

Will foreign investors ever buy Japanese equities again?

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There is a massive divergence today in markets:

- We believe Japan is an interesting market, with many positive things occurring at the policy level and very inexpensive and improving fundamentals.
- Market participants outside Japan often don't want to speak to us about Japan, feeling that the "hype" of Abenomics¹ has passed and the opportunity has passed.

With Japan so far out of the general favour amongst investors, is it a contrarian opportunity, or are we continuing to be fooled with the false allure of Japan's potential?

Progression of flows: Massive excitement to massive pessimism

Going back to late 2012, it is true that Japan has represented massive potential for reform and excitement that many viewed as almost certain to contribute to strong equity returns. Figure 1 indicates:

- Non-Japanese investors ploughed nearly \$155 billion into Japan's equity market in 2013, based largely on the initial excitement of Prime Minister Shinzo Abe's election and agenda, as well as the initiation of Japan's own massive Quantitative Easing (QE) policy under the leadership of Bank of Japan (BOJ) Governor Kuroda.
- Since 2013, the pattern of foreign investor flows has become progressively more volatile. 2018 was the worst year of Prime Minister Abe's tenure from an investor flows perspective, as foreign investors pulled more than \$50 billion out of Japan's equity market.

Figure 1: Calendar year flows indicate a progression from optimism to pessimism

Sources: Bloomberg, Japan Ministry of Finance. Data is for each specified year, starting 1st January and ending on the date of the last Friday in December. Data is reported weekly and based on the annual calendar, so holidays may have an impact and cause the reporting of less than 52 datapoints during a given year.

Historical performance is not an indication of future performance and any investments may go down in value.

Assumption: Japan's equity returns must have been horrible

While we'd like to think that each investor is studying Japan's market, poring over financial data and becoming as excited as we are when Japan implements what we view to be innovative tax and incentive policies—not to mention a central bank buying equities -- the reality is different.

Investor flows frequently follow performance

Japan has had substantial volatility during the Abenomics period since December of 2012, making it possible that investors could have caught a Japanese equity exposure at the wrong time. However, for comparative purposes, we're frequently resigned to using more standardized periods of time, such as calendar years. Figure 2 indicates:

- Last year -- when more than \$50 billion was taken out of Japan by foreign investors, --we see that Japan's equity returns were poor, ranking behind United States, the Eurozone, the United Kingdom and even emerging markets. Outflows during that particular year made sense based on our behavioural assumption that poor performance correlates positively to investor outflows.
- If we extend the horizon and look at the full period of Abenomics, calendar year by calendar year, based on the feeling we get when we try to schedule meetings about Japanese equities, we'd assume that Japanese stocks would be at the bottom of the pack. In 2016 and in 2018, Japanese equities were the worst performers of the regions we show. But importantly in 2013 and in 2015 they were the top performing, and in 2014 and 2017 they were in the middle of the pack. Even the US equity market—viewed frequently with unassailable performance supremacy in recent years--only led the other regions in two of these years.
- During the full period, only two markets achieved double-digit returns. The US equity market was at the top of the range—which likely surprises no one. Japan came in second —beating the Eurozone, the United Kingdom and Emerging markets. That's something that we'd predict surprises almost everyone.

Figure 2: Japanese equities have done reasonably well during the Abenomics period

Source: Bloomberg, with data for each specified calendar year beginning on December 31st of the prior year and ending on December 31st of the specified year. Average Annual Returns are measured from 31 December 2012 to 31 December 2018. Returns are measured in local currency, so as not to be impacted by currency performance either positively or negatively. United States refers to the S&P 500 Index. Japan refers to the MSCI Japan Index. Eurozone refers to the MSCI EMU Index. United Kingdom refers to the MSCI United Kingdom Index. Emerging Markets refers to the MSCI Emerging Markets Index. You cannot invest directly within an Index.

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The case for Japan as a contrarian investment

Is it possible that Japan has a volatile year in 2019, ending yet again in negative territory?

Of course. But the possibility would be true of any contrarian investment. In a way, the definition implies that the consensus view would be for further negative returns.

One of WisdomTree's core principles is that valuation matters. Unfortunately, the data doesn't suggest that valuation always matters equally across all markets—nothing in investing is that simple. On the other hand, trying to say “valuation doesn't matter” leaves one back in the US tech sector in 1999 and 2000 -- where suddenly it did matter in a big way.

In Figure 3, we see that the risk of Japan's largest and most global companies could be close to being “priced-in” in that, yes, we know trade tensions have been apparent and Japan has been challenging, but Japan's forward Price/Earnings (P/E) ratio is at about two-thirds that of the S&P 500. The risks of emerging markets, for example, are widely known, and these businesses are trading at even lower valuations.

Figure 3: Japan's global companies are trading at very low valuations

Source: Bloomberg, with data as of January 31, 2018. You cannot invest directly in an index.

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Sometimes the strongest returns are those that surprise the consensus

There is no question that Japan and Japanese equities is a hard allocation to position today and most investors would rather not discuss it. This tells us that there is an opportunity that it might surprise people in 2019. And surprises to the consensus have historically been some of the best return opportunities.

¹ Abenomics refers to the multi-pronged economic program of Japanese prime minister Shinzō Abe.

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