

# A Japan Strategist Roundtable Discussion

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WisdomTree has compiled a Japan Strategist roundtable—a compilation of views from three of the most widely followed Japan investment strategists. In separate one-on-one interviews, we asked these strategists to share their views on Japan's equity markets, the economy, government initiatives and the currency.

We greatly benefited from their collective years of experience serving as heads of research or chief investment strategists covering Japan. We want to thank the strategists for their participation in our roundtable and hope you enjoy the conversations with them as much as we did. The strategists for our roundtable included:

- 1) **Naoki Kamiyama – Head of Japan Equity Strategy at BofA Merrill Lynch**
- 2) **Masatoshi Kikuchi – Pan Asia Chief Equity Strategist at Mizuho Securities Equity Research**
- 3) **Jesper Koll – Director of Japan Equity Research at J.P. Morgan Japan**

Let's start with their ultimate investment bottom lines—the shorter-term outlook for the market, along with main drivers, before we dive into specifics on the economy, Prime Minister Abe and the currency markets.

## **QUESTION: KAMIYAMA-SAN, PLEASE DISCUSS YOUR OUTLOOK FOR 2014.**

**Naoki Kamiyama:** My year-end target for the TOPIX is 1,420, so I think there is about a 19% upside potential from levels on February 4, 2014. Earnings (EPS)<sup>1</sup> growth is expected to be a little less than 10%—because of a consumption tax hike [from 5% to 8%] in April, I am conservative on EPS. I think we get some P/E<sup>2</sup> expansion, mostly from global expectations of a recovery—not only from Abenomics<sup>3</sup>, but a global economic recovery. Japan is outperforming other markets because its rate of change in EPS is higher than other markets and it has a higher sensitivity to the global economic recovery.

WisdomTree notes that Forecasts and estimates have certain inherent limitations and may not actually come to pass.

<sup>1</sup> Earnings per share: Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

<sup>2</sup> Price-to-earnings ratio (P/E): Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

<sup>3</sup> Abenomics: Series of policies enacted after the election of Japanese prime minister Shinzo Abe on December 16, 2012, aimed at stimulating Japan's economic growth.

**QUESTION: HOW DOES THE YEN FACTOR INTO YOUR ESTIMATES?**

**Naoki Kamiyama:** Our year-end forecast for the yen/dollar exchange rate is 108. I used a conservative forecast in coming up with EPS—I used 105 yen/dollar as average of the year. In my main scenario for the markets, I expect market confidence in the global recovery, especially the U.S. will improve. The last U.S. employment report was not great, but I have stronger confidence in the U.S. recovery. I think the yen will be weaker in the first half, and the market will be led by exporters. I have a bear<sup>4</sup> scenario, where the yen trades down to 95, and that would be a scenario if the U.S. recovery was weaker than expected and market participants were less confident in a global recovery—and things would go back to the original position before Abenomics started around 95 yen/dollar.

**QUESTION: KIKUCHI-SAN, YOU HAVE LOOKED AT HOW THE MARKETS PERFORMED HISTORICALLY FOLLOWING MOVES LIKE WE SAW THIS LAST YEAR. WHAT DID THAT SHOW AND HOW HAS THAT IMPACTED YOUR OUTLOOK?**

**Masatoshi Kikuchi:** Last year, the Nikkei 225 went up more than 50%. After a sharp rally, my research shows the following years tend to be more modest. Therefore, I expect more modest returns this year. There were two exceptions when the stock market was strong in two or three consecutive years. First in 1951, an exceptional year because there was a Korean War and special demand for the Korean War. The second exception was 1958 to 1960. At that time, it was a great economic expansion era to our 1964 Tokyo Olympics, where the stock market rallied for three consecutive years. This second exception period—1958–1960—has been compared by some to the current period. We have the 2020 Tokyo Olympics, therefore we have big spending or capital expenditures<sup>5</sup> for six years before the Olympics takes place in 2020. Some of the bullish people say the same thing could happen now. But I think economic conditions are still quite different from the 1960s. Japanese economic growth rates were over 10%, but now it's just 1% or 2%. Therefore, my conclusion is that this year stock market returns will be more modest after very strong performance last year.

**QUESTION: JESPER KOLL IS ONE OF THE MOST BULLISH OF THE JAPAN STRATEGISTS WE SPOKE WITH, AS HE BELIEVES WE ARE IN A STRUCTURAL BULL MARKET FOR RISK ASSETS, WITH A TARGET FOR THE TOPIX OF 1,600 IN THE NEXT 12 TO 15 MONTHS. ONE OF HIS MAIN REASONS: HE IS ABOVE CONSENSUS ON HIS EARNINGS OUTLOOK. WHY?**

**Jesper Koll:** Margins are currently 4.1%. Over the last decade, the high has been 5.1%, and I think that it's very likely that margins will go back up to at least 5.1%. You are in a sweet spot with a benefit of higher productivity and cyclical pickup in output. Secondly, note that the capital stock for the listed companies has actually fallen by about 7% over the last three years. So, fixed cost gearing has improved tremendously.

**QUESTION: YOU THINK THAT CONSENSUS EARNINGS CATCH UP WITH YOUR VIEW AND THAT'S A DRIVER FOR 2014 MARKETS?**

**Jesper Koll:** Yes, this time last year, Japan was still undiscovered. People were still looking in the rearview mirror and saying, "Oh, well. It's just a one-day wonder." By now, every manager has been to Japan, has visited companies, and I think that certainly the global investment community now basically is afraid of being short Japan.

