

# Japan: Opening Up the Playbook

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## WisdomTree

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Investors who withstood last spring's volatility have a good problem to solve for.

S&P 500 returns since its 23 March 2020 low have been remarkable well over 80%<sup>1</sup>. But with this head-spinning rebound has come unattractive valuations. Multiples have expanded from 13 times forward 12-month earnings last March to nearly 23 times forward 12-month earnings today<sup>2</sup>.

With valuations on the S&P 500 the highest it has been since the early 2000s, investors may want to consider "opening up the playbook" potentially reducing US equity exposure, a large chunk of most global benchmarks, and possibly seeking more areas considered to be attractively valued, such as Japan.

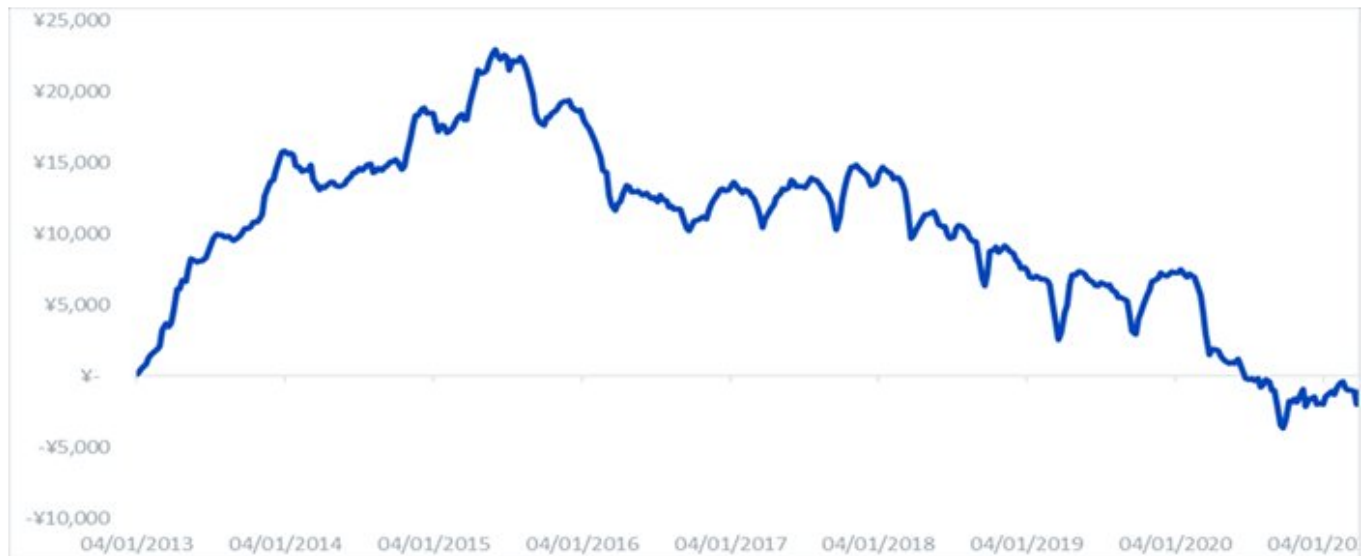
## Can Headwinds Bring Opportunity?

Arguably no market has been more unloved in recent years than Japan. There are a few theories as to why:

- **Sector Composition:** A lack of domestic tech mega-caps in favour of cyclical sectors like Autos and Banks has been a headwind for Japanese indexes during a global rally in growth stocks
- **Policy mistakes:** A government that has made a handful of policy missteps particularly with consumption tax hikes in 2014 and 2019
- **Ageing population:** Demography is destiny, or so it's said. There has been fear that an ageing population in Japan will put a lid on the country's long-term growth potential, coupled with a chronically low equity investment from a notoriously conservative domestic investor base

Figure 1 shows how non-Japanese investors have been decreasing their investment in Japanese equities in recent years to the point where they are now below where their allocations were when the 'Abenomics'<sup>3</sup> period began.

## Figure 1: Cumulative Foreign Net Equity Investment (¥ Bn)



Source: Japan Ministry of Finance. 4 January 2013-4 February 2021.

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

In part as a by-product of low investor interest, Japanese equities can be considered discounted relative to the US equity market, which is again a rather large part of most global benchmarks. Japanese equities typically also have a much lower valuation relative to their history than most other major markets:

- Figure 2 shows that the MSCI Japan Index had a Price-to-Earnings Ratio – P/E in the 61st Percentile in other words, less expensive than 39% of monthly observations going back to the end of the year 2000.
- The S&P 500 Index, by contrast, had a P/E ratio in the 92nd Percentile in other words, less expensive than only 8% of monthly observations in the same period.

**Figure 2: Current Valuations vs. History (31 December 2000-31 March 2021)**



Source: WisdomTree, MSCI, S&P, FactSet. Price-to-Earnings as of 31 March 2021. Rank vs. history using monthly observations between 31 December 2000 and 31 March 2021.

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Japan’s position as a market may be perfectly primed for an environment in which economic growth is expected to make a significant recovery in the coming years.

For example, WisdomTree’s Japan Hedged Equity Index which tilts more towards cyclical sectors than the broad MSCI Japan Index has outperformed the S&P 500 by over 800 basis points since the end of August 2020 when measured on a basis of hedging the yen vs. US dollar exchange rate:

There was a response in the WisdomTree Japan Hedged Equity Index during the period of the cyclical rotation trade, defined in Figure 3 as 31 August 2020 to 8 April 2021.

