JAPAN FINANCIALS RALLY ON BOJ DECISION

Jeremy Schwartz — Global Chief Investment Officer
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Japanese financials have been clobbered over the last year. Going into the latest Bank of Japan (BOJ) meeting on July 29, the WisdomTree Japan Hedged Financials Index (WTJFH) was down 31% year-to-date.[1] On the day of the meeting, when the BOJ doubled its exchange-traded fund (ETF) purchases but failed to add to its bond-buying program or cut interest rates more, a move that disappointed analysts WTJFH rose 7.7%, while the broader Japanese market was up just over 1%. What's behind this rally? Firstly, Japanese financials are attractively priced. On a price-to-book (P/B) basis, the Japanese banks, which make up 56% of WTJFH, are currently selling at.51. This is a very depressed set of valuations for banks that have strong balance sheets.

Valuations of Japanese Banks and Financials

	Weight	Price-to-Book Ratio (P/B)	Dividend Yield	Price-to-Earnings (P/E)	Dividend 5-Yr Growth Rate
WTJFH	**100%**	**0.61**	**3.05%**	**8.9x**	**8.45%**
Banks	56%	0.51	3.17%	8.1x	5.51%
Insurance	26.30%	0.75	2.68%	11.0x	13.85%
Diversified Financials	17.70%	0.91	3.25%	12.6x	20.51%
MSCI Japan Index			2.24%	16.7x	9.46%

Source: Bloomberg as of 7/29/16. WTJFH refers to the WisdomTree Japan Hedged Financials Index.
Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, visit our glossary. One of the primary fears for Japanese financials has centered on the negative interest rate policy (NIRP) that Japan implemented earlier this year. NIRP has hurt bank profitability, as Japanese government bonds (JGBs) held on bank balance sheets show no income, and it also has put pressure on the entire interest rate curve, causing a decline in interest rate margins and profits the banks can earn. These negative-yielding JGBs act like another tax on the banks. Going into the BOJ meeting, as investors widely expected more stimulus, it was possible the BOJ would lean more heavily into the NIRP policy and take rates more negative. When that didn't happen, it was viewed largely as a positive for the banks. Also, there was a release from the BOJ stating that there will be a comprehensive review on the entire BOJ stimulus package of quantitative easing combined with negative rates at the meeting in September. Some have commented that perhaps the BOJ will go back on its NIRP policy and hike rates, although that is viewed as just a small possibility currently. Further, the Bank of Japan increased U.S. dollar funding for Japanese banks; it doubled a swap line from $12 billion to $24 billion of U.S. dollar funds that could be lent by the BOJ to banks for a period up to four years. The BOJ also established a new facility to help banks access this funding market. As U.S. dollar bank funding markets were starting to become more expensive for the banks, this provided additional relief and positive sentiment for the banks.[2] One of the strongest performers in WTJFH on the day of the BOJ's meeting was Nomura Holdings, a 3.09% weight in the Index as of July 29. Nomura was up over 12% on news that it will conduct a buyback of up to 2.5% of its shares.[3] We have discussed this trend for Japanese financials in particular to increase their buybacks after being the worst-performing segment of the market. The net buyback yield of WTJFH is over 2%, which combined with the 3% dividend yield gives a 5% dividend plus net buyback yield.[4] These companies are returning cash to shareholders at rates hardly ever seen in Japan in the last 30-years.

Over-Weight Financials on Valuation Normalization

Japan remains a hotly contested market, with many investors not sure what to think about the current disappointing market returns as well as the BOJ's lack of action. We'd emphasize the Bank of Japan did take some meaningful decisions, such as the doubling of equity purchases and the support for banks discussed above. After Prime Minister Shinzo Abe's fiscal package becomes clearer, we are also highly likely to see additional bond buying from the BOJ. Japanese financials are a sector worth considering to supplement broader market positions in Japan on sharply depressed valuations. It would take average gains of 50% in the banks (over 56% of WTJFH) before you'd reach a .75 P/B ratio on the banks.[5] With NIRP policy looking to be on hold, we'd suggest investors look at the WisdomTree Japan Hedged Financials Fund (DXJF), which is designed to track the performance after taxes and fees of WTJFH, as a sector allocation option for Japan.

[1]Sources: WisdomTree, Bloomberg as of 7/28/16. [2]Source: Bank of Japan 7/29/16. [3]Sources: WisdomTree, Bloomberg as of 7/29/16. Note that Nomura was a 3.45% weight in DXJF as of the same date. [4]Sources: WisdomTree, FactSet as of 6/30/16. [5]Sources: WisdomTree, Bloomberg as of 7/29/16.

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DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

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.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Negative Interest Rate Policy (NIRP) : A monetary policy where by interest rates.

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.

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.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.