<sup>4</sup> Bear: A sustained downturn in market prices, increasing the chances of negative portfolio returns.

<sup>5</sup> Capital expenditures: Spending by a company typically made to enhance longer-term productive capacity.

While investment is rising, it's still underinvested. The naysayers say, on a risk-adjusted basis, the cost of engaging in Japan is just very high. Look at it in U.S. dollar terms. The Nikkei was up about 25% last year, with a volatility<sup>6</sup> of just slightly above 20%, while the S&P was up just shy of 30% with a volatility of about half of what Japan delivered. The reason for the volatility is the fact that you've got no engagement from the domestic institutional investor. Japan is like an emerging market in the sense that you've got global speculators playing against local retail investors while the domestic institutional investors basically are sitting back.

## The Impact of Abenomics and Monetary Policy

To varying degrees, the Japan strategists we spoke with believe the Bank of Japan's [BOJ] monetary policy accommodation is one of the reasons to be bullish on the market. But there are also other factors that largely stem from Prime Minister Abe's economics program referred to as Abenomics. Abe has himself admitted that the third arrow of structural reform, geared to increase investment in the economy, takes more time to negotiate. But the first two arrows have been fairly spot-on, especially the monetary policy arrow. Most of our questions just focused on the potential of this third arrow and the implications of monetary policy.

**QUESTION: JESPER, YOU'VE SAID THE BANK OF JAPAN IS NOT "PUSHING ON A STRING" AND THAT A SURPRISE FOR 2014 WILL BE THAT INFLATION EXCEEDS 2% BY MID-YEAR, KEEPS ON RISING, AND BY END-2014, THE BOJ POLICY BOARD FORECASTS 3.1% INFLATION FOR 2015. WHAT DRIVES THIS?**

**Jesper Koll:** Yes. I think the most important thing in Japan is that you are hitting resource constraints. The labor market is shrinking. Every year, there are about 750,000 people leaving the Japanese workforce. Before long, a labor shortage puts real upward pressure on wages and puts pressure on inflation. Japan for 2013 and 2014 is in a sweet spot where productivity is rising faster than wage growth. But, eventually you're going to have unit labor costs actually beginning to increase.

**QUESTION: LABOR MARKET REFORM IS A BIG TOPIC, GIVEN THE DECLINING LABOR FORCE. WHAT DO YOU THINK ABE SHOULD BE DOING?**

**Jesper Koll:** The one reform that needs to happen: a more open immigration policy. Let me be very clear. That's not Mr. Abe's fault. That is not the fault of the visa rules and regulations—it's a function of corporate governance really being very closed to outsiders and whether these outsiders are non-Japanese or whether they are females. You can't change this management style legislatively; corporations have to change. There are some examples of this occurring. Lawson, the second-largest convenience store operator in Japan, three years ago started a policy: Every third person they hired here in Japan is a non-Japanese. The CEO is globally educated, and the moment he became the CEO, he forced the HR department to open the doors to employ non-Japanese.

**QUESTION: WHAT WILL DRIVE THIS CHANGE GOING FORWARD?**

**Jesper Koll:** The scarcity of labor is becoming acute, and it will be a necessity. When you look at the logistics business, shipping parcels, base pay is rising at a rate of 9% compared to a year ago. In the construction industry, base pay is increasing at a rate of

<sup>6</sup> Volatility: A measure of the dispersion of actual returns around a particular average level.

between 12% and 15%. Literally, a lot more money right now cannot buy you an additional construction worker. At the top end of the economy there's still excess. There's still an excess of utility workers, government bureaucrats and public sector employees. To some extent, there's an excess of employment manufacturing, where more robots are being used. But at the lower end there is a shortage, and this is putting wage pressures and could cause Japan's companies to open up.

## Forecasts for the Yen and How That Impacts the Markets, Earnings

One factor, more than any other, dominates discussions of risk factors for Japan's equity markets—and that is if the yen had another prolonged strengthening period. Japan's equity markets have exhibited one of the strongest negative relationships—correlations<sup>7</sup>—between its currency and its equity markets. We talked to each of the strategists about their various views regarding the currency and implications for the markets.

**QUESTION: KIKUCHI-SAN, THE GROWTH OF THE MONETARY BASE IN JAPAN IS GOING TO START TO OUTSTRIP THAT OF THE U.S., AND YOU HAVE DISCUSSED THIS RELATIONSHIP RELATIVE TO THE YEN. IS THAT ONE OF THE PRIMARY FACTORS YOU'RE LOOKING AT TO DRIVE THE YEN OVER TIME, AND WHERE DO YOU SEE IT HEADING VERSUS THE U.S. DOLLAR?**

**Masatoshi Kikuchi:** Currency forecast is quite difficult. But I think the yen can depreciate to 105 at the end of March this year, and 110 at the end of next fiscal year, March 2015. In the long run, it will depend on how Japanese nuclear power is allowed to restart and also how U.S. monetary policy goes. But I think the Japanese current account<sup>8</sup> balance is now switching to deficit because of import of oil and gas, which is also negative for the yen. In the long run, Japanese current account surplus is going negative because of aging populations. On January 22, we published a long-term investment report that assumes 130 yen to the dollar by 2020.

