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# THE YEN CARRY TRADE UNWINDS: WHAT'S NEXT?

Jeremy Schwartz – Global Chief Investment Officer, Jeff Weniger – Head of Equity Strategy  
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Recent central bank actions and currency interventions have created shock volatility in the markets, leading to large-scale position selling across the world, but particularly in East Asia. On Monday, [Japan's Nikkei 225](#) dropped over 10%, one of its biggest moves since the 1987 crash. The market has largely stabilized as we write.

Japan has been one of our top long-term favorite markets. This short-term turmoil has brought an influx of questions as to whether we are still bullish, along with inquiries about how to handle the currency hedging question.

*Our house view is that this sell-off is an attractive buying opportunity.*

To summarize:

## What Changed?

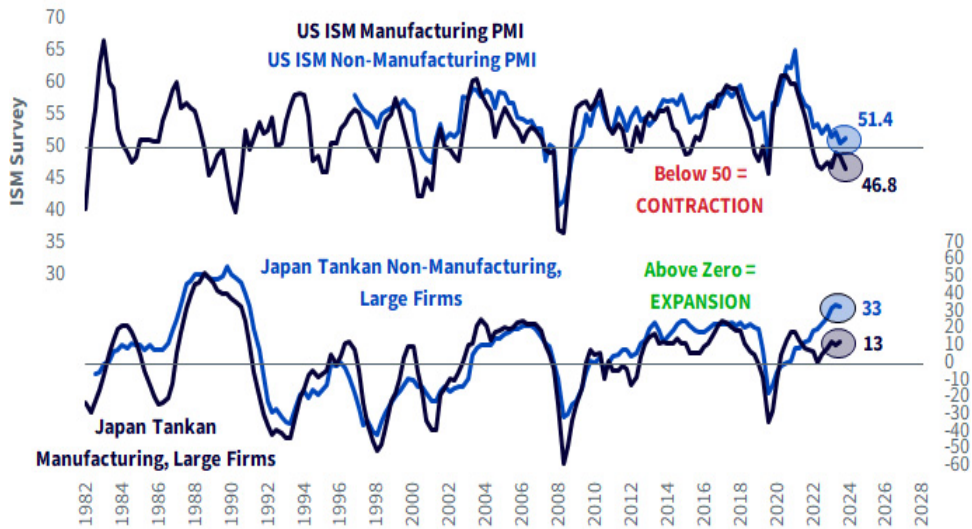
- **Narrative-wise:** Quite a bit. Soft U.S. labor and inflation readings led to fear that the Federal Open Market Committee (FOMC) was making a policy mistake by keeping rates in the current 5.25%–5.50% band. In turn, this led to anticipation of deeper and quicker rate cuts.
- **Elsewhere:** The Bank of Japan (BoJ) raised rates marginally last week, from a 0.0%–0.10% range to “around 0.25%,” along with some hawkish plans with respect to quantitative tightening (QT). In combination with the perceived shift in the outlook for the FOMC, this led to a dramatic unwinding in leveraged positioning across the USD/JPY complex.

It is important to note that currencies trade on the future, not the present—and the future differential between U.S. and Japanese yields narrowed quickly. The yen snapped stronger in response.

## What Didn't Change?

- **Fundamentally:** Labor market indicators softened but remained positive. U.S. manufacturing remains weak and disappointing, but this is the status quo. We and others have been highlighting the pain in domestic manufacturing for the better part of 18 months. The services sector—the largest component of the U.S. economy—remains in expansion mode, although the Street's consensus is that this former strong point is weaker than it was in 2022 and 2023.
- In Japan, interest rates were increased because the economy is moving along in a satisfactory manner. No champagne or fireworks out of Japan, but its Tankan surveys are in expansion mode (Figure 1).

