
JAPAN: OPENING UP THE PLAYBOOK

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Investors who withstood last spring's [volatility](#) have a good problem to solve for. [S&P 500](#) returns since its March 23, 2020, low have been remarkable—over 90%. But with this head-spinning rebound have come unattractive valuations. Multiples have expanded from 13 times forward 12-month earnings last March to over 23 times forward 12-month earnings today.

With [valuations](#) on the S&P 500 the highest they have been since the early 2000s, investors may want to consider “opening up the playbook”—reducing a home country bias toward [large-cap](#) U.S. equities in favor of allocations toward more moderately valued international equities.

Headwinds Bring Opportunity

Arguably no market has been more unloved by international investors in recent years than Japan. There are a few theories as to why:

- **Sector composition:** A lack of domestic tech mega caps in favor of cyclical sectors—like Autos and Banks—has been a headwind for Japanese indexes during a global rally in growth stocks
- **Policy mistakes:** A government that has made a handful of policy missteps, particularly with consumption tax hikes in 2014 and 2019
- **Aging population:** Demography is destiny, or so it is said. There has been fear that an aging population in Japan will put a lid on the country's long-term growth potential, coupled with chronically low equity investment from a notoriously conservative domestic investor base

Most recently, a surge in coronavirus cases has added to near-term economic uncertainty. Several of Japan's largest cities recently enacted a lockdown for the next several weeks—coinciding with the Golden Week holidays—to curb the virus. Unsurprisingly, the lockdowns have dented Japanese equity returns over the past week.

Cumulative Foreign Net Equity Investment (¥ Bn)



Source: Japan Ministry of Finance, 1/4/13–4/16/21.

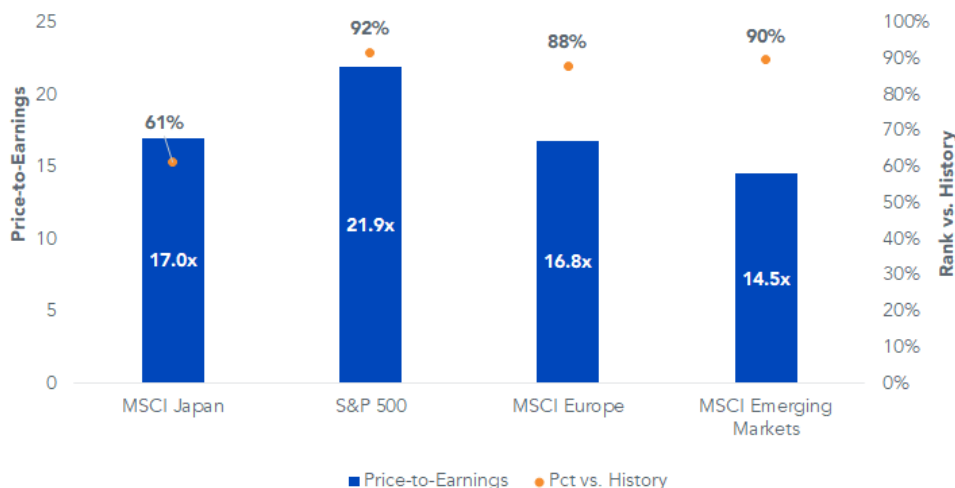
In part as a byproduct of low international investor interest, Japanese equities are significantly discounted relative to the U.S., and have a much lower valuation relative to its own history than most other major markets.

These valuations are what [attracted Warren Buffett to initiate a 5% stake in five Japanese trading houses in August of last year.](#)

To compare current valuations relative to history, the below chart shows the current price to earnings (P/E) ratio (blue bars) of each MSCI regional index alongside the S&P 500 with a percent rank comparison to how each market is priced relative to its own history (orange dots).

A rank of 61% for the MSCI Japan Index indicates that the Japanese market is at a premium relative to its historical P/E ratio as it is above its historical median (the 50th percentile). The S&P 500 is trading at the highest level relative to its history as its current P/E is in the 92nd percentile.

Current Valuations vs. History (12/31/00–3/31/21)



Sources: WisdomTree, MSCI, S&P, FactSet. Price-to-earnings as of 3/31/21. Rank vs. history using monthly observations between 12/31/00 and 3/31/21. Past performance is not indicative of future results. You cannot invest directly in an index.

While Japan’s position as a market more tilted to cyclical sectors was a headwind during a global rally in growth stocks, it may be perfectly primed for an environment in which economic growth is expected to make a significant recovery in the coming years.

For example, [WisdomTree’s Japan Hedged Equity Index](#)—which tilts more toward cyclical sectors than the broad [MSCI Japan Index](#) and neutralizes yen fluctuations—has outperformed the S&P 500 by nearly 300 [basis points](#) since the end of August. The recently enacted lockdowns have been a headwind to year-to-date returns.