**QUESTION: JESPER KOLL ALSO AGREED THE CURRENT ACCOUNT DYNAMIC WAS CHANGING THE STRENGTH OF THE YEN.**

**Jesper Koll:** Japan is no longer a creditor country, it's a debtor country. You've seen the current account data now showing a structural current account deficit. This has very, very big implications for the macro<sup>9</sup> of the country. It makes it likely that the yen is going to be a weak rather than a strong currency.

**QUESTION: HOW MUCH OF THIS IS THE OIL IMPORTS, AND HOW MUCH IS BUYING AHEAD OF THE CONSUMPTION TAX?**

**Jesper Koll:** One-third of the deterioration of current account is due to the terms of trade and the higher fossil fuel imports that Japan is doing because it's gone ex-nuke. But exports are not picking up, because more than two-thirds of production has shifted overseas. Five years ago, it was only 45%. No matter how weak the yen, Japan's official exports are unlikely to be accelerating from here. But importantly, you and I as investors don't really care. In fact, every time a Japanese company announced that they are buying another global company or that they're building another offshore factory, I hop up and down in joy because profit margins<sup>10</sup> on offshore factories are typically two-and-a-half to three times higher than they are on Japanese factories. This is good for profits.

<sup>7</sup> Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly opposite directions.

<sup>8</sup> Current account: The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

<sup>9</sup> Macro: Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

**QUESTION: WHEN YOU LOOK AT THE YEN'S IMPACT ON THE BIG EXPORTERS, GIVEN THIS OFFSHORING PHENOMENON, HOW DOES A WEAK YEN INCREASE PROFITS LIKE IT HAS FOR BIG COMPANIES LIKE TOYOTA<sup>11</sup>?**

**Jesper Koll:** The year-on-year increase in dollar earnings translates into a higher yen revenue (with the yen weakening). You're increasing your dollar costs as well. It's obviously not a one-for-one relationship. Given the fact that the profit margins are in Toyota's case about 3.5 times higher for the American operations, the impact is a significant positive. In general terms, for the listed company, a 10% depreciation of the yen against the dollar basically adds back about 10% to corporate earnings from current levels.

**QUESTION: KIKUCHI-SAN, WHY IS THE MARKET SO NEGATIVELY CORRELATED TO THE YEN?**

**Masatoshi Kikuchi:** That is a difficult question. Macro hedge funds assume a high correlation between weak yen and strong stock market. Also, some recent investors in the foreign exchange market say the currency is driven by stock market movement. On the other hand, stock market investors believe the stock market is driven by the weak yen. I think this year, domestic demand will be weak because of higher consumption tax. Therefore, Japanese corporate earnings and economic conditions will highly depend on the overseas market and the currencies for growth. Therefore, I believe macro investors will continue to focus on high correlation between currency and the stock market. I think traditional long-only<sup>12</sup> investors want to see a stronger economy, a stronger yen and a strong stock market driven by the right domestic demand. But I think this will not happen this year, and the negative correlation will continue.

## Further Abenomics Policies to Spur Growth

Prime Minister Abe has been a central reason why many people have become bullish on Japan. Yet many are frustrated by the lack of progress on Abe's so-called third arrow growth strategy for Japan. There will be more to come from Abe's agenda on this growth strategy this coming June. Our strategists discussed what they see as prime focal points both for the growth strategies already in place and those to come.

**QUESTION: KAMIYAMA-SAN, YOU ARE ENCOURAGED BY NEW TAX POLICIES THAT YOU THINK ENCOURAGE BUSINESS CONSOLIDATION. TALK ABOUT THIS.**

**Naoki Kamiyama:** There is a new tax incentive program to encourage mergers of subsidiaries of companies that are generating losses. It is a bit of a technical accounting issue, but the new incentive structure will help encourage the reduction of oversupply in certain industries. For many years, large companies complained that taxation discouraged mergers of these consolidated enterprises. This is a big issue for technology companies in Japan.

<sup>10</sup> Profit margin: Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

<sup>11</sup> As of 12/31/2013, the WisdomTree Japan Hedged Equity Fund (DXJ) held 4.78% in Toyota, the WisdomTree Japan Hedged SmallCap Equity Fund (DXJS) held 0.00% in Toyota, and the WisdomTree Japan SmallCap Dividend Fund (DFJ) held 0.00% in Toyota. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

<sup>12</sup> Long-only: The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value; the opposite of short (or short position).

**QUESTION: ONE OF YOUR RESEARCH PIECES DISCUSSED THE GOVERNMENTS IN BOTH THE U.S. AND JAPAN WERE SHOCKED BY THE DECISION OF APPLIED MATERIALS<sup>13</sup> AND TOKYO ELECTRON<sup>14</sup> TO REGISTER THEIR COMBINED HOLDING COMPANY IN THE NETHERLANDS. HOW IS TAX POLICY APT TO CHANGE?**

**Naoki Kamiyama:** Overall corporate taxes are quite high in Japan and in the United States. In the Netherlands, it is quite lower. Japan needs to make its taxes lower so it becomes more of an industrial location choice. This merger shows that tax policy discourages formation of companies in Japan. This is a competitiveness issue—for encouraging companies to set up factories or headquarters. Lowering corporate taxes is a fiscal issue, and the MOF<sup>15</sup> doesn't like lowering tax revenue. This year, Mr. Abe would like to lower corporate taxes. The ideal tax would be more similar to Korea's or the Netherlands' at 25%. But I think a political compromise is most likely, and I expect 30%–33% is a short-term target for Mr. Abe.

