JAPAN FOR 2022?

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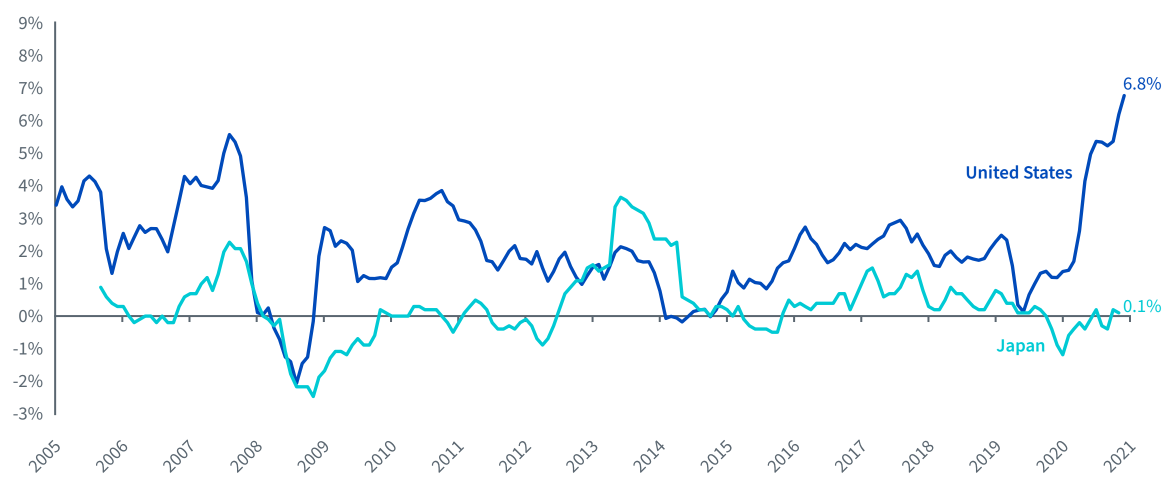
The markets may be handing a gift to Japan's export machine in 2022, courtesy of a suddenly more hawkish Federal Reserve.

The textbooks say that if one country catches an inflation shock while another does not, the currency of the former should weaken.

Yet with U.S. Consumer Price Index (CPI) rising 6.8% year-over-year (YoY)—notably more than the 0.1% rise in Japan's inflation rate (figure 1)—the market has chosen to respond with dollar strength relative to the Japanese yen.

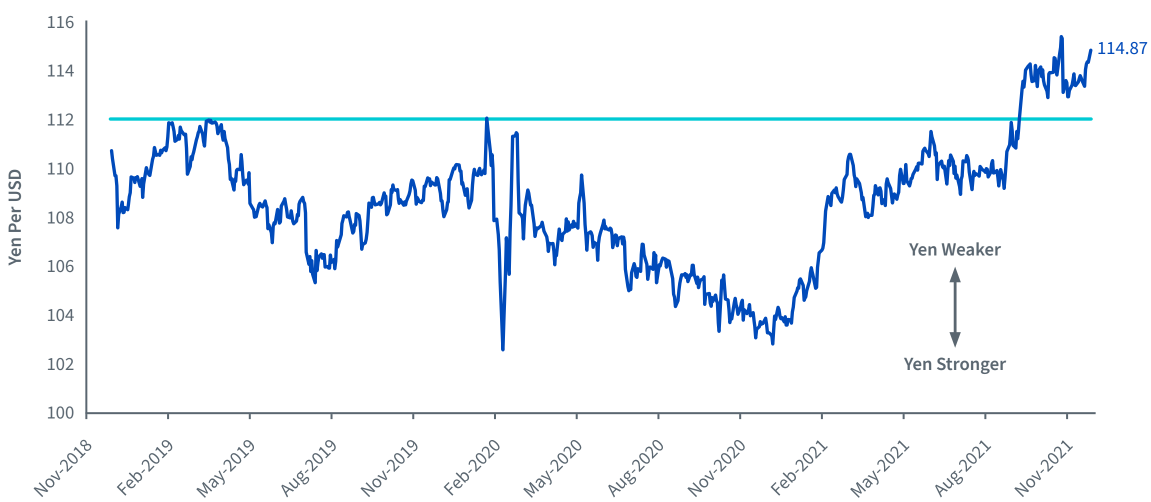
Figure 1: Consumer Price Inflation (YoY %)



Sources: Refinitiv, U.S. Bureau of Labor Statistics and the Statistics Bureau of the Japan Ministry of Internal Affairs & Communication, as of October 2021 for Japan and November 2021 for the United States.

