JAPANESE ELECTION RESULTS CONTRIBUTE TO WEAKENING YEN AND STRONGER EQUITY PERFORMANCE

Jeremy Schwartz – Global Chief Investment Officer
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The Japanese election results came in, and the markets got their wish—Shinzo Abe and the Liberal Democratic Party (LDP) produced a landslide victory in the December 16 election. Abe made the war on both deflation and the strengthening yen central objectives of his candidacy. Along these lines, he has called for very aggressive and potentially unlimited monetary easing policies by the Bank of Japan (BOJ) to weaken the yen. Most of all, he has stressed his intention to hold the BOJ accountable to these goals, threatening to remove the central bank's independence if it fails to act. The majority of Abe's coalition government is now large enough to single-handedly implement his policies. The markets were predicting this outcome, and the yen had already started weakening compared to the U.S. dollar over the last month, when there were calls for a new election and Abe appeared to be the frontrunner. I believe this is critically important for the MSCI Japan Local Currency Index (Japan's equities), which has experienced performance that has tended toward a sharply negative correlation with the currency's seemingly unending strength.[1] In other words, as the yen has tended to appreciate relative to the U.S. dollar, Japan's equities have tended to decline. **What are potential targets for the yen?** I remember when WisdomTree launched its first Japan Fund on June 16, 2006, and the exchange rate was approximately 120 yen to one U.S. dollar.[2] Today, December 17, 2012, it's approximately 84 yen to the dollar.[3] I think about Toyota selling a car for $20,000—and the 2.4 million yen they used to receive has been cut down to 1.68 million yen today.[4] The revenue hit to Japan's multinationals over these six years has just been incredibly hard for corporate Japan—specifically the companies that depend on exports for the bulk of their revenues. No one knows what target level Abe has for the yen, but if he can produce a psychological shift in the prospects for the currency, I believe that there could be major moves over the next few years. As a baseline, from the December 17, 2012 level of approximately 84 yen to the U.S. dollar, a 50% depreciation of the yen relative to the dollar would bring the value of the yen close to the 120-yen-per-dollar level seen around June 16, 2006. I am not expecting that to happen in the immediate future, but it provides a sense of how significant the yen's performance relative to the U.S. dollar has been over this period. Over the short run, I believe there is potential for many swings in the yen's value relative to the U.S. dollar. This week there is a monetary policy meeting at the BOJ, and announcements of more monetary easing policies are expected. The question awaiting an answer is, Will the BOJ dig in and be more conservative in their easing, or will they acquiesce to the calls for more aggressive measures quickly? The term of the current head of the BOJ, Masaaki Shirakawa— essentially Japan's Ben Bernanke, the Chairman of the Federal Reserve in the United States—is expiring in April, and given the December 16, 2012, election results, he may end up being replaced by a leader more supportive of Abe's aggressive calls to action on monetary policy. There is the possibility that the notably more conservative Shirakawa could disappoint the market in the short run by failing to quickly implement an aggressive monetary policy, but many may look forward to next year, when Abe can more greatly influence policy. Of course, we also have the fiscal cliff issues in the U.S., which I believe will impact sentiment on the foreign exchange market. If there is a deal accomplished in the U.S. in the next few weeks that removes some uncertainty about the U.S. economy, this could provide another catalyst for downward pressure in the yen relative to the U.S. dollar. **Hedging Currency and Multi-National Exposure** The weakness in the yen and Japan's corresponding strength in the equity markets that we have seen due to this election illustrate the central motivation behind the WisdomTree Japan Hedged Equity Fund (DXJ). DXJ tracks the returns generated by the WisdomTree Japan Hedged Equity Index, after costs, fees and expenses. We implemented a change to this index on November 30, 2012, to reposition the Fund to allocate more weight to companies that derive at least 20% of their revenues from overseas and whose prospects and equity performance have greater potential to be inversely correlated to the currency's moves. With one of Shinzo Abe's primary goals being to weaken the yen, I believe DXJ is a valuable implementation vehicle to express a view that Abe will be successful in this battle. To read more about how the Index became positioned, please see this commentary. [1] Source: MSCI. The MSCI Japan Local Currency Index delivered a negative average annual return of approximately 1.2% from 11/30/1992 through 11/30/2012, while the yen has appreciated approximately 2.2% per year over the same period. [2] Source: Bloomberg. [3] Source: Bloomberg. [4] This is a hypothetical example developed by WisdomTree to illustrate how a changing exchange rate can lead to a changing level of revenues for a company that exports its products. In general, an exporter receives units of a foreign currency that have to be converted back to the exporter's home currency. If the units of the foreign currency have greater value compared to the units of the home currency, more units of home currency are gained on the conversion. If the home currency has greater value, fewer units of home currency are gained on the conversion.

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