**Figure 3: Japan for Cyclical Rotation**

S&P 500 Sector Returns and Japan	
Year-to-date (31 Dec 20–8 Apr 21)	Cyclical Rotation Trade (31 Aug 20–8 Apr 21)
29.54% - Energy	41.49% - Energy
18.79% - Financials	41.28% - Financials
13.83% - Comm. Svc.	29.39% - Industrials
12.72% - Industrials	27.51% - Materials
11.98% - Japan	26.70% - Japan
11.22% - Real Estate	21.18% - Comm. Svc.
9.92% - Materials	18.18% - S&P 500
9.54% - S&P 500	14.33% - Real Estate
7.93% - Info. Tech	14.20% - Info. Tech
7.29% - Cons. Disc	12.28% - Utilities
4.21% - Utilities	11.73% - Cons. Disc
3.14% - Health Care	9.02% - Health Care
2.44% - Cons. Staples	7.34% - Cons. Staples

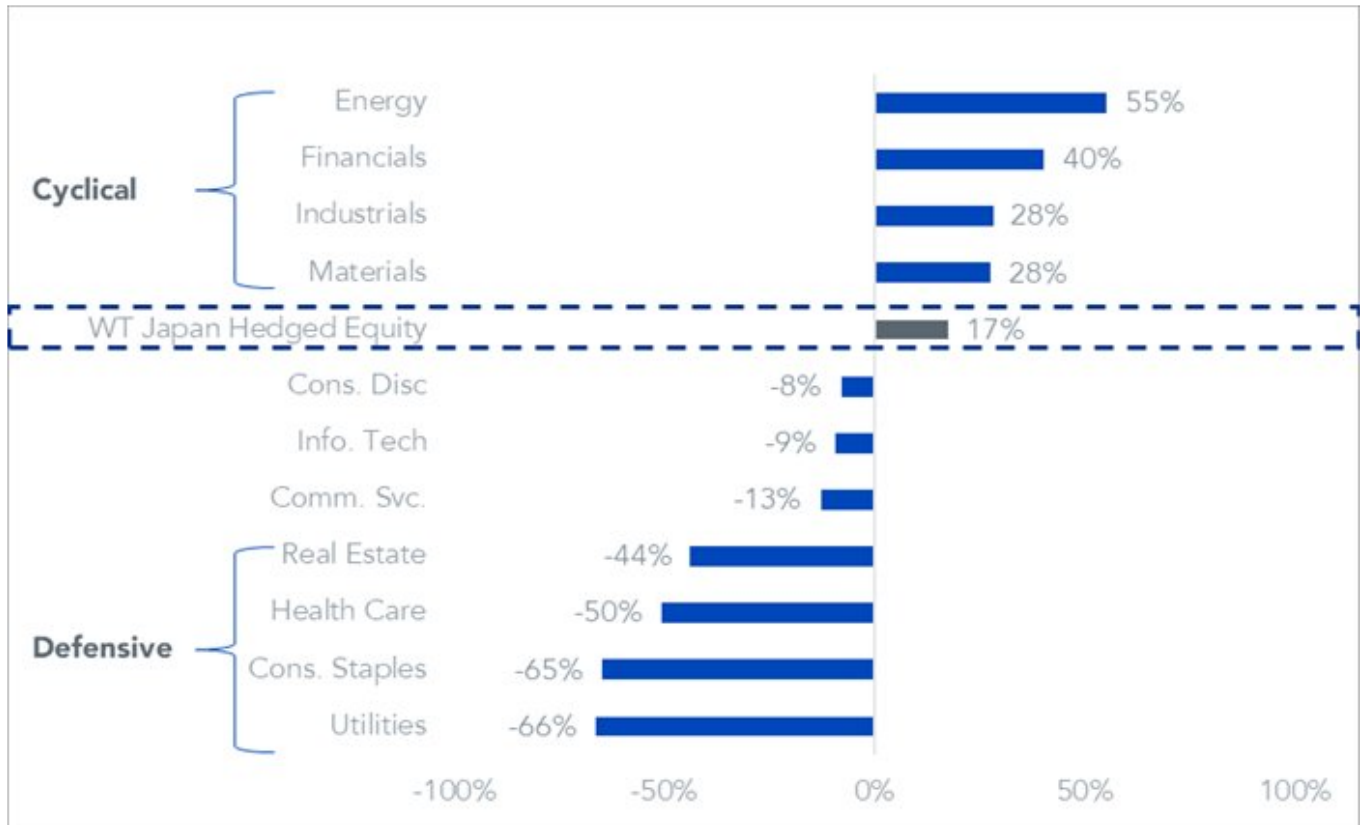
Source: WisdomTree, S&P, FactSet. Japan measured by the WisdomTree Japan Hedged Equity Index Net Total Returns. You cannot invest directly in an index.

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The S&P 500 is up over 9% to start the year despite concerns over rising interest rates<sup>4</sup>. Nonetheless, the potential for higher rates becoming a headwind to both fixed income and equity returns remains a top concern among asset allocators.

Given the cyclical tilts of the Japanese equity market, as well as the tendency for the yen to weaken alongside a rise in US rates, the WisdomTree Japan Hedged Equity Index has historically had a positive correlation between its outperformance and rising US treasury yields.

#### Figure 4: Trailing 3yr Correlation: Excess Returns vs. 10-Year US Treasury Yield



Source: WisdomTree, S&P, FRED. Correlation measures monthly excess returns relative to the S&P 500 between 31 March 2018-31 March 2021. Sector returns from S&P 500 sectors. Japan measured by WisdomTree Japan Hedged Equity index. You cannot invest directly in an index.

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**Conclusion:**

The steady and reliable earnings growth from US mega-caps powered both the US, and by extension global indices higher over the past few years. With US valuations now near two-decade highs and the potential for a synchronized global recovery on the horizon

- 1 Bloomberg
- 2 Bloomberg
- 3 Economic policies implemented by the Government of Japan
- 4 Bloomberg

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