JAPAN: OPENING UP THE PLAYBOOK

Wisdomtree EU
28 Apr 2021

Investors who withstood last spring's volatility have a good problem to solve for.

S&P 500 returns since its 23 March 2020 low have been remarkable well over 80%[1]. But with this head-spinning rebound has come unattractive valuations. Multiples have expanded from 13 times forward 12-month earnings last March to nearly 23 times forward 12-month earnings today[2].

With valuations on the S&P 500 the highest it has been since the early 2000s, investors may want to consider "opening up the playbook" potentially reducing US equity exposure, a large chunk of most global benchmarks, and possibly seeking more areas considered to be attractively valued, such as Japan.

Can Headwinds Bring Opportunity?

Arguably no market has been more unloved in recent years than Japan. There are a few theories as to why:

- **Sector Composition:** A lack of domestic tech mega-caps in favour of cyclical sectors like Autos and Banks has been a headwind for Japanese indexes during a global rally in growth stocks

- **Policy mistakes:** A government that has made a handful of policy missteps particularly with consumption tax hikes in 2014 and 2019

- **Ageing population:** Demography is destiny, or so it's said. There has been fear that an ageing population in Japan will put a lid on the country's long-term growth potential, coupled with a chronically low equity investment from a notoriously conservative domestic investor base

Figure 1 shows how non-Japanese investors have been decreasing their investment in Japanese equities in recent years to the point where they are now below where their allocations were when the 'Abenomics[3]' period began.

Figure 1: Cumulative Foreign Net Equity Investment (¥ Bn)

Source: Japan Ministry of Finance. 4 January 2013-4 February 2021.

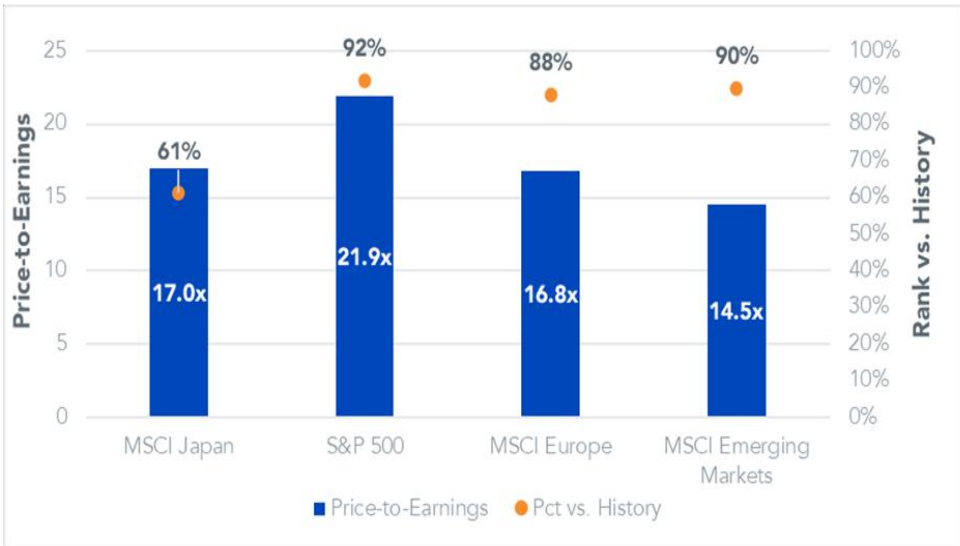
Historical performance is not an indication of future performance and any investments may go down in value.

In part as a by-product of low investor interest, Japanese equities can be considered discounted relative to the US equity market, which is again a rather large part of most global benchmarks. Japanese equities typically also have a much lower valuation relative to their history than most other major markets:

- Figure 2 shows that the MSCI Japan Index had a Price-to-Earnings Ratio – P/E in the 61^{st} Percentile in other words, less expensive than 39% of monthly observations going back to the end of the year 2000.

- The S&P 500 Index, by contrast, had a P/E ratio in the 92^{nd} Percentile in other words, less expensive than only 8% of monthly observations in the same period.

Figure 2: Current Valuations vs. History (31 December 2000-31 March 2021)



Source: WisdomTree, MSCI, S&P, FactSet. Price-to-Earnings as of 31 March 2021. Rank vs. history using monthly observations between 31 December 2000 and 31 March 2021.

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Japan's position as a market may be perfectly primed for an environment in which economic growth is expected to make a significant recovery in the coming years.

For example, WisdomTree's Japan Hedged Equity Index which tilts more towards cyclical sectors than the broad MSCI Japan Index has outperformed the S&P 500 by over 800 basis points since the end of August 2020 when measured on a basis of hedging the yen vs. US dollar exchange rate:

There was a response in the WisdomTree Japan Hedged Equity Index during the period of the cyclical rotation trade, defined in Figure 3 as 31 August 2020 to 8 April 2021.