There are several explanations for the greenback's advance relative to the yen (figure 2).

Figure 2: Japanese Yen Per Dollar



Source: Refinitiv, as of 12/28/21.

For one, if you asked almost anyone a year ago which country—the U.S. or Japan—was more likely to have a big inflation surprise, I suspect most of us would have picked the former. No surprises there.

But it's not like the December 10 release of the November U.S. Consumer Price Index data was some new revelation that inflation is percolating; rising prices have been on many minds for months. The most recent report was the seventh in a row to witness year-over-year inflation above 5%.

While many observers point to twin stimulus packages as fuel for U.S. inflation, there is not much concern in Japanese policy circles that consumer price inflation will run away in response to Tokyo's new ¥40 trillion ($350 billion) transfer payment package. That initative is one of the first orders of business of new prime minister Fumio Kishida, who wants to put cash directly into the hands of families with children. Tax breaks for businesses that raise wages are also in tow.

Though there is skepticism that such measures will trigger Japan's spending impulse, the fact that the economy witnessed a bigger-than-expected drop in Q3 GDP helps Japanese Keynesians make the case for this package and perhaps more in 2022.

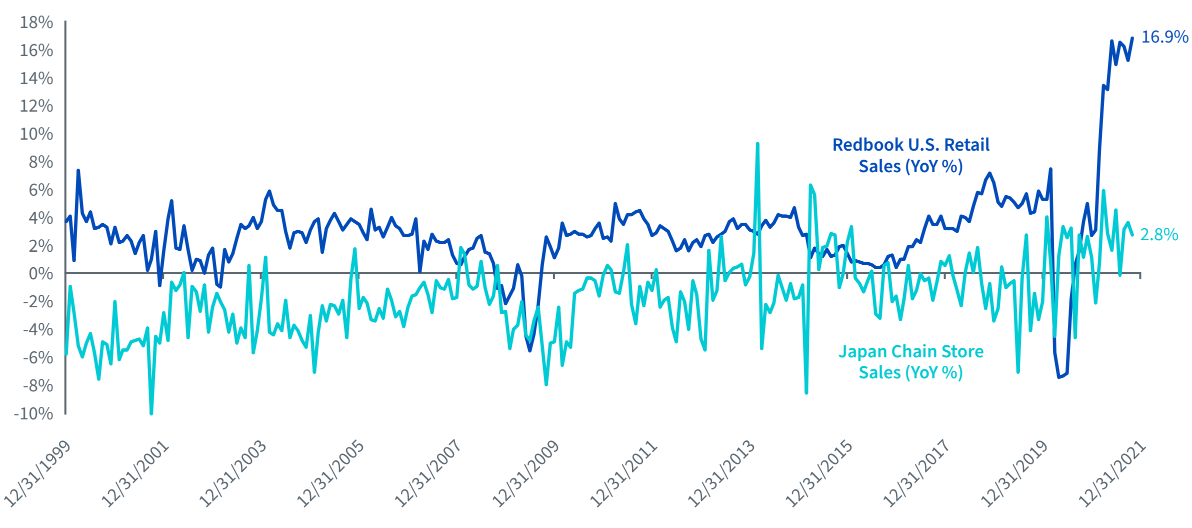
The dollar is rallying against the yen because the market is getting in front of a scenario that has the Fed tightening monetary policy more aggressively than previously expected—with hardly anyone anticipating anything other than subzero policy rates out of the Bank of Japan in 2022.

Take note of the stark contrast between consumers' appetite for shopping in the U.S. versus Japan.

The Johnson Redbook gauge of U.S. chain store retail sales jumped 16.9% from this time last November (figure 3), corroborating our view that this will be the biggest U.S. holiday shopping season on record. That sets up a nonzero probability that the Fed will spend 2022 sweating an overheating economy, or at least one where inflation is smoldering to such an extent that investors are fielding rate hikes with some frequency.