**QUESTION: ONE OF THE REASONS JESPER KOLL REMAINS SO BULLISH ON THE MARKETS IS HIS BELIEF THAT ABENOMICS IS GOING TO STAY PRO-BUSINESS. JESPER, WHAT AREAS ARE YOU FOCUSED ON?**

**Jesper Koll:** The big headline is going to be the whole corporate tax debate. Abe himself has made it very clear. He will present the next concrete growth strategy and corporate taxes are going to be a big part of the plan in June 2014. The second part is deregulation or the government getting out of the way, creating investment opportunities for the private sector. Energy policy is one of them, where the independent power providers can now feed into the grid. Corporations like Toyota having applied for and received licenses to become for-profit power generators. In agriculture, corporations will be allowed to actually purchase or lease large plots of land to actually increase the size of farms and get productivity of farmland going. Then healthcare is the third sector where deregulation is going to be a big help. Further, privatization is the one area—if you ask me, “Where could Abenomics surprise in 2014?” that would be one area. Whether it is some of the dormitories for civil servants being sold off and privatized, toll roads and, believe it or not, airports. This will create investment opportunities for private capital to be put to work.

**QUESTION: NAOKI KAMIYAMA WAS ONE OF THE FIRST STRATEGISTS WHO PUBLISHED A DISCUSSION OF POTENTIAL NEW INITIATIVES DESIGNED TO SPUR INVESTMENT INTO TAX-DEFERRED ACCOUNTS BEYOND THE NISA<sup>16</sup> ACCOUNTS, WHICH HAVE BEEN A FOCUS OF MANY THIS YEAR. KAMIYAMA-SAN, PLEASE DISCUSS THESE NEW INITIATIVES.**

**Naoki Kamiyama:** Abenomics has three arrows: money easing, fiscal expansion and third, we say “growth strategy,” but mostly deregulation and taxation reform. One thing from the growth strategy perspective—the government would like money to shift into risky assets to support higher velocity of money—it is related to the first arrow of money easing. NISA, which started January 1st, was a starting point. I expect more. For instance, with individual savings accounts in the UK, the money can be directed to all types of assets, even cash reserves. In Japan, NISA is only for risk assets<sup>17</sup>. NISA is for anyone above 20 years of age. The amount per person is quite small. The Ministry of Finance does not want too much in tax-exempt accounts. But I believe Mr. Abe does not think this is enough to support risk assets and would like to add a bit more to this part of the growth strategy. The establishment of

<sup>13</sup> Applied Materials: As of 12/31/2013, Applied Materials was a 0.00% holding in DXJ, a 0.00% holding in DXJS and a 0.00% holding in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

<sup>14</sup> Tokyo Electron: As of 12/31/2013, Tokyo Electron was a 0.27% holding in DXJ, a 0.00% holding in DXJS and a 0.00% holding in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

<sup>15</sup> Ministry of Finance.

<sup>16</sup> NISA: Nippon Individual Savings Account. Nippon is the Japanese word for Japan.

<sup>17</sup> Risk assets: Assets not backed by the full faith and credit of a government entity.

a type of IRA<sup>18</sup> retirement account would be in addition to the NISA accounts from a retirement perspective. It is being supported by the FSA, the Financial Services Agency, but it has not actually been decided on yet. The MOF tax office does not approve of this IRA yet. As long as Abe has strong leadership, I think he can add it to the second agenda for the growth strategy.

**QUESTION: WHAT TYPE OF YEN FIGURES ARE WE TALKING ABOUT AS A RESULT OF THESE ACCOUNTS GOING INTO RISKY ASSETS?**

**Naoki Kamiyama:** The NISA has potential to get ¥4–5 trillion and may gather a total of ¥20 trillion over time. The IRA would be designed for older people, and they have more money in a sense, but they may be more conservative in their allocations. So the total money moving to equities and risky assets may be similar or less to that ¥20 trillion. A lot of the flows will depend on the market environment.

**QUESTION: ARE THERE OTHER TOPICS RELATED TO ABENOMICS YOU WANT TO DISCUSS?**

**Naoki Kamiyama:** Quite many investors might be interested in the casino issue. Gambling is quite regulated, but we expect exemptions to be put in place, like the Atlantic City, New Jersey, area. This is quite likely for this year to see reduced restrictions on gambling, creating more opportunities for gambling companies and also real estate, construction companies, gaming companies. This is representative of the deregulation of the government.

**QUESTION: LET'S ALSO TALK ABOUT YOUR "RETURN REVOLUTION" REPORT, WHICH IS FOR JAPAN ROE<sup>19</sup> TO REACH 15% IN 2019 AND THE TOPIX TO EXCEED 2,500 IN 2017.**

**Naoki Kamiyama:** The most important point—the reasons of low margins in Japan. Quite many believe low margins are caused by labor market structure, lifetime employment, the seniority system and high fixed costs due to social structure. My point is that this labor market is not a big issue. If low margins really came from labor costs, during the 2002–2007 global economic expansion, Japan should have been the highest-margin country in the world. It was not. My conclusion: The primary issue is, pricing strategy is wrong in Japan. Companies have preferred sales volume over profitability. Once Japan's management changes its mindset, we can change quickly. That's why I called the report "Return Revolution." We can change suddenly. We do not have to stress labor market reform—we need to change the mindset of the corporate management and pricing strategies. As long as corporates can sell higher prices and higher margins, they should stay in a business. But once the company loses competitiveness, companies need to move on. Flexibility is the key there. Japan can do that, we can change. But I am not sure we are changing yet. This would be a bull scenario for this mindset change. Once management changes its thinking, we can see U.S. or European levels of margins in the next five years.

