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JAPANESE DIVIDENDS LOOK MORE SECURE THAN U.S. DIVIDENDS

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Bond yields[1] are so low that the stock market has gotten spoiled.

You don't have to go all the way back to the double-digit yield peaks of 1981–1982 to find U.S. Treasury rates considerably higher than the current 1.99% dividend yield of the S&P 500[2]. Just consult recent memory—of 2006—when the 2-Year Treasury Note changed hands at a yield of 5.28%. In our zero-interest rate world, we easily forget.

Now the 2-Year Treasury yields 0.19%. Largely because of such bond yields, corporate America can "get away with" broad market equities offering barely 2% to beleaguered dividend investors.

The result?

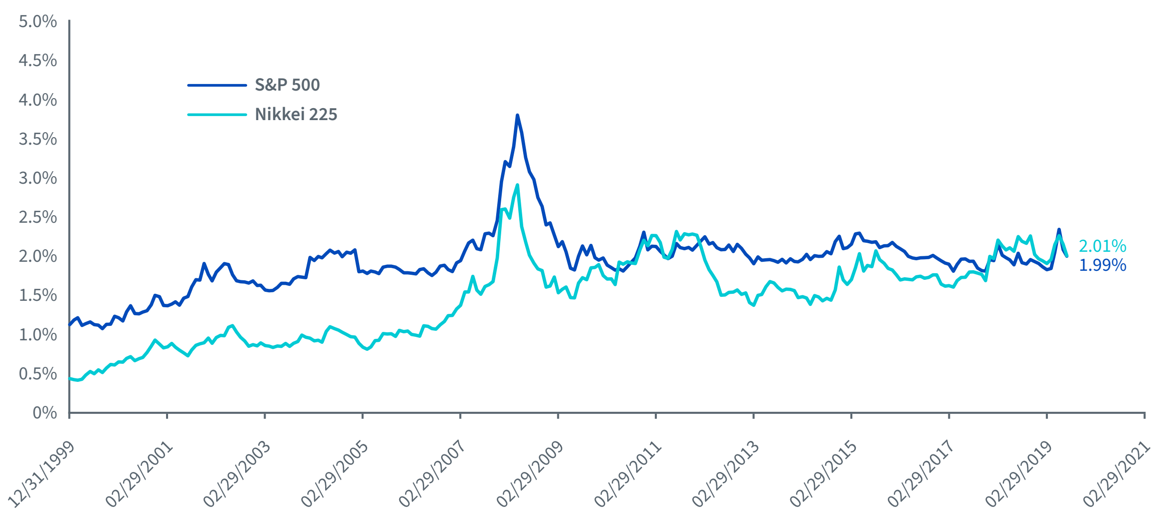
A convergence between U.S. dividend yields and those of countries like Japan, which began flirting with zero and negative policy rates a generation ago. We view Japanese dividends in aggregate as more secure too, owing to the country's build-up of large corporate cash balances—in sharp contrast to the state of S&P 500 balance sheets.

Though we don't frequently write about Japan's Nikkei 225 Index[3] (whose price-weighting methodology is anathema to WisdomTree), it has a dividend futures market that is so intriguing that it is worthy of analysis.

1 Bond yield: Refers to the interest received from a bond and is usually expressed as an annual percentage based on its current market value.
2 S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee and designed to represent the performance of the leading industries in the U.S. economy.
3 Nikkei 225 Index: A price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average (DJIA) Index in the U.S.

Figure 1 shows our starting point—a yield of 2.01%, slightly higher than the 1.99% accorded U.S. equities. Note that many Japan indexes yield more; the market capitalization-weighted MSCI Japan[4] and the TOPIX[5] both yield 2.5%.

Figure 1: Dividend Yield (%)



Source: Bloomberg, 12/31/1999–6/3/2020. Past performance is not indicative of future results. You cannot invest directly in an index.

The question is not whether stock market dividends will be cut because of Covid-19, but rather by how much. The dividend futures are in Figure 2.

