Low valuations, earnings growth and a weaker Yen: What's the smart approach to Japanese equity exposure?

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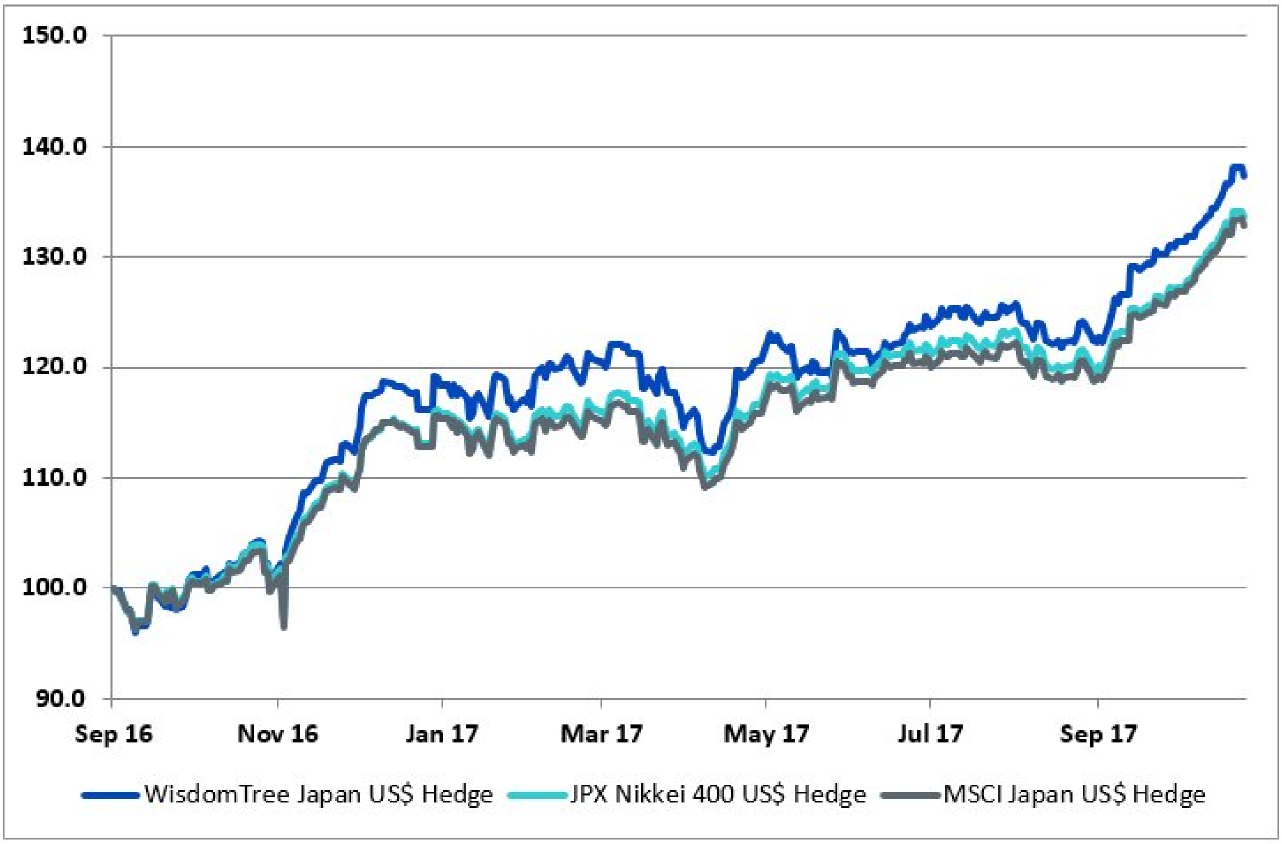
After US equities, Japanese equities are the second largest country weighting in the MSCI World Index, at close to 9% as of the end of October 2017. As such, Japan is an important allocation for many investors. However, the country has unique economic and equity market attributes, and therefore it's paramount that investors find an appropriate investment solution. Some of the more common Japanese indices include:

- The WisdomTree Japan Equity Index, which has an export tilt
- The MSCI Japan Index which covers large and mid-cap companies
- The JPX Nikkei 400 that has a focus on corporate governance

The chart below shows how these indices have performed over the past year.

Chart 1: Exporters have outperformed broad Japan indices in the one year to September 2017



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. Please note that you cannot invest directly in an index.