**QUESTION: WHAT FACTORS LED TO THIS TYPE OF PRICING STRATEGY?**

**Naoki Kamiyama:** Banking-led governance of companies was a historical tradition. Banks do not need growth. Banks want companies to emphasize size, reliability of payback, stability. Equity holders need growth and profitability. Banking governance was strong from the 1950s to the 1960s up to the banking crisis in the late 1990s. Many management teams suffered from banks'

<sup>18</sup> IRA: Individual retirement account.

<sup>19</sup> Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

involvement in management. Now things have changed. After 1998, banks have gotten weaker, management paid back loans and management is cash rich and doesn't care about banks. But management doesn't care about profitability metrics yet. They keep cash on the balance sheet.

**QUESTION: WHAT ARE CATALYSTS FOR THIS RETURN REVOLUTION TO CHANGE?**

**Naoki Kamiyama:** The stewardship code<sup>20</sup> is one. The stewardship code was introduced in the United Kingdom. I think this is an important catalyst to change governance from banking relationship to equity holders. It is quite natural to adopt a stockholder way of thinking due to the aging population and globalization. Intentional growth is really important and more important than before. The change in mindset can be provided by stockholders' communications using the stewardship code for institutional investors and management to be more responsive to stockholders' governance over the next several years. There are good signs. Some companies are being more conscious of profitability. Size is not just the most important thing, profitability is also the key. The trends are going the right way. I am not sure of the speed at which this will occur, but this is a focus point for the next several years.

## Japan Themes and Sectors in Focus for 2014

With the macro picture covered, we now turn to some specifics about Japanese investment themes and parts of the market that each of the strategists favor. There were some collective and shared insights among the strategists, as might be expected, along with a diversity of opinions on certain industries.

Much of the discussion centered around ways to play the reflation of Japan's economy for coming inflation increases, along with a focus on stocks primed to benefit from an increase in domestic demand, which could be a second phase of the export-led profit growth that occurred last year.

**QUESTION: JESPER BELIEVES THE RESOURCE CONSTRAINTS ARE SPURRING WAGE GROWTH AND THAT THIS IS CENTRAL TO HIS FOCUS ON HIS THEME OF "DOMESTIC DEMAND." CAN YOU TALK ABOUT THIS?**

**Jesper Koll:** Let me give you a thesis for Japan: I think Japan is going to be the one society where a new middle class is emerging, because you'll find that the domestic service sectors, which is predominantly merchandising and individual services, over the last 20 years has seen wages decline by an average 1.5%. That, because of the greater shortage of workers, is now going to inflect up. The low-end employees at smaller companies, the mom and pop shops, as well as employees in the merchandising and domestic service sectors, wages are actually going up.

**QUESTION: THIS IS WHY YOU THINK THE CONSUMPTION TAX IN APRIL IS REALLY A NON-EVENT?**

**Jesper Koll:** Yes, absolutely. People look at wage growth, and they focus on the base pay negotiation. Well, I'm terribly sorry. The base pay negotiation applies to companies that are in the manufacturing sector and only employs 17% of the people. In the national income statistics and the gross domestic product (GDP) statistics, workers' compensation currently is rising already at a rate of about 2.5%.

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<sup>20</sup> Stewardship code: Aims to enhance the quality of engagement between asset managers and companies to help improve the long-term experience of shareholders.

**QUESTION: MOREOVER, ON DEMOGRAPHICS, JESPER THINKS THERE ARE IMPORTANT CHANGES IN THE WORKS.**

**Jesper Koll:** The baby boom drag—the baby boomers moving to retirement—is over, and the children of the baby boomers for the first time in their employed lives are actually seeing greater stability of jobs. More people are going to be hired on a full-time basis. Once that happens, you start to have a family. As the certainty of lifetime income improves, you get greater household formation, marriage rates go up, and then before long, you're going to have another baby boom.

**QUESTION: JESPER, YOU TALK ABOUT FINANCIALS AS A DOMESTIC DEMAND STORY. WHY DO YOU LIKE THEM?**

**Jesper Koll:** First of all, I think I'm not so interested in the exporter story because, quite frankly, if you want to discuss Toyota, you don't need to talk to me—Toyota is essentially a discussion about U.S. car sales, Chinese car sales and the exchange rate. Japan's car sales effectively are almost a non-sector for Toyota. The banks are, I think, the key issue. The banks are the only sector where consensus expectations for 2014 earnings growth is negative or a fall of 8%. We think this is very wrong, that earnings can actually rise by about 20%, and the reason is threefold: 1) You've got loan growth that is accelerating; 2) you've got net interest margins<sup>21</sup> actually going up; 3) fee income from consolidated businesses like consumer finance is actually now contributing very nicely to the bottom line.