The cash-poor S&P 500 may have a tougher go of this virus-induced slog. If the Street is right, index-level dividends could fall by 22% from their peak, with 2021's dividend yield equaling just 1.48% at current index levels.

In contrast, Nikkei dividends are priced by the futures market to fall much less, a decline of 11.9% at the worst of it. That would put Japan's yield at 1.76%.

If the WisdomTree Japan Dividend Index[6] also witnesses an 11.9% dividend cut, its 3.18% yield would be 2.80%, about double the Street's S&P 500 yield for 2021.

[4] MSCI Japan Index: A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

[5] The Tokyo Price Index (TOPIX): A capitalization-weighted index that lists all firms in the "first section" of the Tokyo Stock Exchange, a section that organizes all large firms on the exchange into one group.

[6] The WisdomTree Japan Dividend Index is a fundamentally weighted Index that measures the performance of dividend-paying companies incorporated in Japan, listed on the Tokyo Stock Exchange and meeting other requirements necessary to be included in the WisdomTree International Equity Index.

Figure 2: Dividend Futures Expectations

	S&P 500			Nikkei 225		
Index Level	3,107.04			22,613.76		
	Dividends Per Share	**Cumulative Decline from 2019**	**Yield**	**Dividends Per Share**	**Cumulative Decline from 2019**	**Yield**
Actual 2019	$58.69		1.89%	$451.56		2.00%
2020 est.	$53.50	-8.8%	1.72%	$409.00	-9.4%	1.81%
2021 est.	$45.85	-21.9%	1.48%	$398.00	-11.9%	1.76%
2022 est.	$47.05	-19.8%	1.51%	$418.00	-7.4%	1.85%
2023 est.	$47.75	-18.6%	1.54%	$421.50	-6.7%	1.86%
2024 est.	$48.10	-18.0%	1.55%	$428.20	-5.2%	1.89%

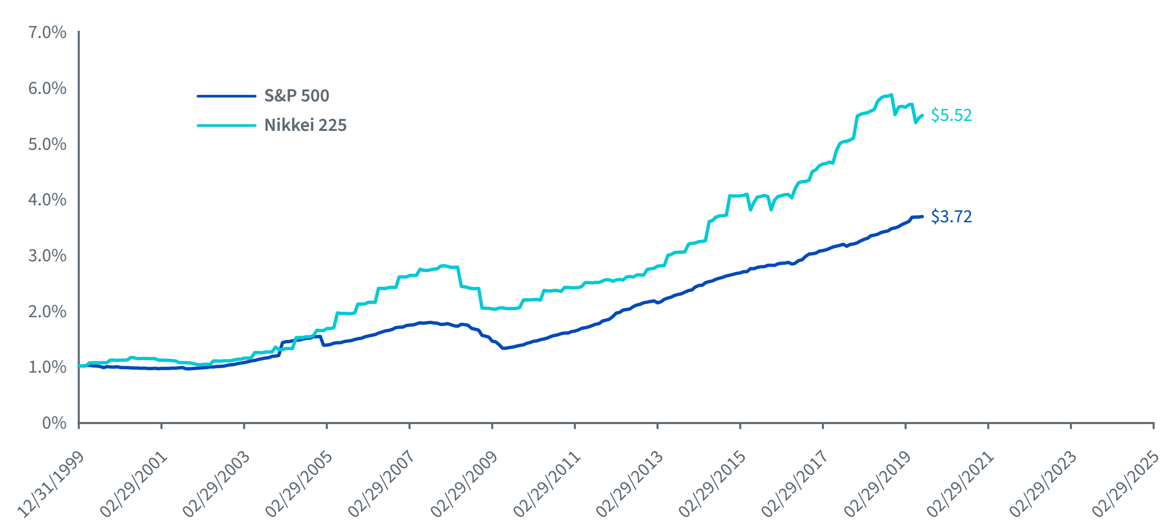
Source: Bloomberg, using futures market pricing for December contracts, as of 6/3/20. Forecasts are inherently limited. You cannot invest directly in an index.

