TIME TO REENGAGE WITH JAPAN

Jeremy Schwartz – Global Chief Investment Officer
07/18/2019

I recently had the opportunity to interview Jesper Koll, a Senior Advisor to WisdomTree, on opportunities in Japan’s equity market for our “Behind the Markets” podcast.

Koll believes Japan will be a source of surprise for both economic strength and corporate performance.

Positioning Japan in Portfolios

Koll sees investors as underweight in Japan today as they were at the time of the Fukushima nuclear reactor disaster. This relative positioning makes Japan interesting by itself, but we do see Abenomics showing positive domestic strength. The industrial sector and exporters have certainly been hit by trade fears, but there is outperformance in some of the small and medium-sized companies within the local economy from a profit perspective.

Delivering Growth, but Valuation Multiples Shrinking

Japan has been delivering healthy earnings growth, but valuations have fallen, making Japan even more of a value play. What can unlock this value?

Koll sees signs of corporate activists getting more involved, with 70 different proposals to Japanese companies at the latest June board meetings.

There is increasingly more focus on capital stewardship in the form of more dividends and buybacks at a time when corporate activism is trying to change businesses’ operational focus to shed non-core assets.

Japan Payout Ratios Rising and Return on Equity (ROE) Increasing

Koll has observed twice as many buybacks as this point last year, and dividends already growing at double-digit rates this year. He sees the Japanese pension program, the Government Pension Investment Fund, putting pressure on Japanese companies to deliver meaningful value to investors.

ROE has increased from 3% over the last 15 years, on average, all the way up to 10% for broad market Japan indexes, with a majority of companies having a target of 14%.

Hitachi as an Example of Newfound Operational Focus

Multinational conglomerate Hitachi[1] has engaged private equity firm KKR & Co. Inc. to help them restructure their business. This would have been taboo in Japan even five years ago, but now they are going to change their operational focus to be more globally competitive.

Koll's Bet

Koll believes Japanese companies have a war chest of cash to deploy around the world, and he foresees one of the mega banks in the market likely to buy a major U.S. bank sometime soon.

The Japanese banks are stuck, however, because the Bank of Japan (BoJ) has capped long-term bonds at 10 basis points, limiting their financing opportunities domestically. Japanese banks are now also the largest creditor to non-China Asia. Their portfolios are growing aggressively in Asia, but they desire more of a U.S. presence.

BoJ Policy and Government Debt

Despite Japan's debt to gross domestic product (GDP) ratio having grown from over 100% of GDP to 300% of GDP, interest expense has fallen and is now only 1% of GDP. The government is getting this debt essentially for free. And despite this "unholy" monetary experiment where the Bank of Japan is financing this debt and capping long-term bond yields, Koll sees no distortions. He sees no signs of an asset bubble, inflation or a collapse in the exchange rate. He believes this program (or bold experiment) may be a precursor of what is to come globally in the future.

Is the BoJ Buying Equity Exchange-Traded Funds (ETFs) a Problem?

Koll sees one of the greatest hesitations that global investors have toward investing in Japan as the Bank of Japan's ETF purchases, which now account for 5% of total ownership of the equity market. There are even fears that the BoJ may eventually have to wind down and sell these ETFs.

But Koll has a proposal for potential buyers. Who has the money to buy? The older generation in Japan, meaning people over age 65. Their biggest concern is an inheritance tax that is 60% of assets. Koll said jokingly that if they can make ETFs exempt from the estate tax, the BoJ could sell their ETFs to individuals in 24 hours as that would eliminate the tax concerns.

Where Is the Yen Headed?

Koll and I discussed the risk on/risk off funding dynamics that make the yen the preferred trading vehicle of global speculators. But as Koll looks out five years ahead, he sees the yen as a weaker currency driven by capital outflows, with corporate Japan making more acquisitions like the bank discussion above.

Koll makes a compelling case that Japan is an unloved market, ripe for catch-up with other global markets, that gets compounded higher with improving corporate governance. Koll particularly likes small and medium-sized companies that could have performances less synchronized with the rest of the global markets.

Please listen to the full conversation below.

Unless otherwise noted, data source is Bloomberg, as of 7/12/19.

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.

For more investing insights, check out our Economic & Market Outlook

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

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dividend : A portion of corporate profits paid out to shareholders.

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

Payout ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

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

Basis point : 1/100th of 1 percent.

Debt to gross domestic product (GDP) : the debt-to-GDP ratio is the ratio between a country's government debt and its gross domestic product (GDP.

Interest Expense : The cost incurred by an entity for borrowed funds.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

Inflation : Characterized by rising price levels.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.