

## Equity Market Lows and Yen at a High: What Is an Investor to Do?

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*"[It] is possible to paint a brighter picture of a Japanese sun that has not permanently set but is merely hidden behind a cloud..." Edward Chancellor, GMO strategist<sup>1</sup>*

### THE EQUITY MARKET LOWS

"The Lost Decade" is a phrase used to describe the ten-year period experienced from boom (12/29/1989) to bust in the Japanese equity market. Japan's economic rise in the developed world, essentially starting from scratch after the country was decimated in World War II, was abrupt and emphatic. The economy became a manufacturing powerhouse that exported goods all over the world and eventually established itself as the second largest global economy, with staggering trade surpluses. At its peak in 1989, Japan came to dominate the international equity markets, as its weight in the MSCI EAFE Index was over 60%.<sup>2</sup> The Japanese government encouraged savings on a national level, and as a result, the banking industry became more willing to lend money for the purchase of Japanese assets, including common stocks and real estate.

Since the Nikkei<sup>3</sup> peaked in 1989, the Japanese have embarked on a Keynesian<sup>4</sup> experiment that has resulted in a deflationary environment, a debt-to-gross domestic product (GDP) ratio of roughly two to one and an aging demographic that appears troubling over the course of the next few decades. Japan's own prime minister, Naoto Kan, gave a policy speech after getting elected in June 2010, where he warned of the debt crisis Japan potentially faces:

*"It is difficult to sustain a policy that relies too heavily on issuing debt. As we have seen with the financial confusion in the European Community stemming from Greece, our finances could collapse if trust in national bonds is lost and growing national debt is left alone."<sup>5</sup>*

Some believe that Japan cannot continue down this path of high debt and deficits for much longer and that it is only a matter of time before the country is forced to turn to inflationary policies (i.e., printing money to pay off its debt).<sup>6</sup> As a result of the realities facing the economy and the memory of the Nikkei collapse, active money managers have made deliberate allocations to underweight Japan relative to the MSCI EAFE Index. Of the five largest international active mutual funds, the average allocations to Japan were more than 10 percentage points below a neutral market cap-weighted benchmark such as MSCI EAFE Index weight in 2010.<sup>7</sup>

<sup>1</sup> Chancellor, Edward, "Japan begins to look pretty cheap," Financial Times, December 5, 2010. GMO, founded in 1977, is a privately held global investment management firm servicing clients in the corporate, public, endowment and foundation marketplaces.

<sup>2</sup> Source: MSCI

<sup>3</sup> The Nikkei 225 Stock Average ("Nikkei") is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

<sup>4</sup> Keynesianism economics is a macroeconomic theory based on the ideas of British economist John Maynard Keynes, which argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes and therefore advocates active policy responses by the public sector (the government) to stabilize the economy.

<sup>5</sup> Tabuchi, Hiroko, "Japan's Prime Minister Warns That Debt Could Bring a Crisis Like That of Greece," NY Times, June 11, 2010. [http://www.nytimes.com/2010/06/12/business/global/12yen.html?\\_r=1](http://www.nytimes.com/2010/06/12/business/global/12yen.html?_r=1)

<sup>6</sup> Société Générale analyst Dylan Grice and hedge fund manager Kyle Bass are two examples of analysts who believe this is the case.

<sup>7</sup> Sources: WisdomTree, Morningstar

## THE CURRENCY HIGHS

Since the onset of the financial crisis in the middle of 2007, the Japanese yen has appreciated strongly versus the U.S. dollar. Over the four years ending December 31, 2010, the yen appreciated 47% versus the U.S. dollar, with a nearly 15% appreciation in 2010.

