

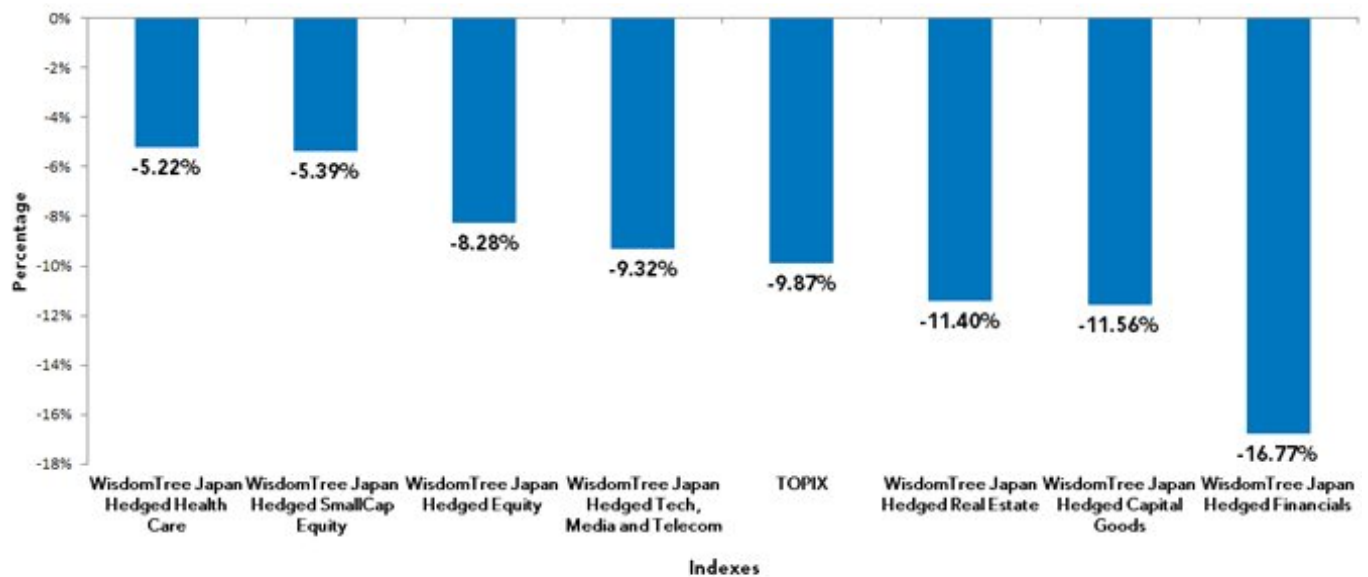
Why the Sun Is Still Set to Rise in Japan

Published May 13, 2014

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Among financial markets, 2013 was the year of Japan. Investors rushed into Japanese financial assets with great excitement, motivated by the policies of abenomics, which aim to end deflation and restore economic growth. These flows were manifested in positioning for a weakening of the yen that led to enthusiasm about Japan's stock market, which tends to trade inversely to the currency. However, since the beginning of 2014, the sun has been covered by clouds, and Japan has become a market that investors love to hate. But let's be clear: clouds cannot stop the sun from rising. Given the pullback in the first four months of 2014 and the underlying earnings growth, I believe Japan now offers a new attractive entry point. Much has been made of the implementation of a consumption tax hike from 5% to 8%. Yes, this is a short-term negative for Japan's local consumption. But Abe is trying to restructure the tax code and lower corporate tax rates to make Japan a more attractive place to do business. This should be good for corporate profits in the longer run. Expect more consumption tax hikes next year, pushing the rate to 10%, which will be offset by lowered corporate tax rates. Some have called for the Bank of Japan (BOJ) to provide additional monetary expansion. Make no mistake—the BOJ stands ready to take more action if its 2% inflation target is not met. But one should not overlook how aggressive its monetary programs already are. The Fed, for instance, has been tapering its accommodation program and is purchasing \$45 billion of securities a month as of April 30. Japan, with an economy one-third the size of the U.S. economy, is expanding its balance sheet by about \$75 billion a month—and not just in bonds but real estate and equities as well. The BOJ remains, by far, the most expansionary central bank in the world, providing plenty of liquidity to Japan and the global financial system.¹ We are still in the early innings of Abenomics, and many of those policies, such as reducing excess capacity, have a deflationary bend to them. Abe will be announcing more of his "third arrow" policies in June—this could be part of a catalyst to re-evaluate the negative sentiment that has gravitated to Japan in 2014, despite a continued growth in earnings. While prices have fallen, earnings expectations have actually increased over the period², so every dollar of earnings from Japan has gotten cheaper. The estimated [price-to-earnings ratio](#) is currently 11.7x and 12.9x for the WisdomTree Japan Hedged Equity Index (WTIDJH) and TOPIX, respectively. For perspective, the [S&P 500 index](#) is currently trading at 16.0x estimated earnings, over a 36% premium compared to WTIDJH and a 24% premium to the TOPIX. As investors look to capitalize on these discounted valuations, consider the following nuggets about Japanese market performance this year: **Japan Index Performance**



Sources: WisdomTree, Bloomberg (12/31/13–04/30/14). Past performance is not indicative of future results. You cannot invest directly in an index.

• **Small Caps Lead:** I find it impressive that small caps were able to outperform their large-cap peers during the most recent pullback. Typically, one would expect small caps to have a higher beta exposure. Also, since the consumption tax hike is one of the most controversial policies this year, one might expect small-cap stocks—which are local to the economic performance—to be hit the most. But they have actually been the best performers, which might indicate that the consumption tax hike is not as big a deal as many claim. • **Yen-Sensitive Capital Goods Stocks Underperform:** The capital goods sector draws only 40% of its revenue from Japan, the rest coming from overseas.³ This is a higher beta sector, and it did decline more than the TOPIX or WisdomTree's broad-based Japan Hedged Equity Index. This reflects, in my view, yen sensitivity and global growth concerns (i.e., China) more than concerns over Japan's local economic performance. • **A Large Divergence between Sectors:** The 10-percentage-point difference between the WisdomTree Japan Hedged Financials Index (WTJFH) and the WisdomTree Japan Hedged Health Care Index (WTJHCH) is quite large. The health care stocks, typically more defensive, have high dividend yields and have been focal points for some individual investors in the new tax-incentivized savings accounts being set up in Japan. The financials are the cheapest part of the market and could be a higher beta exposure for those who want to make a contrarian allocation in the “cheapest” part of Japan, as measured by the price-to-earnings ratios or [price-to-book ratios](#). **Land of the Rising Sun** I believe 2013 marked the start of a multi-year bull market in equities, and this recent pullback offers an opportunity to increase under-weight allocations or add new positions. Japan is one of the lowest-priced regional markets on a price-to-earnings basis and the only market that actually had earnings outpace price gains over the most recent year.⁴ I believe equity markets will remain supported as Abenomics continues to gain traction and especially as Abe makes more progress on his growth strategy for Japan (the third arrow of Abenomics). While broad-based approaches should continue to serve many investors well, I believe there is also a place for more finely honed precision tools, such as sector allocations or small caps, to express specific views regarding how Abenomics will play out. ¹Sources: WisdomTree, Bloomberg

(04/30/14) 2Period: (12/31/13-04/30/14) 3Sources: WisdomTree, Bloomberg, as of 12/13/13 4Sources: WisdomTree, Bloomberg. Most recent year is 04/30/13–04/30/14

Important Risks Related to this Article

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