
THINKING INTERNATIONAL: WHAT'S DRIVING JAPANESE EQUITY PERFORMANCE?

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This blog post is the third installment of a four-part series that examines the tactical and strategic case for investing internationally despite a multi-year period of U.S. equity outperformance.

Since the previous peak in Japanese markets, investors have long hoped for a so-called “virtuous cycle” to finally take root in Japan. Despite some of the most accommodative [central bank](#) policies in the world, Japan has experienced doggedly low levels of [inflation](#) and even [disinflation](#). With prices forecast to be lower in the future, consumers are incentivized to forego consumption and increase their savings rate. For Japanese companies, this results in anemic sales growth and a headwind for earnings. This cycle may be ending now.

Like most other countries in the developed world, Japan has seen the lingering impacts of supply chain disruptions result in stubbornly persistent inflation. However, this has also had the effect of incentivizing consumption today rather than in the future. As economic activity increases, wages are also starting to rise. This combination of rising wages and consumption creates a positive feedback loop resulting in a virtuous cycle of investment, labor productivity growth and potentially higher multiples for Japanese stocks.

Big Catalyst: TSE Reform

For all of the reasons highlighted earlier, the same investment cycle also applies to companies. One of big thorns in the side of global asset allocators was that Japanese markets perpetually appeared cheap based on common value metrics such as [price-to-book](#) value. With future profits potentially crimped by low growth, many companies hoarded cash as opposed to reinvesting in their businesses. This resulted in a high percentage of companies trading at significant discounts to their book value. In response, the Tokyo Stock Exchange (TSE) sent a public letter at the end of January 2023 to listed companies imploring them to take steps to increase their book value per share through share [buybacks](#), dividend increases and capex investment.

The TSE published a report titled, “Action on Cost of Capital-Conscious Management and Other Requests” at the end of March 2023. This required companies to (a) increase actions that are conscious of [returns on equity \(ROE\)](#) and [cost of capital](#), (b) seek improvements in ROE through investment in human capital, capex and business line restructuring, (c) repurchase shares and hike dividends on a continual basis promoting long-term growth and (d) increase dialogue with investors about corporate targets and strategies for enhancing returns.

According to JPMorgan, at the time of the announcement in January, there were 922 companies trading below book value. Since then, 308 of these companies have announced share buybacks or dividend increases. It is also forecasted that many other companies such as banks may be poised to do more on this front once the turbulence from the U.S. regional banking crisis moves further out of memory. While many investors may fear that

they have in effect “missed the trade,” we believe this may be the start of a multi-year process that starts to see fundamental changes to Japanese company fundamentals and multiples.

Looking under the Hood

As we show in the table below, one of the single biggest drivers of returns over the last year has been this focus on shareholder yield: increasing dividends and share buybacks.

1-Year Attribution: WisdomTree Japan Hedged Equity Index vs. MSCI Japan Local Index

Over this period, companies ranking in the top quintile based on shareholder yield have outperformed companies in the bottom quintile by nearly 40%! Additionally, WisdomTree’s approach, which focuses on exporters and dividend payers, showed even more value versus a market cap-weighted approach.

While Japan has experienced periods of false dawns in the past, we believe that we are still in the early innings of a meaningful shift in Japanese corporate behavior that focuses on shareholder returns. After being challenged publicly by TSE officials, many companies have already responded. As profits continue to increase as part of a virtuous cycle of growth in Japan, we believe an even more meaningful shift may soon occur. For investors seeking targeted exposure, we believe the [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#) may be poised to benefit from these trends.

For access to the complete developed international market insight, click [here](#).

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DEFINITIONS

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

Inflation: Characterized by rising price levels.

Disinflation: Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Price-to-book ratio: Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

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

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

Weighted average cost of capital (WACC): The average rate that a business pays to finance its assets. It is calculated by averaging the rate of all of the company's sources of capital (both debt and equity), weighted by the proportion of each component.