Low U.S. yields are sometimes justified by a coterie of investors asserting that American dynamism can allow the S&P to grow earnings at a faster clip than companies domiciled elsewhere.

Figure 3 may disabuse you of that notion.

The Nikkei 225 has grown earnings at a compound 8.7% this century, exceeding the 6.7% growth rate of the S&P 500.

Figure 3: Index-Level Earnings Growth (12/31/1999 = $1)

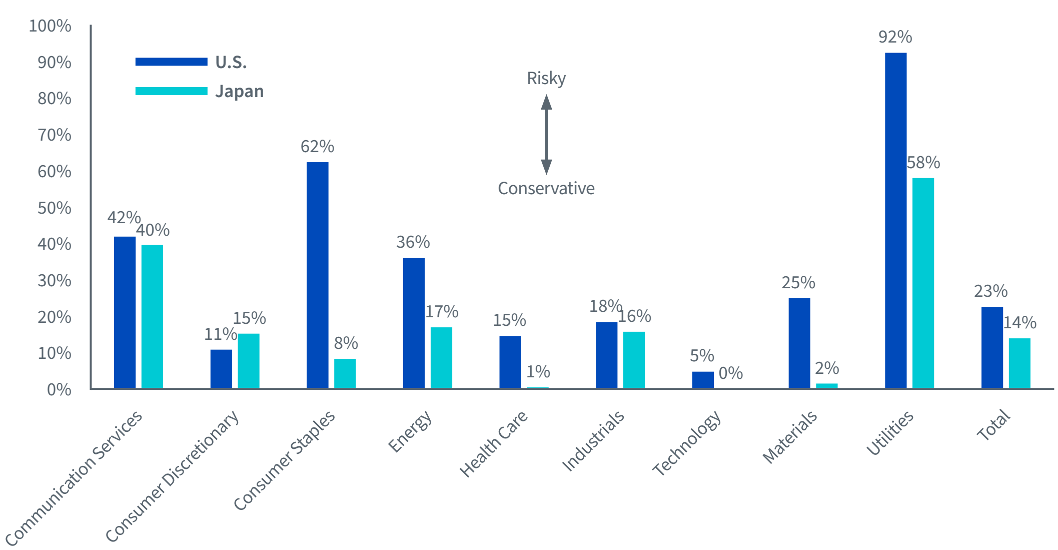


Source: Bloomberg, 12/31/1999–5/31/2020. You cannot invest directly in an index. Past performance is not indicative of future results.

Also, and critically in our Covid-19 world, Japan's dividends may be safer than U.S. dividends because the former country's balance sheets are more fortified. Though both countries spent the post-global financial crisis years building asset bases relative to debt, Japan took the fortification more seriously.

During difficult economic times, the last thing a company needs is current liabilities—those due within the next year—to be high. If they are higher than current assets, such as cash and accounts receivable, then deteriorating business conditions can pose a problem. Figure 4 shows the stark contrast between the U.S. and Japan on this liquidity metric.

Figure 4: Proportion of Sector Market Capitalization, Current Liabilities in Excess of Current Assets



Source: Bloomberg, as of 5/31/20, using MSCI Japan and MSCI USA, excluding Financials and Real Estate. Past performance is not indicative of future results. You cannot invest directly in an index.

Figure 5 shows another stark disparity between the two stock markets, and warrants some conceptual discussion before we take a look at it.

Consider that while intangible book value captures things like goodwill and the value of brands and trademarks, tangible book measures the value of cash, factories, inventory—things you can "hold in your hand." Both are real. The Coca-Cola brand is worth billions, as is the concept of Mickey Mouse. They exist in our brains.

The U.S. stock market is heavily weighted toward companies characterized by intellectual property. Think Google and Netflix. Japan is different; it is more of a tangible asset environment. Auto plants, for example. Cash. Buildings.