**QUESTION: SPEAKING TO THE NEGATIVE VIEW OF BANKS, KIKUCHI-SAN RECENTLY DOWNGRADED THE BANKS.**

**Masatoshi Kikuchi:** I used to over-weight banks, but downgraded them on January 24. The reason why we were over-weight banks is low valuations. But banks will deliver very cautious earnings for guidance in the next fiscal year. Consensus earnings suggest banks' earnings growth should be negative, and therefore investors may not want to buy bank shares in the beginning of next fiscal year.

**QUESTION: BUT YOU LIKED THE SECURITIES COMPANIES.**

**Masatoshi Kikuchi:** Brokers just depend on market conditions. I believe market demand is firm, I think brokers should benefit. Also the number of IPOs<sup>22</sup> should continue to tick up and there are several good IPOs this year, which will help commissions for the brokers.

**QUESTION: WHAT IS YOUR CASE FOR ELECTRICAL EQUIPMENT, TECHNOLOGY AND AUTOS?**

**Masatoshi Kikuchi:** Japanese electrical equipment companies are now regaining competitiveness because the yen weakened against the Korean won. Japanese companies such as Panasonic and Fujitsu made a good restructuring. New government initiatives are helping to encourage consolidation in the electronics industry. Deflation in electronics looks like it's ending, so I'm bullish about electronic sectors. On autos, I believe earnings growth for autos will be slowing next year. This year, Japanese companies, specifically

<sup>21</sup> Net interest margin: A measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their (interest-earning) assets.

<sup>22</sup> IPO: Initial public offering, which is the first sale of stock by a private company to the public.

<sup>23</sup> Panasonic: As of 12/31/2013, Panasonic was a 0.00% weight in DXJ, a 0.00% weight in DXJS and a 0.00% weight in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

<sup>24</sup> Fujitsu: As of 12/31/2013, Fujitsu was a 0.00% weight in DXJ, a 0.00% weight in DXJS and a 0.00% weight in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

Toyota, made a big, big profit. Also some auto companies increased capital expenditures (capex), therefore earnings growth should be moderated. Also, many investors are heavily over-weight autos already, therefore I am neutral on auto stocks.

**QUESTION: HEALTH CARE IS A SECTOR THAT TYPICALLY HAS HIGHER DIVIDEND YIELDS<sup>25</sup>, WHICH YOU LIKE, BUT YOU DON'T LIKE THE HEALTH CARE SECTOR. DO YOU WANT TO TELL US ABOUT THAT?**

**Masatoshi Kikuchi:** Our pharmaceutical stocks are usually regarded as defensive sectors in Japan. When our stock market goes up, pharmaceutical sectors tend to underperform. Also, social security reform is the biggest political agenda this year, and the Japanese government wants to reduce medical expenses. Japanese pharmaceutical companies failed to produce innovative medicines, so there is no good pipeline of products. I am thus under-weight the pharmaceutical sector.

**QUESTION: YOU MENTIONED THAT PRIME MINISTER ABE IS TRAVELING THE GLOBE AND HE'S BECOMING A SALESMAN FOR INFRASTRUCTURE. HOW IS THIS PLAYING OUT?**

**Masatoshi Kikuchi:** Our government made a target to increase infrastructure product for export. Mr. Abe will be traveling to Southeast Asia, India, the Middle East, even Africa. The prime minister visiting does not directly lead to orders in the short run, but businesspeople are saying it will help in the long run. I think Japanese infrastructure companies such as Mitsubishi Heavy<sup>26</sup> and Hitachi<sup>27</sup> are going to benefit from Prime Minister Abe's help to get orders for infrastructure products.

**QUESTION: KIKUCHI-SAN, YOU HAVE A PREFERENCE FOR DIVIDEND-PAYING STOCKS CURRENTLY. WHEN DO YOU THINK IS THE BEST TIME TO OWN DIVIDEND-PAYING STOCKS?**

**Masatoshi Kikuchi:** First of all, there is a seasonality of dividend policy in Japan. Many of Japan's companies pay dividends end of March and end of September. Therefore, high-dividend stocks tend to outperform before these dividend payments. From a long-term viewpoint, the tax-free investment accounts called NISA started at the beginning of this year. Japanese individual investors prefer dividends. In the past, Japanese dividends have been low. Japanese individual investors used to invest in high-income foreign bonds, such as Australian or Canadian bonds. But now Japanese companies are more willing to pay high dividends in the interest of shareholders. Therefore, our long-term viewpoint of Japanese dividend effectiveness or stock position should be strong going forward.

**QUESTION: MASATOSHI KIKUCHI LIKES SMALL-CAP STOCKS IN 2014. WE HAVE KIKUCHI-SAN DISCUSS WHY HE LIKES SMALL CAPS AS A THEME.**

**Masatoshi Kikuchi:** I think small-cap stocks will outperform this year, following last year's outperformance. Earnings forecasts for the next fiscal year for small caps are higher than big caps earnings forecasts. Secondly, with the start of NISA accounts, individual

<sup>25</sup> Dividend yield: Synonymous with trailing 12-month dividend yield, which indicates dividends over the prior 12 months added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

<sup>26</sup> Mitsubishi Heavy: As of 12/31/2013, Mitsubishi Heavy was a 0.76% weight in DXJ, a 0.00% weight in DXJS and a 0.00% weight in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

<sup>27</sup> Hitachi: As of 12/31/2013, Hitachi was a 1.55% weight in DXJ, a 0.00% weight in DXJS and a 0.00% weight in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

investors will be buyers of Japanese stocks. Individual investors tend to focus on small caps. In the longer run, it also depends on currency and valuations. There are many small-cap indexes. The Mothers Index is one Japanese small-cap index that looks expensive because of valuations of biotech companies. But the Tokyo Second Exchange looks more reasonably priced. But on currencies, if the Japanese yen depreciates against other currencies, big cap exporters tend to outperform.