Now think about the contrast: the calculus of Haruhiko Kuroda, head of the Bank of Japan (BoJ). Inflation is nowhere near hot on the streets of Tokyo; the consumer is relatively lethargic, as evidenced by Japan's chain store sales. A 2022 rate hike by the BoJ is highly unlikely.

Figure 3: Year-over-Year Change, Chain Store Sales (%)



Sources: Refinitiv, Japan Chain Stores Association as of 11/30/21, Johnson Redbook as of 11/30/21.

Notable for Japan's international exporters: the yen isn't waiting for U.S. monetary authorities to surprise the market with something more than just one or two rate hikes next year. It is weakening right now, busting up through the ¥112 area a couple months ago.

"YEN OFF AND JAPAN ON" HAS BEEN THE REOPENING PLAY

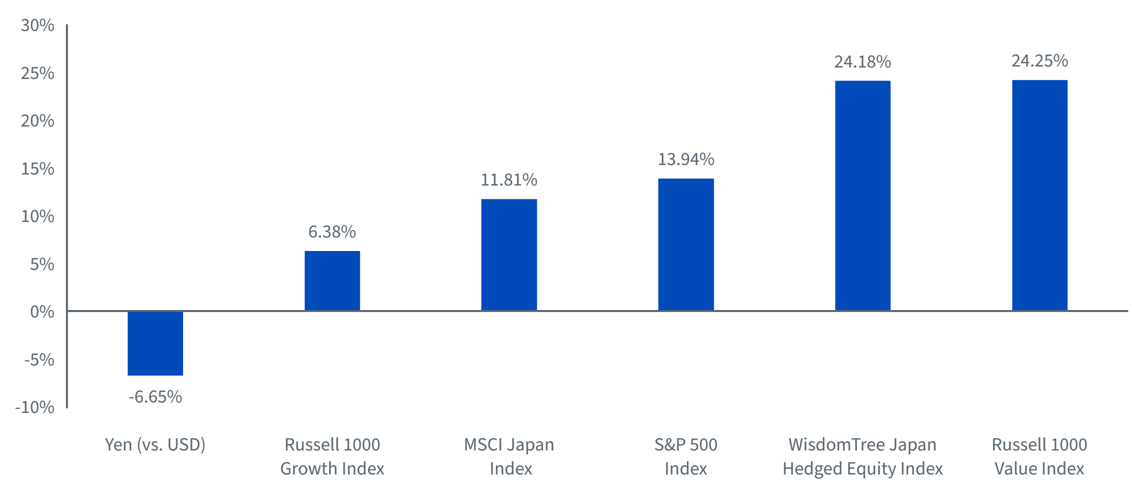
If the market spends 2022 brewing over stagflation, the cyclically focused Japanese stock market may struggle.

Then again, if a "post-COVID-19" sentiment sets in—one where people are out and about—it may pay to go back to late 2020 and early 2021 to find a playbook for what has worked in past situations when spirits brightened on the path of the pandemic.

The last time the market had a sense that COVID-19 was soon ending was after the original Pfizer vaccine announcement on November 9, 2020. In the weeks and months after that news hit the wires, investors piled into trades that capitalized on the concept of "the Great Reopening."

Because Japan's stock market skews more heavily to value, it had a better go of it than domestic growth stocks (figure 4). Additionally, the real boost to returns came to investors who hedged the yen, a currency that fell out of bed as investors exited "risk-off" positions.