One of the problems with intangible assets like brands is that they can become worthless. For example, MySpace once had a lot of intangible value…before Facebook rendered it obsolete. We also guess that the recently bankrupt J Crew, which will enter Chapter 7 liquidation, has a once-valuable brand that is now essentially worthless.

Not that intangible assets are bad. Unlike Toyota, Facebook doesn't need a factory. And the value to McDonald's of Ronald McDonald is very real. Then again, Facebook could "get MySpaced" or McDonald's could fall into some corporate disrepute. Who would pay handsomely for the rights to Ronald, a cartoon that, in some unknown scandal-laced disgraced future, would be worth pennies on the dollar?

Now let's look at the data.

The contrast between intangible asset-heavy U.S. equities and tangible-asset Japanese equities is stark. Both countries have $2.2 trillion in very real, tangible assets. But while you would have to pay $3.4tn to own Japan, the U.S. stock market is valued at $26.1tn. A large chunk of that is the intangibles of Silicon Valley.

Figure 5: Price-to-Tangible Book Value, Japan vs. U.S.

Stock Market	Market Capitalization	Tangible Book Value	Market Cap as % Tangible Book Value
Japan	$3.4tn	$2.2tn	154%
United States	$26.1tn	$2.2tn	1,171%

Sources: WisdomTree, Bloomberg, as of 6/3/20, using MSCI Japan and S&P 500. You cannot invest directly in an index. Past performance is not indicative of future results.

In contrast, Japan's tangible book value is heavily in cash, which is critical to appreciate in assessing Japan's profitability problem.

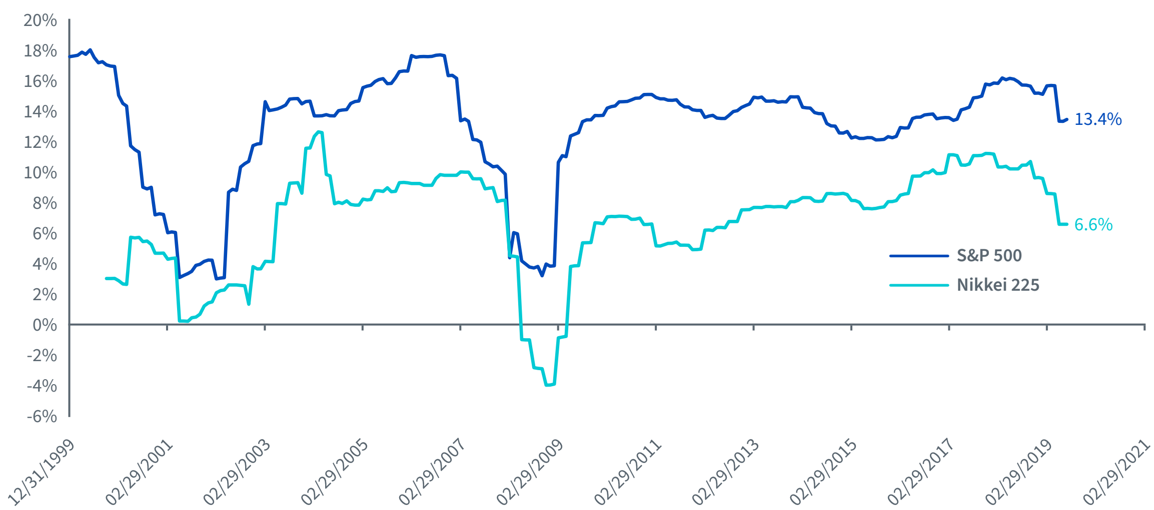
Figure 8 is a frustrating chart for Japan bulls. The cash hoard earns zero, which pulls the country's aggregate return on equity (ROE)[7] down. Comparing the Nikkei 225 to the S&P 500 is like comparing two people, one with an equity portfolio and one with stocks but also a mountain of cashing sitting in a checking account. The return to the all-equity investor is higher in a bull market, though the equity-and-cash investor has a lower chance of foreclosure if they fall on hard times.