**QUESTION: KAMIYAMA-SAN, PLEASE TALK ABOUT YOUR FAVORED POSITIONS FOR 2014.**

**Naoki Kamiyama:** I am quite positive on exporters in the first half of the year—technology and autos—on the back of a weaker yen as well as expanding sales volume because of a global recovery. In the Technology sector, we also have some structural changes from the micro perspective, like a reduction in oversupply. In semiconductors or consumer electronics, that should be beneficial to margins. In the second half, I have a bigger expectation for inflation. Expectations for higher inflation are good for real estate, banks and other financials. The second half I thus see as good for domestic industries—like retail and others. But our central focus should be on financials, with better loan growth. Interest rates are starting to go up, and people are trying to borrow more money—to build houses or buy condos before the interest rates increase too much. So far, analysts are not that optimistic yet for the financials, including real estate, but in the second half I believe, domestic industries and financials will be supporting the market.

**QUESTION: YOU ALSO HAVE A SECTOR MODEL. HOW DOES THAT MODEL WORK?**

**Naoki Kamiyama:** My sector model is quite short-term—three months—driven and not a year outlook. The model is quite systematic. The Japan Cycle Indicator (JCI) is quite important as a top-down<sup>28</sup> analysis tool to favor sectors. The JCI has six inputs; the most important one is U.S. employment numbers, but also included in it are U.S. and Japanese interest rates, foreign exchange rates, volatility indicators and earnings revisions. This month, U.S. employment was much weaker than expected, so there was a down trend in our cycle indicator. From that perspective, we are negative to cyclical-sensitive sectors—so sectors like steel, which are correlated to cyclical. Steel was thus very negatively ranked by the JCI indicator. Autos today are quite well-balanced in both top-down model and my bottom-up model—and it is my most preferred sector. I don't see that changing in the short term. Banks or real estate are not highly ranked yet, because we don't have much confidence in the inflationary environment yet. We think this will be in the second half of the year—this is related to interest rate sensitivity. Once we get more confidence in inflation, interest rate ranking will move up, and then banks and real estate will go up. Wage increases are a starting point for inflation expectations. Wage season is coming in April. If wages go up, as many expect, more people are likely to go out and buy houses, condos, real estate and more businesses to expand.

**QUESTION: TALK ABOUT HOW THE YEN IMPACTS YOUR SECTOR MODEL.**

**Naoki Kamiyama:** Our ranking is based on our judgment of the direction. Defensive sectors have a high rank when we think the yen is appreciating, and export sectors have a high rank when we think the yen is depreciating.

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<sup>28</sup>Top-down: A method of analysis that involves looking at the “big picture” first and then analyzing the details of smaller components.

**QUESTION: KIKUCHI-SAN, YOU ALSO COVER PAN-ASIA<sup>29</sup>, AND I WANTED TO SEE WHAT YOU THOUGHT JAPAN'S ROLE OF THE WEAK YEN IS DOING TO SOME OF THE OTHER ASIAN ECONOMIES AND THEIR MARKETS AND WHAT, MAYBE, YOUR TAKE IS ON KOREA AND ASIA.**

**Masatoshi Kikuchi:** The weak yen is definitely hurting Korea, especially auto and heavy industries. I thought the Korean market was cheap, so I over-weighted it, but I was wrong. Korean earnings were worse than I expected. Korea has seen a negative impact from the weak yen.

Other areas of Asia, such as Southeast Asia, there is no competition between Japanese companies and Southeast Asian companies. In Thailand, much industry production in Thailand is made by Japanese companies. Also, Japanese companies continue to increase direct investment in this region; therefore, the weak yen has not damaged Southeast Asian countries in terms of Japanese direct investment. I think political stability is more important. Thailand, Indonesia are facing political uncertainties. But I think the Japanese companies are going to continue to invest in this region.

**QUESTION: THERE'S A LOT OF NEWS FLOW ON THE JAPANESE BANKS TRYING TO BUY EITHER INDONESIAN BANKS OR THAI BANKS OR EVEN SOME OF THE MALAYSIAN BANKS. WHAT IS DRIVING THIS?**

**Masatoshi Kikuchi:** In Japan, there's an excess supply of capital. Interest margins and lending continue to decline in Japan, so Japanese major banks want to expand overseas. Japanese banks continue to want to invest in Southeast Asia, but there is this restriction of holding investment in major banks in each country that limits how much they can do.

**QUESTION: WHAT ABOUT BEYOND THE BANKS?**

**Masatoshi Kikuchi:** Japanese investment in Asia is more greenfield investment<sup>30</sup> than M&A [mergers & acquisitions] activity. There are small M&A activity. But there are less targets. Japanese auto companies just expanded factories in Indonesia and Thailand. Also Japanese food companies, household companies expand factories. For M&A activity, the Japanese companies target the U.S., where rules are easier and also there are a lot of good targets in U.S. and Europe.