Figure 4: Total Returns Post-Pfizer Vaccine News



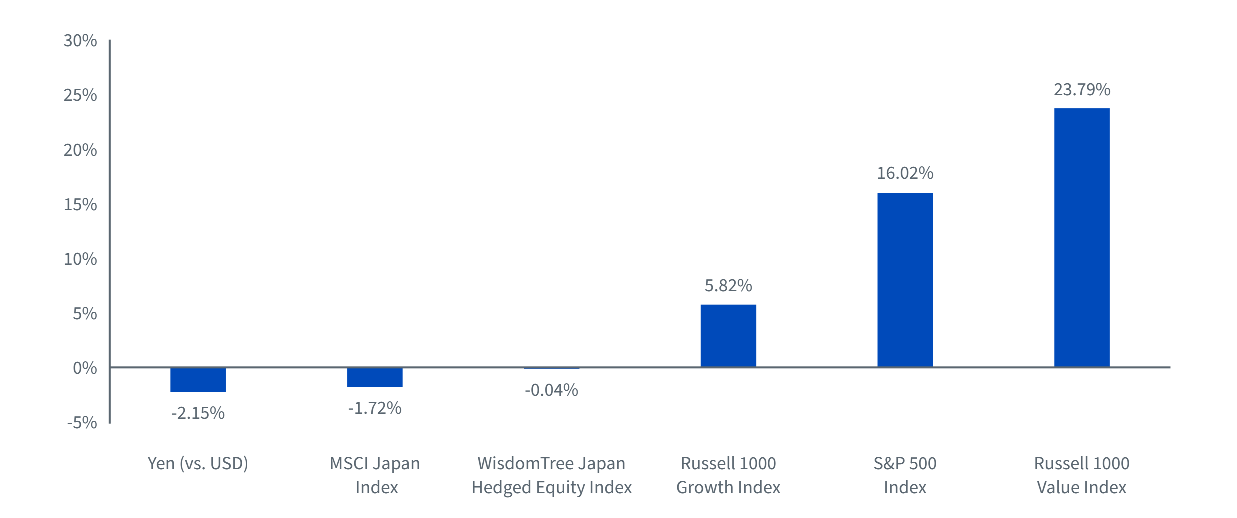
Sources: WisdomTree, MSCI, S&P, Russell, FactSet. You cannot invest directly in an index. Past performance is not indicative of future returns. Index returns based on total returns from 11/6/20-3/31/21.

Despite multiple vaccines being available for more than a year, a coordinated global economic rebound has been stymied on many fronts, from new variants cropping up to the ongoing supply chain quagmire.

The U.S. has not been immune to these headwinds, but it has been better positioned on many fronts.

Countries like Japan—an export-dependent economy with an initially slow vaccination rollout—have been more challenged, forcing the country to play catch-up. Amid Japan's COVID-19 struggle and a more sober assessment of COVID-19, most of 2021 witnessed Japanese equities lagging (figure 5).

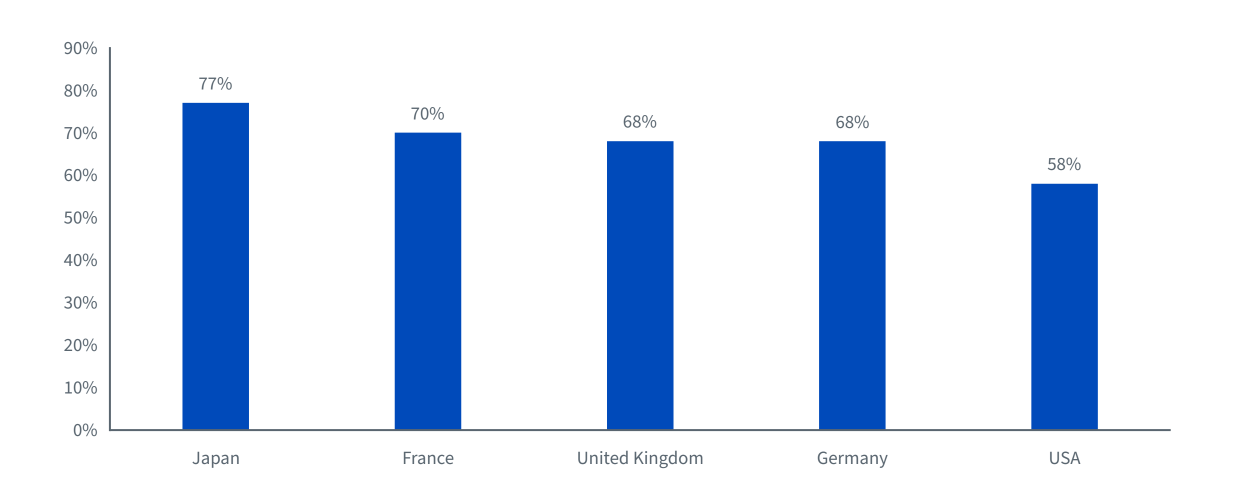
Figure 5: The Rotation to Growth Hindered Japan



Sources: WisdomTree, MSCI, S&P, Russell, FactSet. You cannot invest directly in an index. Past performance is not indicative of future returns. Index returns based on total returns from 3/31/21-11/30/21.

