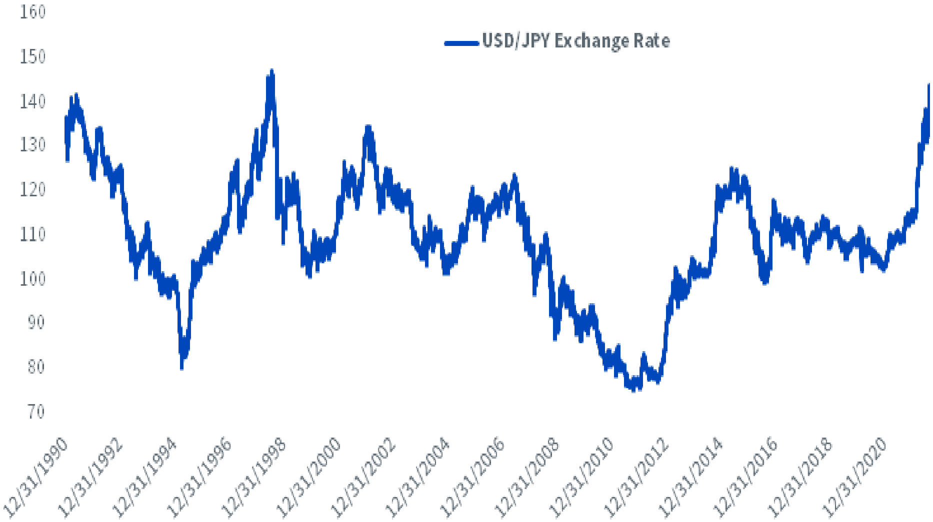
THOUGHTS ON THE JAPANESE YEN AT 145

Bradley Krom – U.S. Head of Research
09/13/2022

On July 21, 2022, the European Central Bank hiked rates by 0.50% to 0.00%, effectively ending its experiment with a negative interest rate policy. This made the Bank of Japan one of only two central banks in the world with a negative deposit rate. Since that time, the Japanese yen has come under pressure versus the U.S. dollar, with the exchange rate rising to 145, a level not seen since the late 1990s.

While a weaker yen helps Japanese exports, investors with exposure to unhedged Japanese equities have experienced losses of more than 20% year-to-date. By contrast, the WisdomTree Japan Hedged Equity Fund (DXJ) is up 6%. With currency risk playing such an important role in international investing, we decided to take a closer look at the drivers of return in Japanese markets.



Source: Bloomberg, as of 8/31/22. Past performance is no guarantee of future results.

Scenario 1: MSCI Japan Index Up, JPY Down

Year	JPY/USD	MSCI Japan Index (Local)	MSCI Japan Index (USD)
2005	-12.83%	44.58%	25.52%
2006	-1.12%	7.26%	6.24%
2009	-2.43%	9.12%	6.25%
2012	-11.31%	21.57%	8.18%
2013	-17.63%	54.58%	27.16%
2014	-12.02%	9.48%	-4.02%
2015	-0.47%	9.93%	9.57%
2021	-10.25%	13.44%	1.71%
YTD	-20.14%	-1.04%	-20.00%

Over the last few decades, the yen has been negatively correlated to the equity market. Put another way, when the yen is falling, stocks are rising (and vice versa). This is the classic example of why we believe that currency hedging in Japan makes sense. In years like 2014, an investor could get the market call correct (equities higher) but still lose money on account of the losses from the exchange rate. In nine out of the last 24 years (the most common outcome in our study), yen weakness has ultimately led to higher returns in Japanese equities.

Scenario 2: MSCI Japan Index (Local) Down, JPY Up

Year	JPY/USD	MSCI Japan Index (Local)	MSCI Japan Index (USD)
2002	10.81%	-18.76%	-10.28%
2007	6.54%	-10.21%	-4.23%
2008	23.17%	-42.56%	-29.21%
2011	5.50%	-18.73%	-14.33%
2016	2.78%	-0.74%	2.38%
2018	2.81%	-15.15%	-12.88%

During periods of heightened risk aversion, Japanese equities can fall, and the yen appreciates versus the U.S. dollar. These years are often described as the unwinding of the yen’s “carry trade.” Since interest rates in Japan tend to be lower than in other markets around the world, the yen can be a preferred funding currency. Borrow yen and buy risky assets. When risky assets start to underperform, the yen tends to appreciate as the trade gets reversed.

Scenario 3: Positive Calendar Year Returns for MSCI Japan Index and the JPY

Year	JPY/USD	MSCI Japan Index (Local)	MSCI Japan Index (USD)
1999	11.12%	46.57%	61.53%
2003	10.82%	22.74%	35.91%
2004	4.47%	10.78%	15.86%
2010	14.60%	0.57%	15.44%
2017	3.83%	19.75%	23.99%
2019	0.90%	18.48%	19.61%
2020	5.15%	8.76%	14.48%

While the first two scenarios showed a negative correlation between the yen and Japanese equities, there have been periods when the two moved in lockstep. In this Goldilocks period of returns, U.S. investors benefit from a stronger yen and higher equity prices. However, while it has occurred seven times over our sample period, the primary driver of double-digit returns in those years was overwhelmingly equities.

Scenario 4: MSCI Japan Index and JPY Down

Year	JPY/USD	MSCI Japan Index (Local)	MSCI Japan Index (USD)
2000	-10.39%	-19.85%	-28.16%
2001	-13.11%	-18.98%	-29.40%

Thankfully, the rarest outcome, scenarios where the yen depreciates along with a decline in Japanese equities, is a worst-case scenario for U.S. investors. It occurred only two times in the last 20+ years, back-to-back years in the early 2000s.

Next Steps

Based on our research, we believe that currency hedging Japanese stocks can lead to the highest probability of good outcomes for U.S.-based investors. For those who think the yen will continue to weaken relative to the dollar or have no view on the direction of the currency, we believe DXJ can help manage risk in international allocations.

Annual Returns (as of 8/31/22)

Fund/Index	YTD	1 year	2 years	3 years	4 years	5 years	10 years
WT Japan Hedged Equity ETF-DXJ (NAV)	6.11%	11.10%	19.13%	14.85%	7.03%	7.36%	11.68%
MSCI Japan Index (Local)	-1.14%	2.26%	12.73%	11.83%	6.03%	6.78%	12.48%
MSCI Japan Index (USD)	-17.87%	-18.96%	-1.40%	2.31%	0.27%	1.97%	6.23%
Excess Return DXJ vs. MSCI Japan (USD)	23.99%	30.06%	20.53%	12.54%	6.76%	5.39%	5.45%
USD/JPY	20.75%	26.30%	14.55%	9.35%	5.77%	4.79%	5.89%
JPY/USD	-17.18%	-20.83%	-12.70%	-8.55%	-5.46%	-4.57%	-5.56%

Sources: WisdomTree, Zephyr StyleADVISOR, as of 8/31/22. Past performance is no guarantee of future results. An investment cannot be made directly in an index

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

See the Fund's page for full performance, risks and other important information.

As we show above, in years when the yen depreciates dramatically versus the U.S. dollar, an export-tilted strategy like DXJ can add significant value versus unhedged strategies.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as the 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 and interest rate fluctuations. Derivative investments can be volatile, and these investments 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.

For the top 10 holdings of DXJ please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/equity/dxj

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

+ WisdomTree Japan Hedged Equity Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Central bank : Refers to the the monetary authority of any country.

Deposit Rate : The rate parties receive for deposits at the central bank.

Stock : A stock (also known as equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.