In terms of operating profitability, there is not much difference between the S&P 500 and the Nikkei, once we strip out their different proclivities for debt.

[7] Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

The S&P's leverage allows its return on assets (ROA)[8] of 2.8% to manifest in a return on equity (ROE) of 13.4% (Figure 6). At 2.5%, the Nikkei's ROA is right there with the S&P's. But corporate Japan only has a 6.6% ROE because it doesn't play the leverage game.

Figure 6: Return on Equity (ROE)



Source: Bloomberg, 12/31/1999–5/31/2020. You cannot invest directly in an index. Past performance is not indicative of future results.

That may soon change.

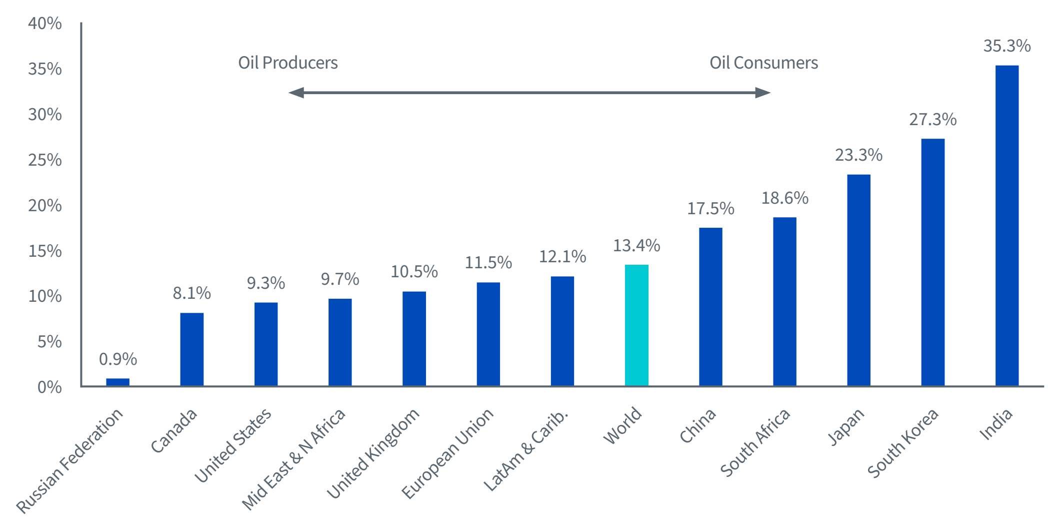
An anti-trust movement is growing in the U.S., particularly with regard to the tech and social media giants, while the exact opposite may be in tow in Japan. There, pressure is on for bigger dividends, consolidation and overseas asset purchases. If such a movement takes hold, the result could be a convergence between the two countries' ROEs.

Meantime, Japan has two other things going for it, both the opposite side of the coin from the U.S. The first is the beneficial effect of oil's collapse on its economy. While the U.S. spent the last generation becoming a Canada-style petrostate, Japan has little in the way of natural resources. It threw in the towel on nuclear power after the Fukushima disaster, and there is only so much wind and solar to go around in 2020.

Can you name a Japanese oil company? Neither can anyone else. Japan is the opposite of Saudi Arabia when it comes to oil (Figure 7).

[8] Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets used to generate them.