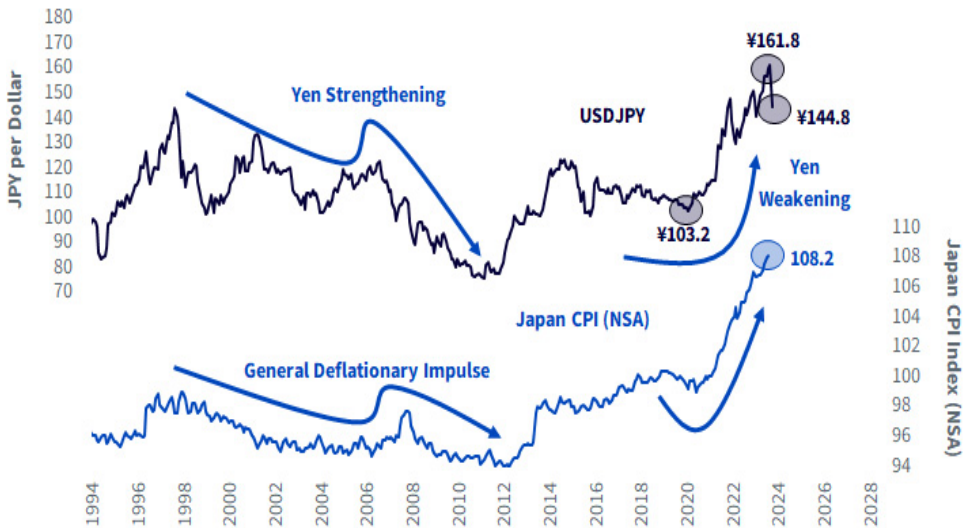
**Figure 1: Japan and U.S. PMIs Are Diverging**



Sources: Refinitiv, ISM, Bank of Japan, as of July 2024 for the U.S., and Q2/2024 for Japan.

- **U.S. Interest Rate Outlook:** The jobs report suggests the labor market was cooling, not falling off a cliff. Against that backdrop, the Treasury rally could very well be overextended.
- **In Japan:** Nothing changed, as far as we can tell. Aside from the BoJ signaling confidence that it could move the policy rate higher, the main bullish drivers, such as corporate governance reform, have witnessed no material news flow in either July or August. The country is flirting with an inflationary vibe for the first time in decades; JPY at ¥144.8 is a driver of that impulse. Though it is stronger than where the market stood last week, it remains remarkably accommodative.

Figure 2: The Yen’s Post-Covid Weakness Has Ushered in an Inflationary Backdrop



Sources: Refinitiv, Statistics Bureau, Ministry of Internal Affairs & Communication, Japan, as of June 2024 for CPI. JPY exchange rate as of 8/6/24.

- **The Opportunity:** There are a few Japanese companies that will be negatively affected by the change in [foreign exchange cross rates](#). But many had already issued earnings guidance based on an exchange rate in the ¥140s. JPY weakened earlier this summer, rapidly, to ¥162. This move simply snapped the pair right back into the ¥140s, where the exchange rate last rested in Q1.

We believe Japanese equities crashed because leveraged market participants received margin calls, not because the fundamental outlook for Corporate Japan has changed.

Over the long run, currency risk brings added volatility and an extra bet that is not core to a long Japan thesis, which we think rests primarily on relative valuations.

The country has positive catalysts, namely the follow-through on corporate promises that we have been highlighting for years. The big one is the Name and Shame List, which identifies companies who have not fixed their profitability metrics. The Tokyo Stock Exchange threatened it, and many shook their heads and said it would never happen. Then voila, the TSE called those bluffs and published the list, right there on the home page of their website.

Additionally, we would be remiss if we didn't give a hat tip to the country's position as a friendly player in Washington. It offers something of a geopolitical tailwind in the event China's hawkishness deepens or simply remains consistent. On the matter of Trump tariffs, this has been a known quantity for how many months, if not years? Markets move on surprises; a 10% tariff on Japanese exports is so well-telegraphed that it would surprise zero Japan watchers.

*We believe a hedged-currency Japan position should outperform the S&P500 over the next five years.*

Consider our arithmetic:

The S&P 500 is priced at 21 times earnings. The reciprocal is the earnings yield, which is less than 5%. Add expected inflation of 2%-3% to arrive at a medium-term return estimate for the S&P 500 of maybe 7%-8%.

