JAPAN DIPS INTO RECESSION AS "JAPAN, INC." PROFITS SET NEW HIGHS

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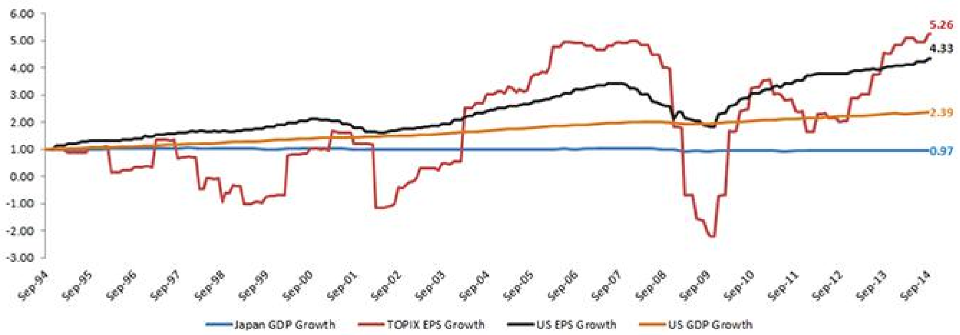
Japan's economy dipped into a surprise recession in the third quarter, causing many investors to question the economic platform of Prime Minister Shinzo Abe. The initial focus has been on the second stage of the consumption tax hike, which was blamed for the setback. The economic contraction seems to be triggering leadership in Japan, including the Ministry of Finance and the Bank of Japan (BOJ), to re-evaluate how to coordinate through supplemental fiscal budget rather than austerity measures designed to raise tax revenue—as well as even further monetary stimulus. While Japan's economic numbers are interesting for economists to debate policy prescriptions, these numbers are, in our opinion, the wrong data for investors to be focusing on. **Corporate Profits More Important than Gross Domestic Product (GDP) Growth** When investors buy Japanese equities, they don't really buy a slice of that economy; they buy shares in corporations that operate both in Japan and around the world. "Japan, Inc." (i.e., Japanese corporations) is showing a profit picture that differs dramatically from the country's economic growth rate. And this is helping to maintain attractive valuations in Japan. Despite having the best price gains—70.7%—from the start of Abe's reign through October 2014, earnings are up nearly 72%, which is more than any other major regional market[1]. Additionally, it is also the only major developed region (the U.S., Europe and broader MSCI EAFE Index markets included) to see a contraction in its price-to-earnings (P/E) ratios since the start of Abenomics, while the U.S., Europe and EAFE saw multiples expand 23%, 22% and 14%, respectively[2]. Critically for future returns, what are the prospects for future earnings growth and corporate profitability? We think they're promising: **Higher Profit Margins Paving the Way for Robust Earnings Growth--GDP v.s EPS Growth Japan**



	GDP Growth*			Growth in EPS			Profit Margin			ROE	
	Japan	U.S.		TOPIX	S&P 500		TOPIX	S&P 500		TOPIX	S&P 500
						10/31/2014	4.44%	9.58%	10/31/2014	8.46%	15.17%
1 Year	0.80%	3.93%	1 Year	16.48%	7.33%	10/31/2013	4.10%	8.92%	10/31/2013	8.22%	14.34%
3 Year	0.60%	4.00%	3 Year	30.13%	6.86%	10/31/2011	2.32%	9.10%	10/31/2011	4.71%	15.26%
10 Year	-0.42%	3.55%	10 Year	5.71%	5.89%	10/29/2004	3.09%	7.66%	10/29/2004	7.42%	15.74%
20 Year	-0.17%	4.44%	20 Year	8.65%	7.59%	10/31/1994	0.90%	5.27%	10/31/1994	2.34%	14.53%

Sources: WisdomTree, Bloomberg, 10/31/94–10/30/14. *GDP growth of the nominal/"current" data series, seasonally adjusted annualized, for the stated periods ending June 30, 2014. Start date coincides with longest data availability provided by the Economic and Social Research Institute of Japan. Past performance is not indicative of future results. ROE: Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