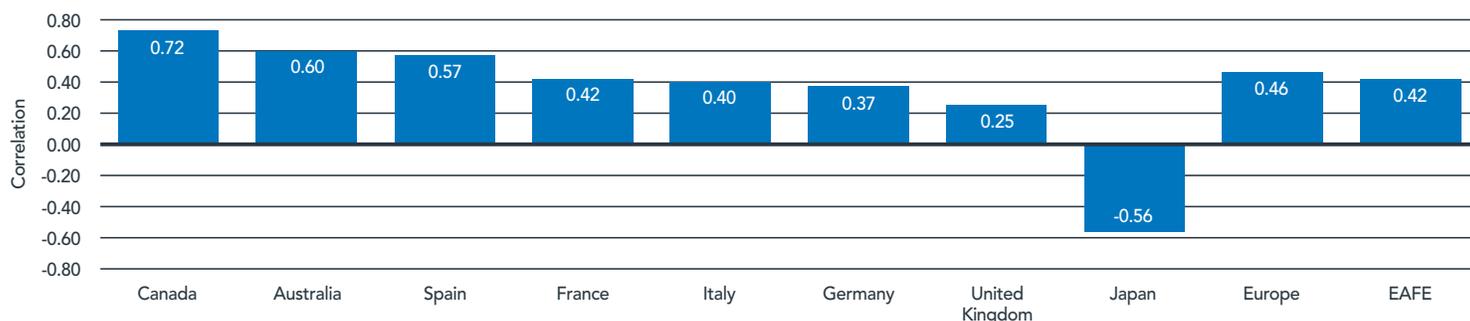
Numerous factors influence the yen-versus-U.S. dollar exchange rate, including factors relating to both the Japanese economy and the U.S. economy. Japan is well accustomed to extremely low short-term interest rates, but the U.S. has kept its rates at very low levels in an effort by the Federal Reserve to jump-start the U.S. economy. Interest rate differentials between Japan and the United States can have a profound impact on relative currency strengths.

With any sign that the U.S. economy is improving, the Japanese yen tends to react vigorously. For example, on January 5, 2011, the ADP Employment Services report showed that the U.S. economy added 297,000 jobs in December, triple what economists had expected.<sup>8</sup> The news immediately sent the yen into sharp decline. If the economic news continues in this fashion to show a rising U.S. economy relative to the strength of the Japanese economy, we believe the initial spike down in the yen could prove to be just an early warning sign of what is to come.

## A WEAKENING YEN A CATALYST FOR EQUITY MARKETS

The Japanese equity markets might represent an attractive buying opportunity if the yen were to backtrack from the 47% gains it made over the last four years. Why should one have a positive outlook for equities if there is a negative outlook for the currency? Japan is one of the rare developed-world economies that exhibited a negative correlation<sup>9</sup> between its equity market's and its currency's movement over the trailing three years. In fact, of the largest developed international countries, none of them (besides Japan) exhibited a negative correlation, and Japan's equities and currency were more negatively correlated (-0.56) than Europe's as a region was positively correlated (+0.46).

## TRAILING THREE-YEAR CORRELATION OF EQUITY AND CURRENCY MARKETS [ as of December 31, 2010 ]



Source: MSCI  
Past performance does not guarantee future results.

<sup>8</sup> Source: Bloomberg

<sup>9</sup> Correlation is a measure of how two assets move in relation to each other; correlations range from -1 to 1, with correlation of -1 meaning assets move perfectly in the opposite direction of each other.

### CORRELATIONS AT COMPANY LEVEL

Below is a table of the largest companies in the WisdomTree Japan Dividend Index, sorted by the correlation of the yen to the local equity prices. Each of the ten companies had a negative correlation of monthly returns over the three years ending December 31, 2010. Of the top ten holdings, the exporters Honda, Toyota, Canon and Mitsubishi were the most negatively correlated, but even the two large financial and telecom companies were negatively correlated over the last three years ending December 31, 2010.

### TRAILING THREE-YEAR CORRELATION OF TEN LARGEST COMPANIES IN WISDOMTREE JAPAN DIVIDEND INDEX

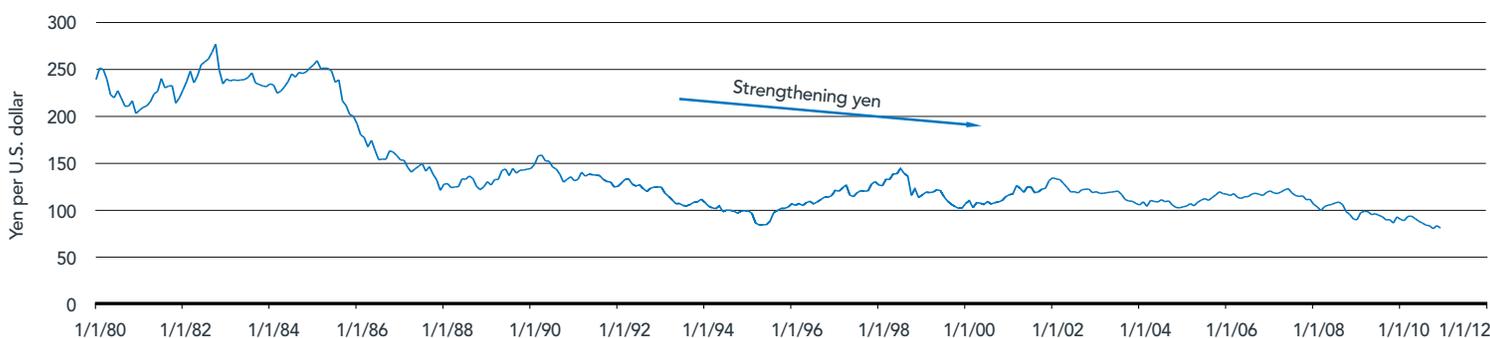
[ as of 12/31/2010 ]