Abenomics and structural reforms are driving Japan's self-sustaining domestic demand-led up-cycle

For many years investors shied away from Japanese equities because of long-term structural weakness in the economy, deflationary pressures, weak GDP growth and a lacklustre approach to corporate governance. The election of Shinzo Abe at the end of 2012 created a new dynamic of monetary easing, fiscal stimulus and structural reforms. Abenomics has been at the heart of the investment thesis for Japanese equities and the recent election results seal Abe's hold on power in the medium term.

Structural reform remains one of the key pillars to change. Recent improvements are positive, including dramatic shifts in monetary policy, to negative rates, and a target of a zero percent yield for 10-year government bonds. The most recent April-June 2017 GDP report suggests that the Japanese economy has entered a sweet spot, with growth accelerating and broadening into all components of domestic demand. The report confirms our view that Japan has entered a self-sustaining domestic demand-led up-cycle.

Positive trends in employment, wages and capital expenditure

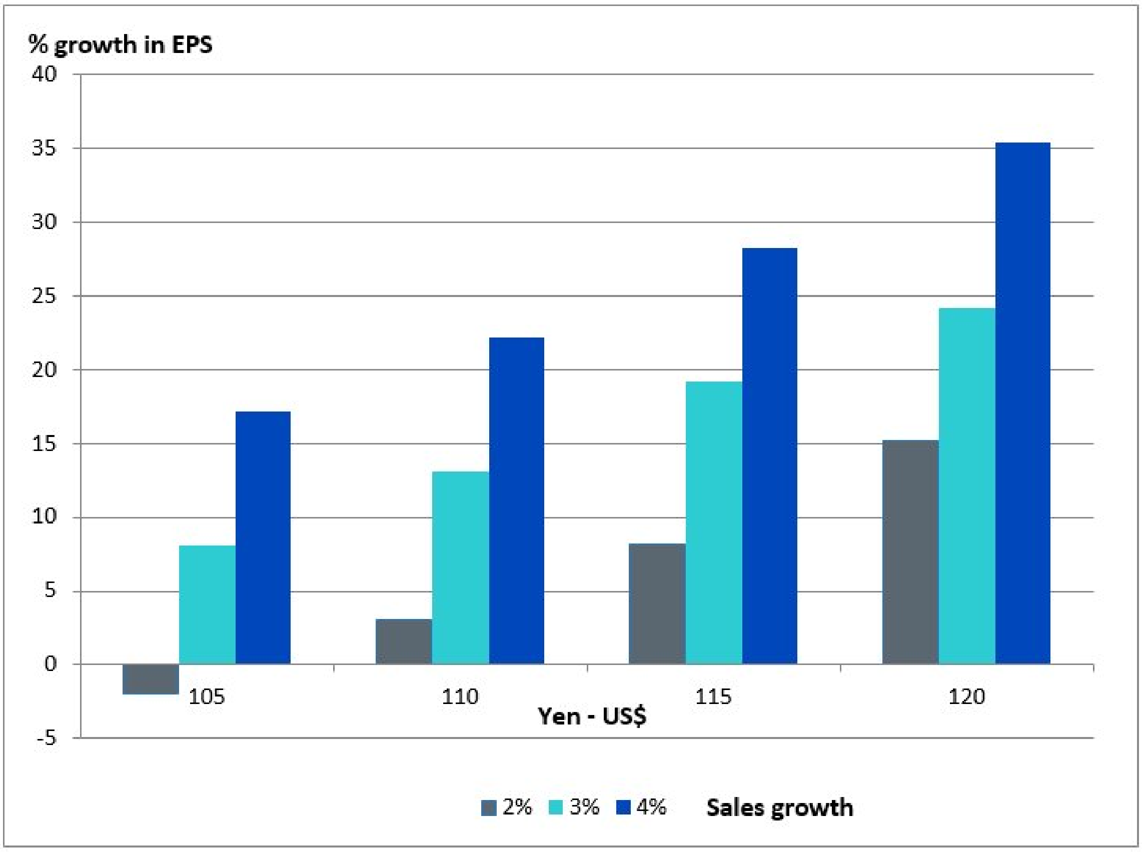
Japan's economy continues to respond positively to structural reform and change. For example, wage and income dynamics have experienced an upturn, with the absolute level of workers' compensation rising by 2.6% in April-June. This has pushed absolute compensation to levels not seen for over 17 years, back in 1998/1999. More importantly this up-trend is structural, not cyclical. At the same time, Japan's demographics, including a shortage of labour, are forcing a structural shift from part-time to full-time employment and placing steady upward pressure on wages and income. We expect this structural improvement in employment quality to create a strong foundation for rising household spending.

