I want to focus on in this post. Hunt writes of the yen: *The Yen has defied economics for some time, in part because Japanese investors' reflexive response in the face of risk is to bring money home and invest it in Yen-denominated assets, and because with domestic deflation, real interest rates in Japan are actually higher than their U.S. counterparts, which are being suppressed by government policy. It has been a fool's game to guess when the Yen would finally weaken, but economic healing in the West and eventually inflation and rising interest rates here could certainly be a catalyst, as could money printing in Japan. Meanwhile, the strong Yen has forced exporters to become more cost efficient in Japan and to move production to lower cost sites in Asia, which will enhance their profitability in the long run.*<sup>2</sup> I agree that it has been especially difficult to predict the yen's performance, to put it mildly. But I believe that the yen is currently the single most important factor driving Japan's relative performance. As one piece of highly anecdotal evidence, just look at the first quarter of 2012—when the yen weakened 7% and Japan was the best-performing country in the developed world markets.<sup>3</sup> On this front, we have recently seen very positive developments and a shift in sentiment. The change in tone is coming from an election set to take place on December 16, which Shinzo Abe, leader of the Liberal Democratic Party, is projected to win. Abe, a former prime minister, has vowed to weaken the nation's currency and boost government spending to stimulate the economy. The specific rhetoric getting the most attention has been Abe's call for “unlimited easing from the central bank to weaken the yen.” Many of the nation's exporters have started to see their stocks react very positively on speculation that the yen's very outsized strength over the past five years may be set to reverse course with an Abe victory in the December 16 election.<sup>4</sup> Given this potential shift the yen may have started, it is all the more interesting that on November 30, 2012, WisdomTree implemented a special, one-time rebalance of the Japan Hedged Equity Index to focus more weight on Japan's global multinational exporters. I believe the currency-hedged nature of this Index calls for a tilt to companies that would benefit from a weaker yen; we thus added a new filter to the Index to remove from inclusion companies that were primarily operating locally in Japan. This filter specifically focuses on companies that derive more than 80% of their revenue from Japan. To see a more detailed analysis of the shift that occurred as a result of this Index enhancement, please see this [research piece](#). In closing, I believe Japan's stocks are attractively priced, but we need to see the yen continue to move downward to keep the momentum going for Japan's stocks. The election on December 16 could be a very helpful catalyst. **Time to invest in Japan? (Video)** <sup>1</sup>Source: Roben Farzad, “Japanese Stocks? Yes, They Really Think So,” Bloomberg Businessweek, Nov. 23, 2012. <sup>2</sup>Source: James Hunt, “The Sun Also Rises? A Contrarian Take on Japanese Equities.” Tocqueville, Nov. 14, 2012. <sup>3</sup>Based on MSCI country index data and countries in the MSCI EAFE Index. Also see our research note. <sup>4</sup>Source: Anna Mukai, “Japan Automakers Jump on Bets Abe Will Weaken Yen: Cars,” Bloomberg, Nov. 27, 2012.

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