NTT Docomo Inc.	-0.07	Mizuho Financial Group Inc.	-0.41
Nippon Telegraph & Telephone	-0.14	Mitsubishi Corp.	-0.45
Takeda Pharmaceutical Co. Ltd	-0.25	Canon Inc.	-0.53
Mitsubishi UFJ Financial Group	-0.29	Toyota Motor Corp.	-0.65
Sumitomo Mitsui Financial Group	-0.31	Honda Motor Co. Ltd	-0.67

Sources: WisdomTree, Bloomberg

If the U.S. economy were to strengthen relative to Japan, or problems with Japan's economy and currency play out and the yen were to fall, this could be very good for the Japanese equity market—for those U.S. investors who are able to hedge that currency risk.

### THE YEN AND ITS EFFECT ON EXPORTERS AND EQUITY MARKETS



Source: Bloomberg

Past performance does not guarantee future results.

We saw earlier in the commentary that there was a negative correlation between the big exporting companies in Japan and the yen, which has resulted in a consistent headwind for the equity markets, given that the yen has been in a 20-year period of appreciation vs. the U.S. dollar. Many of these companies derive significant portions of their revenues from overseas (and the U.S. in particular); therefore, minor gains in the yen relative to the U.S. dollar can have a meaningful and negative impact on the operating profits of these exporters. For instance:

**+ Japan's electronics companies lose a combined ¥31.8 billion (\$383 million) in annual operating profit for each ¥1 appreciation against the U.S. dollar.<sup>10</sup>**

For each one point move in the yen:<sup>11</sup>

**+ Toyota: Operating profits are impacted by ¥30 billion (\$361 million) for each ¥1 gain.**

**+ Honda: Annual operating profit is reduced by ¥16 billion (\$193 million) for each ¥1 gain.**

**+ Suzuki: Annual operating profit lowered by ¥4 billion (\$48 million) for each ¥1 gain.**

**+ Sony Corp: Receives 70% of its revenue in foreign currency, and estimates that it loses ¥2 billion (\$24 million) of annual operating profit for each ¥1 gain against the U.S. currency.**

During the last four years, the yen has gone from ¥120 to the dollar to ¥80—a significant appreciation. The yen tends to attract flows when global investors appear to be most risk averse, as many consider the currency a safe haven investment.

Any number of factors could act as a catalyst for the weakening yen, including Japan's structural dilemma leading to inflationary measures, the global economy continuing to stabilize and grow, the shift in investors' mind-set to shed risk-averse strategies, etc. As the global economy strengthens and global interest rates increase relative to the Japanese interest rates, investors may look to flee the yen and invest in assets that offer potential for gain. The country's largest exporters are poised to reap the rewards of a depreciating currency, and if the negative correlations experienced over the last three years continue to play out, that could lead the equity markets higher. However, U.S. investors who ignore the currency implications could potentially be hamstrung by a depreciating yen, even if the equity market rallies.

Below we review in more detail the three Ds of Japan, Debt, Deficits and Demographics, and why they have the potential to place pressure on the currency over time.

## **MOUNTING DEBT AND DEFICITS**

Debt issuance in Japan has more than quintupled since 1985, approaching 200% of its GDP, while tax revenues have actually decreased by ¥15 trillion (\$181 billion). The Japanese government remains in a difficult situation as it attempts to deal with its long-term fiscal problems while somehow trying to spur economic growth.

According to the Wall Street Journal, such is the dire state of Japan's fiscal situation that the budget announced on December 24, totaling ¥92.4 trillion (\$1.11 trillion), continued to rely more heavily on revenue from new bonds, projected at ¥44.3 trillion (\$534 billion), than on tax receipts, estimated at ¥40.9 trillion (\$493 billion).<sup>12</sup>

<sup>10</sup> Source: Daiwa Research

<sup>11</sup> Exchange rate conversion data based on 83 yen per U.S. dollar (exchange rate as of 1/7/11).