Now Japan.

If we own equities with a currency hedge, which is the way most WisdomTree investors do it, the carry from the currency forward contracts is above 5%—at the moment. It is now “everyone's” base case that the Fed and BoJ will change that, so let's price in a slide in this gap between U.S. and Japanese short rates to something like 3% in 2025.

The [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#), our flagship currency-hedged equity ETF, is priced at 10-11 times earnings. The reciprocal of that is the earnings yield, about 9%. Add the aforementioned carry of approximately 3% and the combination presents nominal returns from this exercise of more than 12%.

When comparing a country with a sub-11 forward P/E (Japan) and one whose P/E is 21 (the U.S.), we have to check for an earnings growth disparity. But we can't find one, at least not a big one. The Street consensus is for Japanese corporate earnings to grow in the high single-digit area for the fiscal year ending March 2025. This is not far off FactSet's 2024 S&P 500 earnings growth aggregation, which points to a 10.7% YoY rise.

In Japan's case, we believe it is a misnomer that earnings estimates would be revised down from the yen's sudden appreciation; many Japanese corporates were guiding earnings based on an exchange rate in the ¥142-144 range. It was trading there, then it bolted into the ¥160s—and now it has bolted back there once again. A round trip.

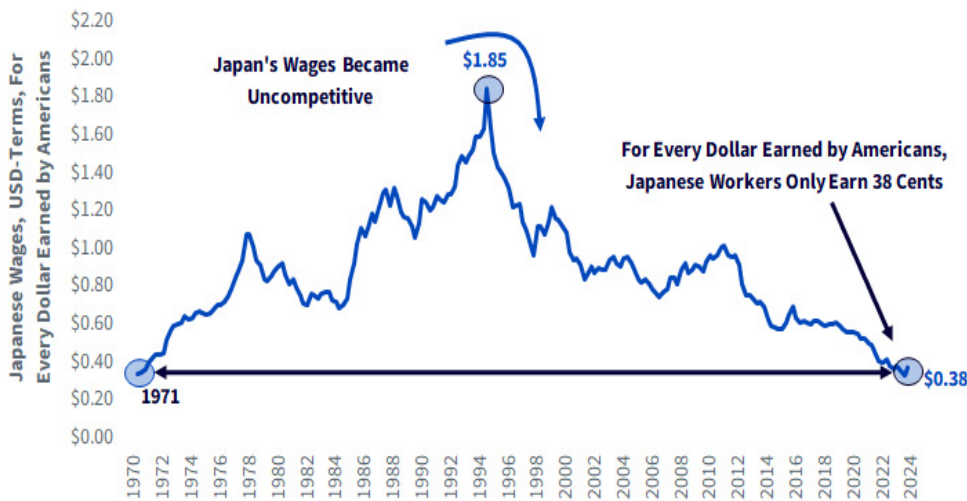
Additionally, we remain stunned at how little attention Japan's cost of labor arbitrage receives in secular outlooks.

Using averages from the [Organization for Economic Cooperation and Development \(OECD\)](#) in U.S. dollar terms, Japan's relative wages peaked in June 1995, when workers there earned 85% more than U.S. counterparts (Figure 3). In retrospect, the play back then would have been to sell Japan to buy U.S. equities, especially since the Netscape IPO that kicked off the U.S. tech mania occurred later that summer.

Today, the situation has strikingly changed. Japanese workers no longer earn \$1.85 for

every buck earned by Americans; they earn 38 cents.

Figure 3: Japan Wages vs. U.S. Wages (USD Terms)



Sources: Refinitiv, OECD, as of Q3/2024 with currency conversion as of 8/6/24.

### Is it Time to Take Off the Yen Hedge?

Remember, we have been doing this for a couple decades, so at this point, WisdomTree has a large number of ETFs that currency hedge and a large number that do not. Which approach to take is often a matter of personal preference but allow us to share the Berkshire case study, which we think is helpful in making the choice.

