Drivers of Japan's equity performance may be changing

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As we study the financial markets, we tend to search for relationships that might be connected in explaining or driving returns. While it’s always exciting to find these apparent nuggets of truth, it is sometimes disheartening to recognize that—in most cases—markets will shift in future, unexpected ways forcing them to disappear.

The relationship between Japan’s equity performance and some of these underlying drivers may be shifting along these lines.

Relationship #1: Inverse Correlation between Equity and Currency Returns

One of the most notable characteristics of Japan’s equities is that they have tended to move in the opposite direction to that of the yen currency, meaning:

- Yen depreciation has been associated with some of the stronger equity returns we’ve seen
- Yen appreciation has been associated with some of the weaker equity returns we’ve seen.

Looking at long time series, it is not yet apparent if the regime of “negative correlation” that we’ve seen largely in place since February 2007 has ended1, but what we’ve seen recently might be an early signal that the yen’s movement is not as strongly determinant as it has been since the start of the Abenomics period.

Since May of 2017, the TOPIX has Risen while the yen has Strengthened!

Abenomics Period: TOPIX level vs. Japanese yen movements (Nov. 30, 2012 to Jan. 12, 2018)

Sources: WisdomTree, Bloomberg, with data measured during the Abenomics period.

You cannot invest directly within an Index.

- Since May 15, 2017, the yen has appreciated approx. 2.5% against the US dollar. Normally, what we've seen during the Abenomics period (and prior to it during 5 years of yen strength) would lead us to expect lacklustre or negative equity performance during such a period, yet Japan's equities are up nearly 20% over this same period over the last 7-months.

Again, we're far from thinking that negative correlation has completely receded from view—and if there was a sharp appreciation of the currency we'd likely see a tough environment for equities again, but divergences from past behaviour like this need to be noted and monitored as we move forward.

Relationship #2: Tight Relationship between the US 10-Year Treasury note & the Yen vs. US dollar

On September 21, 2016, the Bank of Japan (BOJ) initiated a policy often referenced as "yield curve control2." A commitment was made to buy as many Japanese Government Bonds (JGBs) as needed to ensure that the yield of the 10-Year JGB was close to 0.0%. This was revolutionary, in that it signalled a commitment to buy a potentially unlimited amount of JGBs.

A result of this policy was that—since the yield of the 10-Year JGB was now locked in due to policy—the yen became highly correlated to the level of the 10-Year US Treasury Note Interest rate.

- A rising US 10-Year Treasury note interest rate—such as around the election of President Donald Trump—was associated with a significant weakening move in the yen vs. the US dollar.

- A falling US 10-Year Treasury note interest rate—such as in early September of 2017—was associated with a significant strengthening move in the yen vs. the US dollar.

While the Yen has been Decoupling from the US 10-Year, Japan's Equities have become More Closely Correlated

Japanese yen vs. U.S. 10-Year Treasury note Interest Rate (Sept. 21, 2016 to Jan. 12, 2018)

TOPIX Level vs. U.S. 10-Year Treasury note Interest Rate (Sept. 21, 2016 to Jan. 12, 2018)

Sources: WisdomTree, Bloomberg, Bank of Japan.