<sup>12</sup> Nakamichi, Takashi, December 26, 2010, "Japan's New Budget Strains to Curb Debt, Spur Growth." Wall Street Journal Online; <http://topics.wsj.com/article/SB20001424052970203568004576043130330414122.html>

## AGING DEMOGRAPHICS

Japan faces a troubling demographic: as a country of net savers, holding approximately 94% of the government debt, approaches retirement age, they will need to draw down assets to fund their lifestyles. Estimates for 2055 suggest that nearly two out of every five Japanese citizens will be 65 years or older.<sup>13</sup> If they are no longer net buyers of Japanese government bonds, then who will be and at what cost? Hedge fund manager Kyle Bass believes that Japan is fast approaching a “Keynesian end point,” suggesting that Japan is on an unsustainable course, which could force the government to issue an increasing amount of bonds to fund the shortfall in collected tax receipts in order to service existing debt. The current social security expenditures and interest payments on debt total were about ¥44 trillion (\$534 billion), but tax revenues were only ¥41 trillion (\$493 billion), so one can ask how long that borrowing can continue. The demographics do not help Japan’s cause.

## TURNING LEMONS INTO LEMONADE: JAPANESE EQUITIES REMAIN LARGELY IGNORED

Despite the problems the government of Japan faces and the pressures that could result on its currency, in our opinion, Japanese equities present an attractive opportunity based on the negative correlation between the equity and the currency markets and the fact that valuations are relatively low in Japan.

Edward Chancellor, asset allocation strategist at GMO, wrote of the contrarian opportunity Japan presents:<sup>14</sup>

*[It] is possible to paint a brighter picture of a Japanese sun that has not permanently set but is merely hidden behind a cloud. ... Japanese companies have reduced their indebtedness to such an extent that they are now net recipients of interest payments (including dividends). ...*

*There is the margin of safety to consider. Japanese equities are priced at a discount to book value. Companies also sit on large cash balances and are less leveraged than their U.S. counterparts. Many stocks in Japan meet Ben Graham’s<sup>15</sup> criteria for cheapness, sustained profitability and robust balance sheets.*

*There is no doubt Japan faces severe challenges. Yet it is hard to avoid the conclusion that today’s apocalyptic discussion is overblown. Therein lies the investment opportunity.*

<sup>13</sup> Source: World Bank population estimates

<sup>14</sup> Chancellor, Edward, “Japan begins to look pretty cheap,” Financial Times, December 5, 2010

<sup>15</sup> Benjamin Graham was an American economist, investor and finance professor who authored the influential books *Security Analysis* and *Intelligent Investor*.

## WISDOMTREE SOLUTION

The WisdomTree Japan Hedged Equity Fund (DXJ) offers investors the ability to access the dividend-paying companies of the Japanese equity market while mitigating the currency fluctuations between the yen and the dollar. Key features of DXJ:

- + **Two trades in one low-cost exchange-traded Fund (ETF): 1) long the Japan equity markets in USD and 2) exposure to yen neutralized with currency hedge.**
- + **DXJ thus strives to achieve the returns of local Japanese equity market.**
- + **Japan ETF with lowest expense ratio<sup>16</sup>: 0.48%.**
- + **Fund assets under management as of December 31, 2010: \$122 million.**
- + **WisdomTree first added the hedged currency feature to DXJ on April 1, 2010. Prior to April 1, 2010, DXJ tracked the WisdomTree Japan Dividend Index, which represents the same equities that the Fund invests in today but without the currency hedge.**
- + **DXJ is designed to track the WisdomTree Japan Hedged Equity Index, and the Index fundamental statistics are illustrated below as measures of valuation and Index characteristics.**

## INDEX FUNDAMENTALS: WISDOMTREE JAPAN HEDGED EQUITY INDEX<sup>17</sup> [ as of December 31, 2010 ]

<b>Market Capitalization (\$ Billion)</b>	\$3,068.80
<b>Constituents</b>	790
<b>Dividend Yield</b>	2.57%
<b>Price/Earnings Ratio</b>	15.66
<b>Price/Book Ratio</b>	1.04
<b>Price/Sales Ratio</b>	0.56
<b>Since Index Inception Return</b>	0.00%

<sup>16</sup> Ordinary brokerage commissions apply.

<sup>17</sup> Index dividend yield is a measure of the annual dividends of the shares of all Index components divided by the Index value. Price/Book ratio is a ratio used to compare a stock's market value to its book value. Price/Earnings ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Price/Sales ratio is a ratio for valuing a stock relative to its own past performance, other companies or the market itself.

Holdings are subject to change.

The sources, opinions and forecasts expressed are as of January 2011 and may not actually come to pass. This information is subject to change at any time based on market and other conditions and should not be construed as a recommendation of any specific security. Past performance is not a guarantee of future results.

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The MSCI EAFE Index is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

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