## What Risk Can Set Japan or Abe Back?

**Naoki Kamiyama:** Two things. The global economy is a big risk. Japan is not isolated. Not only Abenomics, but we need a better economic situation in the U.S., and I expect Europe's economy is hitting bottom. So there is a better developed economy situation. If the U.S. is weaker or Europe returns to turmoil, that is a risk scenario.

From a domestic perspective, political leadership is very important. If Mr. Abe's candidate lost the upcoming Tokyo local election, there could be a problem for Abe to do anything, like corporate tax cuts—it could be weaker or late. The local elections could be an important issue.

<sup>29</sup> Pan-Asia: Refers to the region of Asia as a whole as opposed to just a single country.

<sup>30</sup> Greenfield investment: Foreign direct investment where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up.

**Masatoshi Kikuchi:** A risk factor will be Abe's popularity. Abe's popularity remains high. But next fiscal year, real income growth will be negative because of the consumption tax. Therefore, Abe's popularity may be going down. That is a risk. Another risk would be NISA. We initially expected over five million accounts to be opened this year. But it opened only 4.7 million according to the National Tax Agency. If individual investors do not put more money in NISA accounts, that could be disappointing to the market.

**Jesper Koll:** The yen is the obvious one, and it is high profile. You need to talk to your U.S. guys, because half of it is going to be a dollar story. But domestically, a key risk is the BOJ losing control over the JGB<sup>31</sup> market. There were these three weeks when it looked like the BOJ had lost control over the long end of the curve. That is the biggest worry that I actually have.

#### **QUESTION: IF THE BOJ ACHIEVES ITS 2% INFLATION TARGET, SHOULD INTEREST RATES RISE?**

**Jesper Koll:** It's very, very interesting. The big banks sold about 15% of their JGB portfolio in the first six months of last year, and the average duration on their bond portfolio now is only 1.6–1.7 years, so very short duration. In terms of valuation losses and that feeding into negative earnings surprises, I think the mega-banks are in a very, very good position. However, the worry is for the regional banks. They are an area that has potential fallout from rising rates. I think for the 10 major regional banks, the average duration we reckon is just shy of five years.

#### **QUESTION: YOU'VE COMMENTED THAT A PRIMARY RISK TO JAPAN IS CEO RISK—THAT ABE IS A KEY PART AND A CHALLENGE TO ABE IS ANOTHER RISK. WHAT IS THE POLITICAL SITUATION?**

**Jesper Koll:** You may have seen that former prime minister Mr. Koizumi has teamed up with another ex-prime minister, Mr. Hosokawa, who is now going to run for the mayor of Tokyo. That's an election that's going to be in early February, but they are running on a specific topic, which is they are running on anti-nuclear topic. That's their agenda. So far, over the last 12 months, Abe has had no opposition. Everybody was in favor. But there was always this strong undercurrent, because the Japanese people hate nuclear policy—85% consistently want Japan to go away from nuclear, and this is because of Fukushima, and Abe has a controversial take of restarting the reactors. So if these two former prime minister win, there's a risk that you've got a local government like the governor of Tokyo challenging Abe on the key economic policy issue, which is energy policy. If this Hosokawa/Koizumi duo, if they become mayor of Tokyo, then I think Abe's public support could drop by another 5%–8%.

#### **QUESTION: WOULD HE POTENTIALLY BACKTRACK ON HIS ENERGY POLICY?**

**Jesper Koll:** On energy policy, I think that they'd be very flexible. But it's an issue because the Tokyo metropolitan government, which is controlled by the mayor of Tokyo, they are the main shareholder of Tokyo Electric Power<sup>33</sup>. The risk is that you've got a regional challenge to Prime Minister Abe's national rule, and the mayor, the race for mayor in Tokyo has just given you a first hint at what that could be.

<sup>31</sup> JGB: Japanese government bond: 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 Japanese financial securities market.

<sup>32</sup> Duration: A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

<sup>33</sup> Tokyo Electric Power: As of 12/31/2013, Tokyo Electric Power was a 0.00% weight in DXJ, a 0.00% weight in DXJS and a 0.00% weight in DFJ. For a full list of current holdings of the WisdomTree ETFs, please visit [wisdomtree.com](http://wisdomtree.com).

## QUESTION: ANY FINAL THOUGHTS?

**Jesper Koll:** I always make it very clear that what has changed here is, number one, you've obviously got the challenge from the People's Republic of China, not as an economic opportunity or an economic rival but as a national rival in the sense that you've got this territorial conflict and that really focuses the mind of the Japanese ruling; so, on defense spending, on national security policy and also the awareness that you need a strong economy to be a credible negotiator on defense and foreign policy and diplomacy. The animal spirits have come back to Japan. Why are the animal spirits back now? Well, it's not because of Abe, but it's because Abe seizes the moment and that moment was triggered ultimately by this external threat that is now very concrete. Very clearly with the territory issue. Japan does not want to become a colony of the People's Republic of China.

To the strategists who participated in this roundtable discussion, again we thank you for spending the time with us, as our knowledge base on many local issues is undoubtedly greatly expanded after these discussions. We look forward to doing this type of roundtable again in the future.

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