The reader may be aware that Berkshire bought a half-dozen Japanese trading houses a couple years back. There were two paths that could have been taken with respect to the yen risk.

One was simple: Berkshire could have converted its massive USD cash stockpile (which currently amounts to \$277 billion after Berkshire's recent Apple sales) into JPY to buy the stocks. End of story. In so doing, Berkshire would have philosophically been aligned with something like [DFJ, the WisdomTree Japan SmallCap Dividend Fund](#), which doesn't hedge the currency.

But instead, Warren Buffett argued that neither he nor his deputies had any special insight into future forex moves. Berkshire instead tapped the market with JPY debt to finance the Japanese equity long. In so doing, Berkshire "went the [DXJ](#) route," and took the yen part of the calculus out of the mix.

### Picking Up the Pieces

What we just witnessed was the worst three-day crash for Japan's stock market since 1973. After the earlier crashes, the median subsequent 12-month stock market return was 10.9% and the average was 14.6% (Figure 4). This includes the miserable 1990 experience, when Japan's bubble was bursting. If we draw a line through 1990, which we think is reasonable given the stock market's bubble status at the time (compared to today's 10-11 forward earnings multiple), that makes the lookback even more compelling.

As with many market crashes, buying after a panic is generally a profitable move.

Figure 4: Japan's Performance after Crashes

Topix Index			Total Return, Next:			
Rank	Worst 3-Day Returns		3 Months	6 Months	9 Months	12 Months
1	8/5/24	-20.3%	--	--	--	--
2	3/15/11	-17.6%	8.5%	-1.0%	-1.2%	12.9%
3	10/20/87	-16.9%	1.6%	20.2%	19.2%	18.1%
4	10/27/08	-16.1%	3.0%	13.1%	25.9%	24.5%
5	10/24/08	-15.7%	-3.9%	4.4%	15.6%	14.2%
6	10/8/08	-14.2%	-1.1%	-8.1%	0.1%	0.5%
7	10/10/08	-14.0%	1.8%	2.0%	5.1%	8.9%
8	8/25/15	-11.8%	13.0%	-9.0%	-5.6%	-7.5%
9	3/16/20	-10.7%	25.3%	35.4%	48.1%	63.1%
10	3/16/11	-10.7%	2.0%	-8.2%	-7.8%	7.3%
11	3/14/11	-10.3%	-3.0%	-11.4%	-9.9%	2.2%
12	3/13/20	-10.3%	26.0%	31.5%	44.4%	58.4%
13	4/2/90	-10.3%	13.5%	-26.2%	-15.9%	-4.6%
14	8/24/15	-10.2%	9.1%	-11.4%	-7.8%	-10.1%
15	10/28/08	-10.1%	2.9%	5.0%	20.1%	16.5%
<b>Median</b>			<b>2.9%</b>	<b>0.5%</b>	<b>2.6%</b>	<b>10.9%</b>
<b>1973-2024 All Periods Median</b>			<b>2.3%</b>	<b>3.9%</b>	<b>5.8%</b>	<b>8.1%</b>
<b>Average</b>			<b>7.0%</b>	<b>2.6%</b>	<b>9.3%</b>	<b>14.6%</b>
<b>1973-2024 All Periods Average</b>			<b>1.8%</b>	<b>3.7%</b>	<b>5.6%</b>	<b>7.7%</b>

Source: Refinitiv, 1/4/1973-8/6/2024, in JPY.

### Important Risks Related to this Article

**DXJ:** There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk, interest rate fluctuations and derivative investments, which can be volatile and may be less liquid than other securities, and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.

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**Foreign Exchange (FOREX, FX)**: The exchange of one currency for another, or the conversion of one currency into another currency.

**Cross rate**: synonymous with exchange rate, which tells the value of one currency in terms of another.

**Organization for Economic Cooperation and Development (OECD)**: the organization for economic co-operation and development aims to promote policies that will improve the economic and social well-being of people around the world.