Private sector capital expenditure recently registered its eighth-consecutive growth quarter. Meanwhile, companies are benefiting from record-low interest rates and record-high cash balances which will strengthen their ability to raise investment. In our view, Japan's business investment cycle has further to run and the visibility of the capital expenditure cycle suggests it is poised to become a key leading indicator of the underlying strength of the economy. This leads us to believe that Japan's capital goods sector is poised for both domestic- and export-led growth.

Low valuations, strong earnings growth and a weaker Yen

We believe that positive earnings momentum predicated on a pickup in top-line sales growth and a weaker currency can deliver substantial earnings growth in the coming year (as shown in Chart 2 below). The broad equity market, as represented by TOPIX, is trading at the lower end of its valuation range in terms of both historic and prospective PE ratios. In the current fiscal year, to March 2018, we expect earnings growth of approximately 25%, based on sales growth of close to 4% and an exchange rate of around Y115.

Chart 2: How a weaker Yen may strengthen profit growth



Sources: WisdomTree, Bloomberg.

At the heart of the Japanese equity story is the performance of the Yen. In early Q4 2016, having languished at levels close to Y100 vs the US Dollar, the rapid appreciation of the dollar in a post-election environment saw the exchange rate weaken to over Y118. The strength of the dollar then unwound over the course of the year, with the Yen dipping below Y110. However, following Abe’s recent strength in the elections the Yen has fallen to around Y115 (see Chart 3 below).

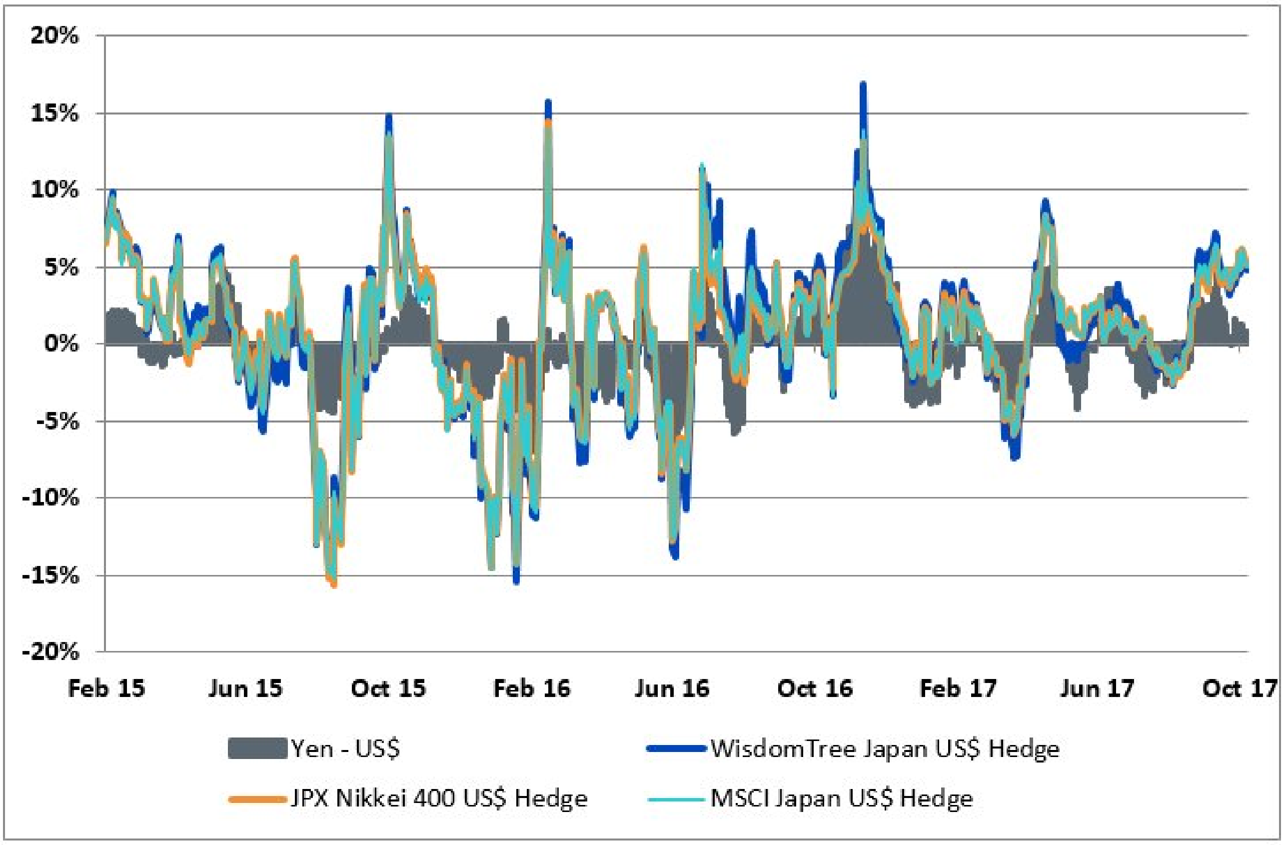
Chart 3: A weaker Yen as desired by the Bank of Japan

Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results.

The main impact of the weaker Yen, which is a core part of the Bank of Japan's policy aims, is to reinvigorate inflation through higher import prices. This should help to stimulate demand, and provide a boost to exporters and overseas sales and profits. Whilst domestic recovery is a long-term aim, we believe a weaker Yen will have a more meaningful and direct impact on export-oriented companies. This has been quick to reveal itself in the outperformance of the export-tilted WisdomTree Japan Equity Index compared to other Japanese equity benchmarks such as the MSCI Japan Index or the JPX Nikkei 400, which are all measured with a US Dollar hedge.

Over time it is also evident that the WisdomTree Japan Equity Index is typically more sensitive to movements in the exchange rate. The chart of rolling one month returns highlights how WisdomTree's focus on exporters generates outperformance as the Yen weakens (see Chart 4).

Chart 4: WisdomTree Japan US Dollar Hedge Index is more sensitive to US Dollar Yen moves



Sources: WisdomTree, Bloomberg. Past performance is not indicative of future results. Please note that you cannot invest directly in an index.

Export sectors as a source of alpha

Our unique export-oriented index focuses on dividend-paying stocks and requires companies to generate at least 20% of their revenue overseas. This provides investors with a differentiated sector and company composition. Our methodology tends to produce an index that has substantial deviations in sector weights compared to benchmarks such as the MSCI Japan. These sector over and underweights can deliver significant contributions to performance, as shown in the table below.

The current largest overweight sector within our index is Consumer Discretionary with a weight close to 24.4%. This is 4.0% overweight relative to the MSCI Japan Index, although this has had a negative impact on performance in the 12 months to November 2017. Industrials, where our index is overweight by almost 2.0% compared to the MSCI Japan, has delivered over half the outperformance of the past year. The main areas where our index is substantially underweight are the domestically-oriented Telecommunications Services, Energy, Utilities and Real Estate sectors. On a combined basis, our index is around 11.5% points underweight relative to the MSCI Japan, and this has delivered a 2.84% outperformance over the past year (see table below). The WisdomTree Japan Equity Index also outperformed the JPX Nikkei 400 Index, which has a focus on quality factors such as return on equity and operating profits, as well as corporate governance measures.

Sector weighting comparison and how export sectors drive outperformance

Sector weighting comparison (%)

Performance attribution: WisdomTree Japan vs…

WisdomTree Japan

JPX Nikkei 400

MSCI Japan

Nikkei 400

MSCI Japan

Consumer Discretionary

Industrials

Financials

Information Technology

Health Care

Consumer Staples

Telecommunication Services

Real Estate

Sources: WisdomTree, Bloomberg. Sector data as of 7 November 2017. Attribution data from 31 October 2016 to 7 November 2017. All indices are hedged for the US Dollar. Past performance is not indicative of future results. Please note that you cannot invest directly in an index.

Summary

We believe investors should consider the WisdomTree Japan Equity Index when allocating towards Japanese equities. With a focus on export-oriented stocks, the index is well placed to capitalise from the weakening Yen, the key to the performance of the Japanese economy. Historically, when the Yen weakens, our index has outperformed other Japan-related exposures such as the MSCI Japan Index and the JPX Nikkei 400 Index due to its greater sensitivity to a declining Yen. The WisdomTree Japan Equity UCITS ETF is available in a number of currency-hedged share classes reflecting the fact that whilst Japanese equities may be attractive, total returns can easily be eroded by a weakening currency.

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