For definitions of terms and Indexes in the chart, visit our glossary. • **GDP Growth ? Profit Growth:** Despite lackluster GDP growth that trailed the U.S. by more than 4.5% annually for 20 years, Japan's earnings per share (EPS) growth for TOPIX not only rivaled but surpassed that of the U.S. during that time—with especially compelling growth in the last one and three years with the revival of the weakening yen and coinciding with the start of Abenomics. • **More Room for Profit Margin Expansion?** In the Unites States, profit margins grew from 5.27% in 1994 to 9.58% in 2014—and many worry that the United States is at a cyclical peak in profit margins, causing future pressure on EPS growth. Japan's margins have surely grown, but at rates that are less than half those of the United States; it is possible for Japan to show even more room for improvement. • **Improving Profitability and Corporate Governance:** While the U.S. return on equity has increased marginally over the last 20 years, Japan's has increased markedly and remains below that of global peers. There are signs of pressure on Japan to be more competitive globally on a return-on-equity focus. In January, the government encouraged the development of the JPX-Nikkei 400 Index, which sought to reward and emphasize more profitable, higher-ROE companies. The Index is ultimately intended to serve as a new benchmark for large allocations from both the Japanese pension funds and the Bank of Japan in their exchange-traded funds (ETF) purchases. Some have referred to this Index as a "shame index," highlighting companies not included and pressuring them to increase ROE. We are already seeing signs of increased dividends and buybacks to better manage balance sheets. • **Japanese earnings have grown 526%** cumulatively from October 1994 to October 2014: Such envious growth was achieved against a backdrop of lackluster Japanese economic growth averaging -0.17%. Let's contrast this with the 433% cumulative growth achieved under "more normal" conditions in the U.S., averaging a 4.44% GDP growth number in nominal terms. This suggests that Japan has vast earnings growth potential that has yet to be unlocked. It's important to note that over the last 20 years, none of these earnings metrics has shown any correlation to Japanese GDP's relative stagnation. To reiterate, Japan, Inc. has grown profits from its global operations, while Japan's local economic performance has languished. In a nutshell, performance in the Japanese equity markets thus far has been strongly supported by earnings growth. When people talk about the Japanese economy and whether it can weather another bout of a consumption tax hike in the future, remember an important formula: **GDP growth ? profit growth**, or stated differently, **GDP growth ? equity market potential.** Japan, Inc.'s overall profit profile is clearly being boosted by its global nature. This is one reason WisdomTree has focused on the exporters of Japan that we think are bound to reap longer-term gains from the more competitive yen exchange rates. This is a new trend that we see in place for the coming years based on shifting monetary accommodation at the Bank of Japan and the U.S. Federal Reserve. We thus think investors should stay favorable to Japan despite the recession headlines. [1]Sources: WisdomTree, Bloomberg, 11/30/12–10/30/14, numbers are based off of the forward earnings filed on Bloomberg. [2]Sources: WisdomTree, Bloomberg, 11/30/12–10/30/14, numbers are based off of the on forward P/E filed on Bloomberg.

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DEFINITIONS

Fiscal budget : is a period used for calculating annual budget requirements for a country or an organization or company.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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.

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.

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.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Profit margins : 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.

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

JPX-Nikkei 400 : is composed common stocks whose main market is the TSE 1st section, 2nd section, Mothers or JASDAQ market (in principle). The components are reviewed annually to keep the representativeness of the market. The Annual Review shall be conducted at the end of August as follows.(1)1000 stocks are selected based on trading value in the past 3 years and the market value on the selection base date (the end of June) of the Annual Review, (2)Each stock is scored by 3-year average ROE, 3-year cumulative operating profit and market value on the selection base date with the weights on the each indicator 40%, 40%, 20% respectively, (3)400 stocks are selected by the final ranking with the scores calculated in (2) and qualitative factors from the perspectives of corporate governance and disclosure. In case of delisting of the components due to a merger or bankruptcy etc, new stocks shall not be added in principle. When the Annual Review is conducted, the number of components is back to 400, therefore the index is calculated with less than 400 components until then.

Dividend : A portion of corporate profits paid out to shareholders.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

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 the opposite direction.