Nevertheless, Japan did ultimately get its act together in its COVID-19 handling; inoculation rates now exceed the U.S. and Europe's three largest powers.

Figure 6: Percentage of Population Vaccinated



Source: WHO, as of 11/30/21.

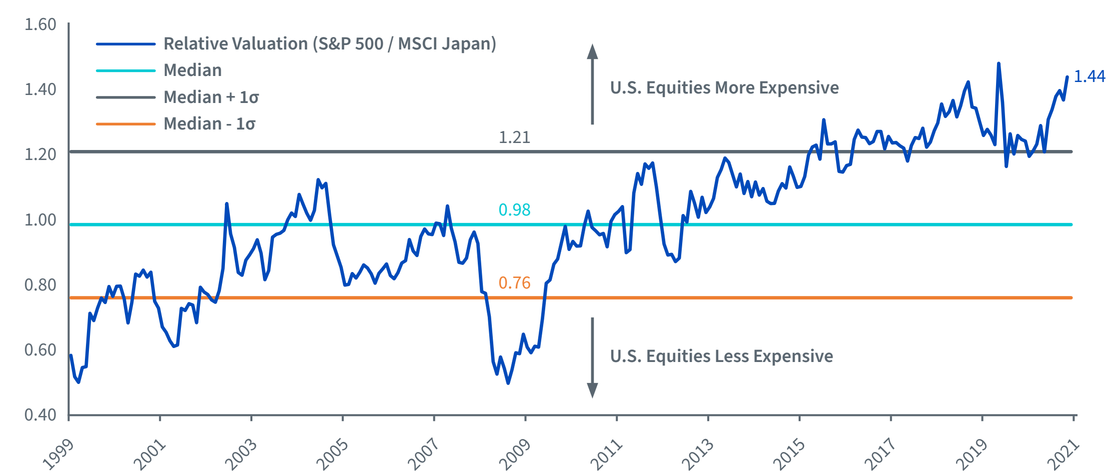
JAPAN: A VALUE MARKET IN AN ELEVATED VALUATION WORLD

After entering 2015 with a weight of 50% in the MSCI All Country World Index (ACWI), the U.S. has outperformed so handily that its composition has increased up to 60% of the global basket. Meanwhile, Japan's weight has shrunk from about 8% to 6%.

The largest country in the global basket has 10 times the weight of the second-largest.

With many U.S.-based asset allocators putting a "home country bias" on top, it is common to come across portfolios that are even more lopsided than ACWI. If valuations start to matter again, the severe valuation premium accorded the U.S. could pose a total portfolio problem.

Figure 7: Relative Valuations



Sources: WisdomTree, MSCI, S&P, 12/31/1999–11/30/2021. Relative valuations based on forward price-to-earnings ratios. You cannot invest directly in an index.

PUTTING ON A YEN HEDGE

Anticipation of the Fed's policy normalization process has led the 2-Year Treasury note, which is sensitive to the Fed Funds Rate, to sell off to a yield of 0.57% from 0.12% at the start of 2021. In the meantime, the equivalent maturity Japanese Government Bond (JGB) yield is essentially unchanged.

With this widening gap in interest rates between the U.S. and Japan, the dollar has appreciated nearly 10% relative to the yen in 2021.

For unhedged investors in Japanese equities, that has meant a nearly 10% headwind to returns.

