THE NIKKEI HAS ROOM TO RUN

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The Japanese stock market has been in limbo since the spring. After running from sub-17,000 at the pandemic lows to 41,088 in March, the Nikkei 225 spent several months chopping sideways before moving on to a new all-time high of 42,426 in June. However, the country's semiconductor industry has been hit by the Biden administration's pressure to cut ties with China, causing a couple thousand points to be lopped off the Nikkei in recent sessions. This action has left Japanese stocks unchanged since March.

One of the other reasons for the market's sideways action has been the Bank of Japan's vocal desire to push interest rates off the zero line. However, with more than five percentage points separating money market rates in the U.S. and Japan, the yen has refused to catch a worthwhile bid, sliding to its current ¥157.

At that exchange rate, the currency's dollar value weakened beyond previous "lines in the sand" at ¥150 and ¥155, though the subsequent line, ¥160, was only briefly breached before the yen settled into its current trading range in the mid-to-high ¥150s.

Though many in the market have a gut instinct to point almost exclusively to the yen for an explanation for why Japan's stock market took out 34-year highs this spring, there is more to the situation.

I think we logically need to point to the Doubling Asset-Based Income Plan (DABIP) as a key positive catalyst. The name is unwieldy, ambiguous and hard to remember…but I have it memorized because WisdomTree is knee-deep in researching Japan's investor reform initiatives. To put it in one sentence, the DABIP's goal is to put a jolt into the Japanese stock market by increasing the number of household investment accounts in the retirement system.

When Prime Minister Fumio Kishida's administration announced the DABIP in 2022, the country had 17 million Nippon Individual Savings Accounts (NISA) in Japan's defined contribution program. Think of these as Japan's equivalent of the 401(k). The goal was to multiply the number of NISA accounts by two, to 34 million, "within five years." For some historical context, there were about 6 million such accounts in 2015.

In mid-June, the Financial Services Agency released a survey that found a total of 23.2 million accounts in Q1, up 24% over the prior year.

While the growth in NISA assets is promising, it does nothing for Japan's bullish set-up if the money flows into S&P 500 tracker funds. For the DABIP to work, large chunks of NISA owners need be comfortable in Japanese stocks. Fortunately, I think we have some pretty solid evidence to support an argument that Japanese are warming to their home country's stocks. We do not yet have Q2 data, but the Japan Securities Dealers Association asked 10 big brokerage houses about their Q1 NISA flows. That survey found that 47% of the contribution total went into Japanese equities.

It's one thing to buy stocks and quite another to stick with them for the long haul. That is where the corporate governance reform push comes in. Japan is attempting to bring valuations closer to those seen in the U.S.

A good example of an area that needs major improvement before valuations can converge with U.S.-listed peers is the matter of Corporate Japan's cross-shareholdings. It is a big issue because corporations often own shares in their suppliers' and/or customers' companies in a "scratch my back and I'll scratch yours" arrangement. Though it comes across as a friendly gesture to important counterparties, it ultimately consolidates voting power in the hands of founding families.

Progress takes years, but it is in tow. According to MSCI, their primary Japanese equity index witnessed 36% of components “flagged for cross-shareholdings” in 2023, an improvement from 43% in 2019. Still, it’s too many.

Private equity is also circling. Joseph Bae, the co-CEO of KKR, says Japan’s corporate governance reform is “unlocking enormous value within companies,” according to Nikkei Asia. Big name activists such as Elliott Management are also drawing attention to the country as it builds equity stakes in large firms, the most recent of which is Sumitomo, the trading house that also counts Berkshire Hathaway on the shareholder roster.[1]

Additionally, with inflation in positive territory (CPI is +2.8% YoY), there is a real push for higher wages. The annual spring *shunto* wage negotiations, which set the stage for compensation across the country, resulted in a pay boost of 5.2%, the highest in over three decades.

You can see the down-market effects too. A big push right now is a boost in the minimum wage to ¥1,500 ($9.55) by the mid-2030s, up from the current level of about ¥1,000 ($6.37).

Something else to note: the weak yen has had several much-needed benefits for Japan’s wishy-washy consumption. For one, tourists are everywhere. The Japan National Tourism Organization reported that 17.78 million foreign visitors arrived in 2024’s first half, breaching the prior pre-pandemic record of 16.63 million in 2019. Retail sales also came in hot last month, jumping 1.8% MoM, no doubt aided to some extent by the influx of tourists.

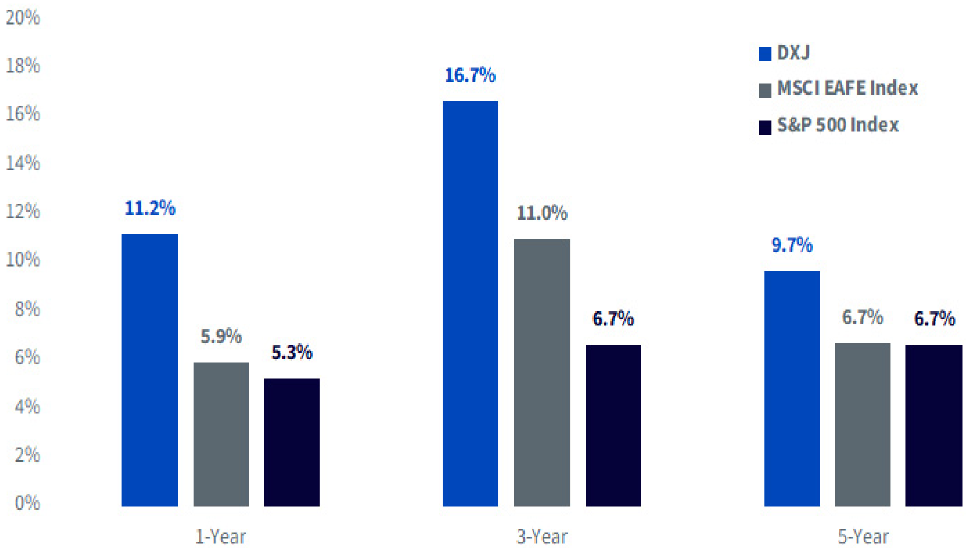
There is a notion that yen weakness helps all Japanese companies, but that is not the case. Bloomberg conducted a survey in May that counted 64% of Japanese corporations saying the yen’s decline hit their profits; only 7.7% say it helped.

Logic says that many of the 64% who are unhappy with JPY weakness are smaller, domestically focused firms who have watched helplessly as the dollar exchange rate has gone from near ¥100 to ¥157 in about three years.

In contrast, the profile of a company that loves yen weakness is a globally focused multinational that has a large Japanese production base and heavy overseas sales. This situation skews positively for the WisdomTree Japan Hedged Equity Fund (DXJ) because its design has an explicit screen for high foreign revenues.

This phenomenon has been borne out in DXJ's fundamental metrics. We ran the numbers and found that its median dividend growth rate not only exceeded the MSCI EAFE Index, but also bested the S&P 500, and handily.

Figure 1: Median Dividend Growth



Source: WisdomTree, as of 5/31/24. **Past performance is not indicative of future results. Investment return and principal**
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original cost. Current performance may be lower or higher than the performance data quoted. For DXJ's full standardized
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[1] Sumitomo was the fifteenth-largest holding in DXJ, at 1.71% on 7/18/24.

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