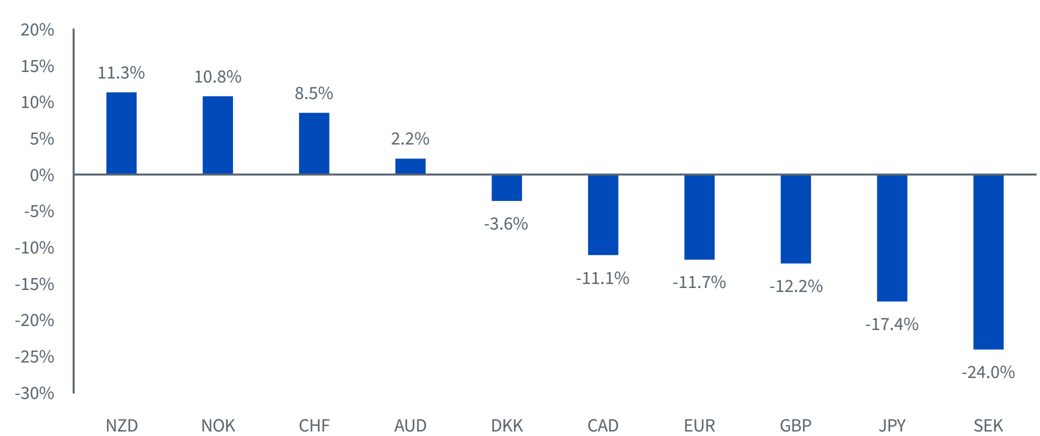
Figure 7: Fuel Imports (as % Merchandise Imports)



Source: World Bank, 2018.

Additionally, at ¥109 to the dollar, the yen is one of the more competitive currencies in the developed world (Figure 8). For an export-focused economy, being 17.4% cheap to the U.S. dollar is a considerable advantage.

Figure 8: Purchasing Power Parity[9] (PPP) Over/Undervaluation vs. U.S. Dollar



Source: Bloomberg, WisdomTree, as of 6/3/20, using an average of CPI-based and PPI-based PPP (Jan. 1982–June 2000 average values) and OECD Purchasing Power Parity. Past performance is not indicative of future results.

[9] Purchasing power parity: An economic theory that compares different countries' currencies through a "basket of goods" approach.

THE NUMBER TWO THAT OFTEN GETS A ZERO

The largest component country of the MSCI All Country World Index[10] (ACWI) is the U.S., at 58% as of May 31, 2020. U.S. stocks have outperformed the rest of the world for so long that Japan is way down the list at 7% of global equities, even though its stock market is the second largest on the planet.

Time and again we speak with investors who have zero or minimal exposure to Japan. For example, a portfolio that holds 80% in an S&P 500 tracker ETF, 10% in one for the MSCI EAFE Index and the remaining 10% in an MSCI Emerging Markets tracker will end up with just 2.6% of its capital in Japan.

Again, that is 2.6% in the world's second-largest stock market.

The catalysts for Japanese equity performance are numerous:

+ Japanese dividends are equal to or higher than U.S. dividends, depending on the index
+ Due to more fortified balance sheets, Japan's dividends may be more secure
+ The Street is pricing in considerably lower Covid-19-related dividend cuts in Japan than in the U.S.
+ Japan trades at a considerable discount to the U.S. on price-to-tangible book value
+ Shareholder activism and pressure to boost return on equity could be on the docket, in sharp contrast to the anti-trust push that is becoming popular in the U.S.
+ Collapsed oil prices are a boon to oil-dependent importers, and Japan is among the most reliant on external supplies
+ At ¥109, the yen is competitive against the U.S. dollar, having weakened from as much as ¥75 to the dollar a decade ago

We have Japan ETFs in both currency-hedged and unhedged forms.

The big one is the WisdomTree Japan Hedged Equity Fund **(DXJ)**, which takes the yen out. It focuses on export-oriented firms, with holdings weighted by each company's quantity of dividends as a proportion of the total pie.

The unhedged one is the WisdomTree Japan Small Cap Dividend Fund **(DFJ)**. It has historically been characterized by low volatility due to the inverse relationship between the stock market and the yen (when stocks have gone down, the yen often has gone up, buffering losses).

The dividend yields on their underlying indexes are 3.2% (DXJ) and 2.8% (DFJ).

[10] MSCI All Country World Index: A broad global equity benchmark that represents large and mid-cap equity performance across 23 developed and emerging markets countries.

Unless otherwise stated, all data through 6/3/20.

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