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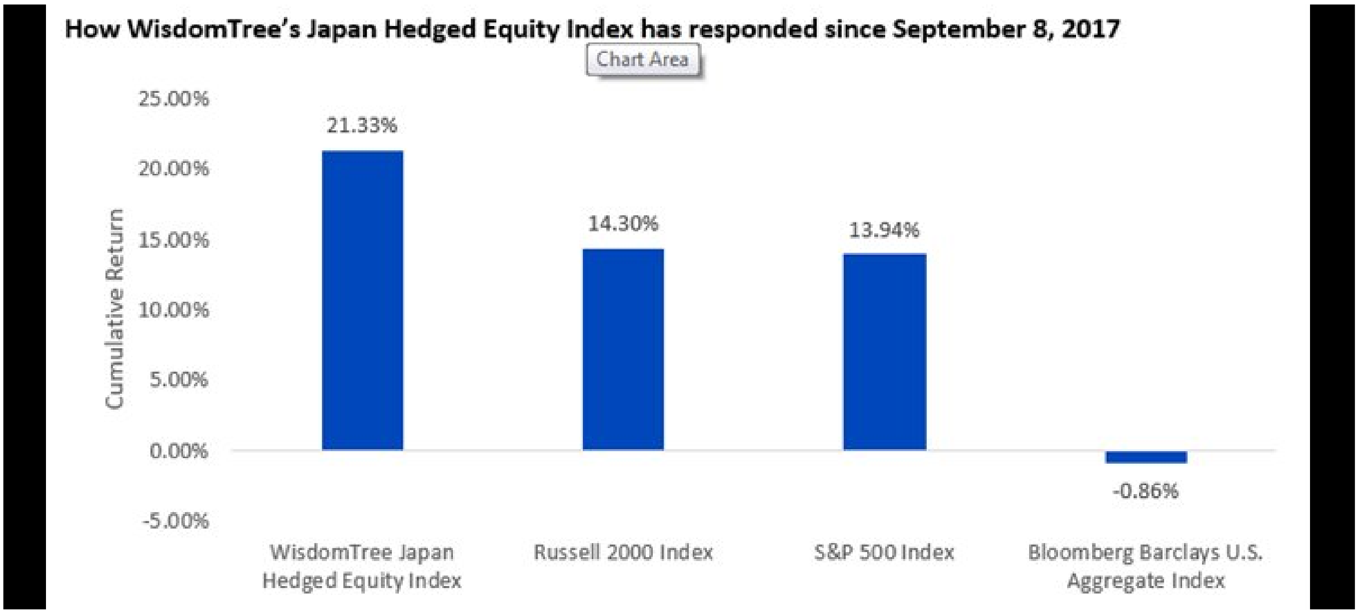
- As we started 2018, we saw the US 10-Year Treasury note interest rate rise above 2.5%. We can see that, in the recent past, we've have expected this move to be associated with significant yen weakness—but this is not what happened. The yen has actually been strengthening in early 2018, breaking the relationship that it has had with the US 10-Year Treasury note. Since this interest rate can and will move over the coming weeks and months, it will be important to see what happens to this relationship.
- Of even greater interest—and possible surprise—since the September 8, 2017 near-term bottom in the US 10-Year Treasury note interest rate Japan's equities, as seen through the TOPIX, have become very correlated to movements in the US 10-Year. As the 10-Year interest rate rose in early 2018, Japan's equities responded in kind, which was not necessarily what would have been expected even one year ago. The argument is that an improving US economy and US interest rates feeds into Japanese equities that are tied to global business prospects and the US economy in particular – including companies that benefit from US reduction in corporate tax rates—part of the factor driving interest rates higher.

Thematically, WisdomTree in Europe has focused on the Exporters theme within Japan. This theme comes in the form of the WisdomTree Japan Hedged Equity Index, which normally see their strongest performance associated with a falling yen. However, we have written in the past about the potential of this strategy to respond to rising US interest rates.

How WisdomTree's Japan Hedged Equity Index has responded since September 8, 2017



Sources: WisdomTree, Bloomberg, with data from Sept. 8, 2017 to Jan. 12, 2018.

You cannot invest directly within an Index.

As investors look to understand what is happening in Japan, what happens in the US economy and US interest rates is of prime importance. We have established a strong link between the performance of Japanese markets with US interest rates and Japanese financials in particular have been some of the strongest beneficiaries during rising rate environments. But notice too that the Japanese exporters have also been strong performers as rates moved higher.

While it is still too early to say the negative correlation between Japanese equities and the yen will have a much different relationship looking forward than it has over the last 10-years, the pattern at end of 2017 will bear watching throughout 2018.

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1 WisdomTree, Bloomberg, with data from Mar. 31, 1975 to Dec. 29, 2017. You cannot invest directly within an Index.

2 "New Framework for Strengthening Monetary Easing: Quantitative and Qualitative Monetary Easing with Yield Curve Control." Bank of Japan. Sept. 21, 2016.

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