Figure 8: Government Yields and USD/JPY FX Rate

Date	UST 2-Year	JGB 2-Year	UST 2-Year minus JGB 2-Year	FX Rate (USD/JPY)
12/31/2020	0.12%	-0.13%	0.25%	103.25
1/29/2021	0.11%	-0.13%	0.24%	104.70
2/26/2021	0.13%	-0.12%	0.25%	106.54
3/31/2021	0.16%	-0.13%	0.29%	110.50
4/30/2021	0.16%	-0.13%	0.29%	109.31
5/28/2021	0.14%	-0.13%	0.27%	109.98
6/30/2021	0.25%	-0.12%	0.37%	110.99
7/30/2021	0.18%	-0.13%	0.31%	109.75
8/31/2021	0.21%	-0.13%	0.34%	109.86
9/30/2021	0.28%	-0.13%	0.40%	111.58
10/29/2021	0.50%	-0.10%	0.60%	114.03
11/30/2021	0.57%	-0.12%	0.68%	113.17
Change	**0.44%**	**0.02%**	**0.43%**	**9.61%**

Sources: WisdomTree, FactSet, as of 11/30/21.

If 2022 witnesses some semblance of a post-COVID-19 world that rewards markets that are heavy in cyclical sectors, then **WisdomTree's Japan Hedged Equity Fund (DXJ)** may stand to benefit.

Figure 9: Sector Exposures

Sector	WT Japan Hedged Equity Fund	MSCI Japan Index	S&P 500 Index
Cyclical	65.9%	55.3%	32.9%
Energy	2.2%	0.7%	2.7%
Materials	9.3%	4.7%	2.5%
Industrials	21.4%	22.2%	7.8%
Financials	14.1%	8.9%	10.8%
Consumer Cyclical	18.9%	18.8%	9.0%
Growth/Defensive	34.1%	44.7%	67.1%
Consumer Growth/Defensive*	9.7%	7.2%	9.7%
Health Care	8.1%	9.9%	12.7%
Information Technology	12.8%	15.5%	29.3%
Utilities	0.0%	0.9%	2.4%
Real Estate	0.0%	3.4%	2.6%
Communication Services	3.5%	7.9%	10.4%

Sources: WisdomTree, MSCI, S&P, as of 11/30/21. *Consumer Growth/Defensive includes Consumer Staples sector and Internet & Direct Marketing Retail industry. Consumer Cyclical includes the Consumer Discretionary sector ex-Internet & Direct Marketing Retail industry. You cannot invest directly in an index.

CONCLUSION

Rolling lockdowns and global supply-chain setbacks have been a headwind to Japan's recovery thus far. But if 2022 witnesses global economic expansion, a lighter lockdown mood and a rewarding of value concepts, Japan's stock market may be primed for a bout of outperformance. Further yen weakness, should that come to pass, may also add fuel to the bull case for the country.

Glossary:

Hawkish: Description used when worries about inflation are the primary concern in setting monetary policy decisions. Inflation: Characterized by rising price levels. Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Inflation: Characterized by rising price levels. Yen: The basic monetary unit of Japan. Keynesian: An advocate of the economic theories of John Maynard Keynes. Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Stagflation: A situation in which the inflation rate is high and the economic growth rate slows. Cyclically focused: Cyclically focused stocks are stocks whose prices are affected by macroeconomic or systematic changes in the overall economy. Risk-on/risk-off: Refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments. Normalization: The process by which a policy or action returns to its historically normal levels. Japanese Government Bond (JGB): A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan. Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value. Unhedged: Strategy that includes the performance of both the underlying asset and the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced. Bullish: A position that benefits when asset prices rise.

Index Definitions:

Russell 1000 Growth Index: A measure of the large-cap growth segment of the U.S. equity universe, selecting from the Russell 1000 Index. MSCI Japan Index: A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market. S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. WisdomTree Japan Hedged Equity Index: Index designed to provide exposure to Japanese equity markets while at the same time neutralizing exposure to fluctuations of Japanese yen movements against the U.S. dollar. Constituents are dividend-paying companies incorporated in Japan that derive less than 80% of their revenue from sources in Japan. Weighting is by cash dividends paid. Russell 1000 Value Index: A measure of the large-cap value segment of the U.S. equity universe, selecting from the Russell 1000 Index. MSCI All Country World Index: A broad global equity benchmark that represents large- and mid-cap equity performance across 23 developed and emerging market countries.

Important Information

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