Figure 3: Japan for Cyclical Rotation

S&P 500 Sector Returns and Japan	
Year-to-date (31 Dec 20–8 Apr 21)	Cyclical Rotation Trade (31 Aug 20–8 Apr 21)
29.54% - Energy	41.49% - Energy
18.79% - Financials	41.28% - Financials
13.83% - Comm. Svc.	29.39% - Industrials
12.72% - Industrials	27.51% - Materials
11.98% - Japan	26.70% - Japan
11.22% - Real Estate	21.18% - Comm. Svc.
9.92% - Materials	18.18% - S&P 500
9.54% - S&P 500	14.33% - Real Estate
7.93% - Info. Tech	14.20% - Info. Tech
7.29% - Cons. Disc	12.28% - Utilities
4.21% - Utilities	11.73% - Cons. Disc
3.14% - Health Care	9.02% - Health Care
2.44% - Cons. Staples	7.34% - Cons. Staples

Source: WisdomTree, S&P, FactSet. Japan measured by the WisdomTree Japan Hedged Equity Index Net Total Returns. You cannot invest directly in an index.

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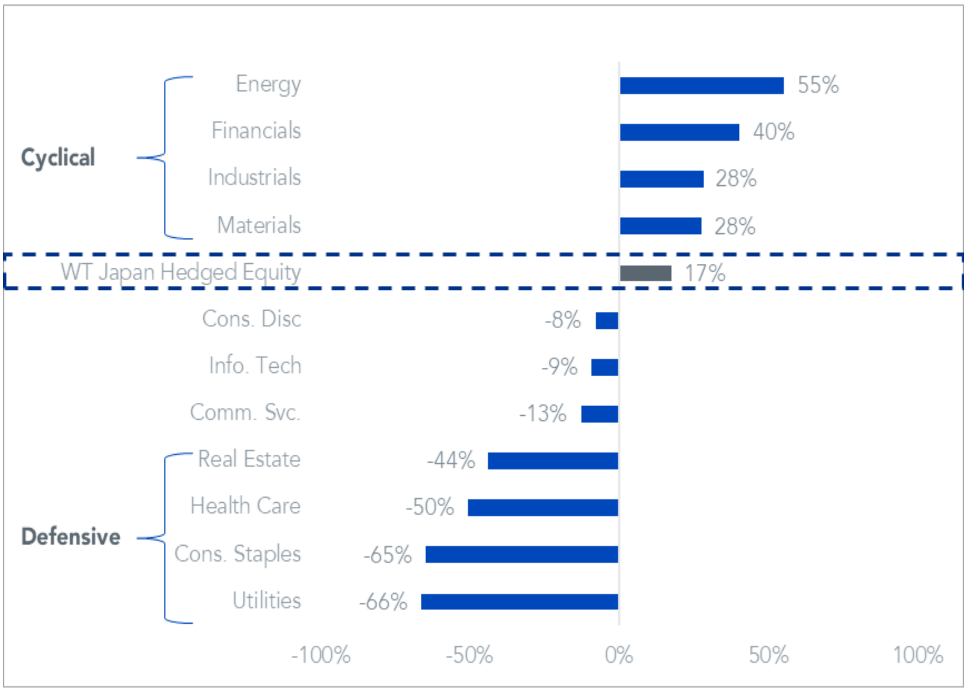
The S&P 500 is up over 9% to start the year despite concerns over rising interest rates[4]. Nonetheless, the potential for higher rates becoming a headwind to both fixed income and equity returns remains a top concern among asset allocators.

Given the cyclical tilts of the Japanese equity market, as well as the tendency for the yen to weaken alongside a rise in US rates, the WisdomTree Japan Hedged Equity Index has historically had a positive correlation between its outperformance and rising US treasury yields.

Figure 4: Trailing 3yr Correlation: Excess Returns vs. 10-Year US Treasury Yield



Source: WisdomTree, S&P, FRED. Correlation measures monthly excess returns relative to the S&P 500 between 31 March 2018-31 March 2021. Sector returns from S&P 500 sectors. Japan measured by WisdomTree Japan Hedged Equity index. You cannot invest directly in an index.

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Conclusion:

The steady and reliable earnings growth from US mega-caps powered both the US, and by extension global indices higher over the past few years. With US valuations now near two-decade highs and the potential for a synchronized global recovery on the horizon

Sources

[1] Bloomberg

[2] Bloomberg

[3] Economic policies implemented by the Government of Japan

[4] Bloomberg

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