Japan for Cyclical Rotation

S&P 500 Sector Returns and Japan	
Year-to-Date (12/31/20–4/27/21)	Cyclical Rotation Trade (8/31/20–4/27/21)
29.42% – Energy	45.30% – Financials
22.17% – Financials	41.36% – Energy
16.92% – Real Estate	33.63% – Materials
15.69% – Industrials	32.81% – Industrials
15.19% – Materials	23.68% – Japan
13.10% – Comm. Svc.	20.81% – S&P 500
11.97% – S&P 500	20.40% – Comm. Svc.
9.97% – Cons. Disc	20.20% – Real Estate
9.97% – Info. Tech	16.36% – Info. Tech
9.31% – Japan	14.59% – Health Care
8.41% – Health Care	14.52% – Cons. Disc
5.54% – Utilities	13.71% – Utilities
2.19% – Cons. Staples	7.08% – Cons. Staples

Sources: WisdomTree, S&P, FactSet. Japan measured by the WisdomTree Japan Hedged Equity Index net total returns. You cannot invest directly in an index. Past performance is not indicative of future returns. Weights subject to change.

The S&P 500 only has about a 34% weight in the cyclical sectors most likely to benefit from an accelerating economy. The WisdomTree Japan Hedged Equity Index has almost twice as much weight and nearly 10% more than the MSCI Japan Index.

Index Sector Weights

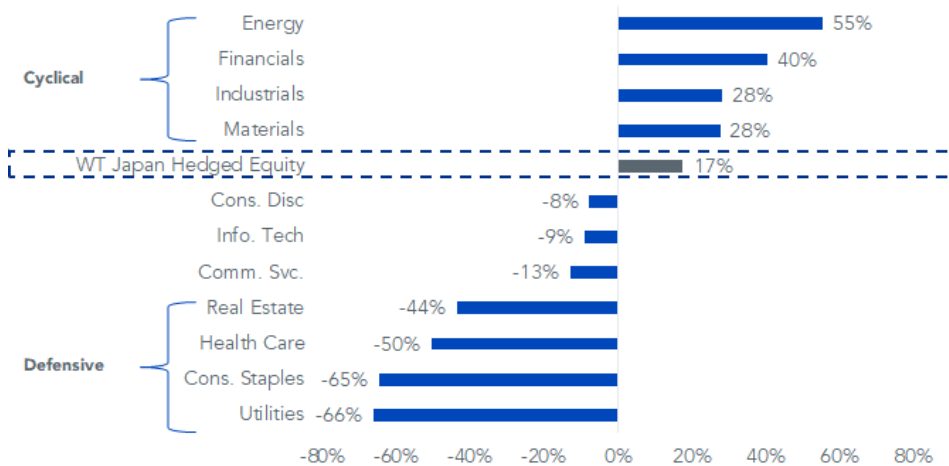
Sector	WT Japan Hedged Equity	MSCI Japan	S&P 500
Cyclical	63.3%	54.3%	33.7%
Energy	2.1%	0.6%	2.8%
Materials	8.4%	5.2%	2.7%
Industrials	19.5%	21.1%	8.9%
Financials	15.8%	9.1%	11.3%
Consumer Cyclical	17.5%	18.3%	8.0%
Growth/Defensive	36.7%	45.7%	66.3%
Consumer Growth/Defensive*	8.3%	7.5%	10.6%
Health Care	10.4%	10.0%	13.0%
Information Technology	13.3%	13.7%	26.6%
Utilities	0.2%	1.3%	2.7%
Real Estate	0.0%	3.6%	2.5%
Communication Services	4.5%	9.6%	10.9%

Sources: WisdomTree, FactSet, MSCI, S&P, as of 3/31/21. *Consumer Growth/Defensive includes Consumer Staples sector and Internet & Direct Marketing Retail industry. Consumer Cyclical includes the Consumer Discretionary sector ex- Internet & Direct Marketing Retail industry. You cannot invest directly in an index. Weights subject to change.

The S&P 500 is up more than 11% to start the year despite concerns over rising interest rates. Nonetheless, the potential for higher rates becoming a headwind to both fixed income and equity returns remains a top concern among asset allocators.

Given the cyclical tilts of the Japanese equity market, as well as the tendency for the yen to weaken alongside a rise in U.S. rates, the WisdomTree Japan Hedged Equity Index has had a positive [correlation](#) between its outperformance and rising [Treasury yields](#).

Trailing 3-Year Correlation: Excess Returns vs. 10-Year U.S. Treasury Yield



Sources: WisdomTree, S&P, FRED. Correlation measures monthly excess returns relative to the S&P 500 from 3/31/18–3/31/21. Sector returns from S&P 500 sectors. Japan measured by WisdomTree Japan Hedged Equity Index. You cannot invest directly in an index. Weights subject to change.

Conclusion: Follow Buffett’s Playbook

The steady and reliable earnings growth from U.S. [mega caps](#) powered U.S. indexes higher over the past several years. With U.S. valuations now near two-decade highs and the potential for a synchronized global recovery on the horizon, investors may want to consider Buffett’s “Buy Japan” playbook.

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.

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DEFINITIONS

Volatility: A measure of the dispersion of actual returns around a particular average level.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States 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.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

MSCI Japan Index: A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

Basis point: 1/100th of 1 percent.

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.

Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.