

---

# THE BOJ IS TELLING US TO BUY JAPANESE EQUITIES. SHOULD YOU LISTEN?

Christopher Gannatti – Global Head of Research  
07/24/2017

At WisdomTree, we track a very interesting weekly statistic reported by Japan's Ministry of Finance (MOF)—the net flows from foreign investors into Japan's equity market.<sup>1</sup>

As of June 16, 2017, approximately \$2.7 billion had gone INTO Japan's equities for the 2017 year-to-date period. That compares to \$155 billion in 2013, \$22.5 billion in 2014, \$3.5 billion in 2015 and nearly \$40 billion OUT in 2016.<sup>2</sup>

In short, the year-to-date data indicated a reversal from a very large outflow year (2016), but still negligible interest in Japanese stocks from foreign investors.

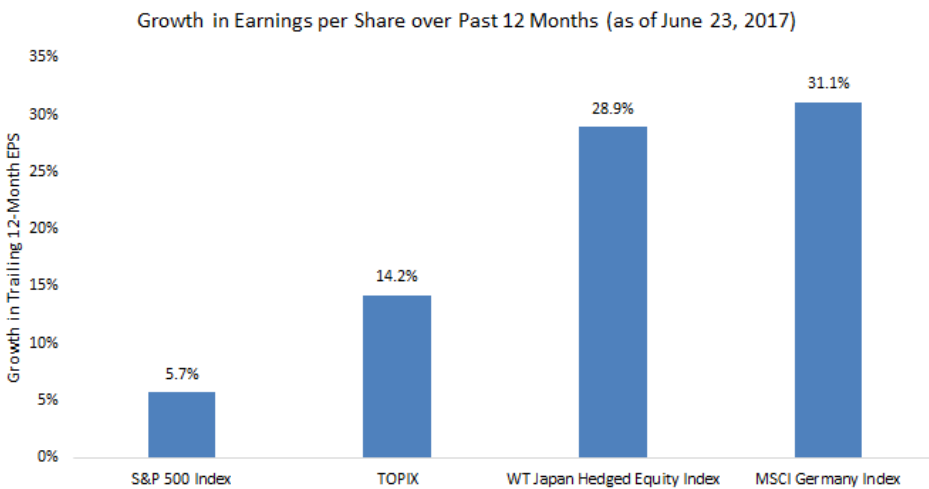
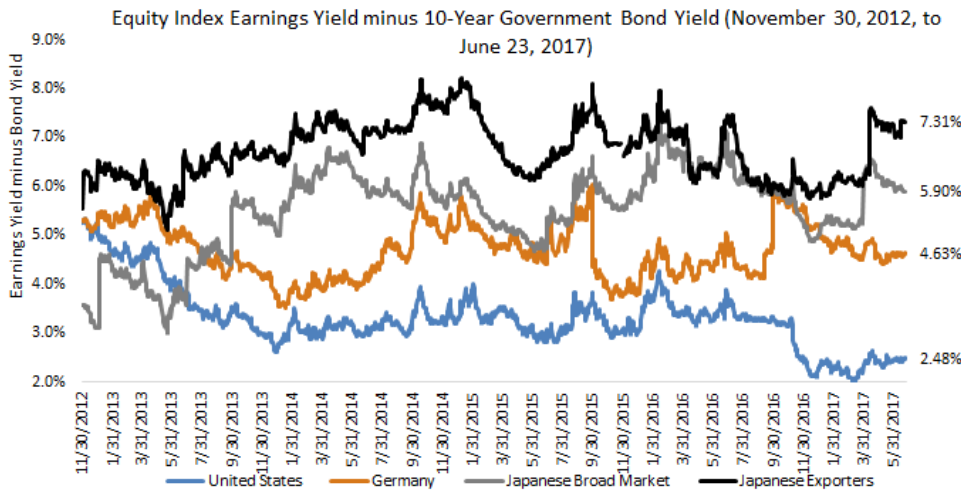
## The Disconnect: Investor Activity vs. Central Bank Policy

We, like most other global investors, have seen the phenomenal run that U.S. equities<sup>3</sup> have enjoyed since recovering from the 2008-09 global financial crisis. In our discussions, one of the universally accepted contributing factors was the responsiveness of the U.S. Federal Reserve (Fed) in its [monetary policy](#).

Today, the Fed has begun a policy "[normalization](#)" process and is contemplating reducing its [balance sheet](#).

Japan represents a market where not only is there policy support to keep rates low, but the central bank is buying equities directly to support the markets and reduce [risk premiums](#) for investors.<sup>4</sup>

## Valuation & Earnings Growth Present a Strong Combination



Sources: WisdomTree, Bloomberg. Period begins 11/30/12 to coincide with beginning of Abenomics' influence on Japan's markets. United States: S&P 500 Index earnings yield minus U.S. 10-Year Treasury note interest rate. Germany: MSCI Germany Index earnings yield minus German 10-Year government bond yield. Japanese broad market: TOPIX earnings yield minus 10-Year JGB yield. Japanese exporters: WisdomTree Japan Hedged Equity Index earnings yield minus 10-Year JGB yield. You cannot invest directly in an index.

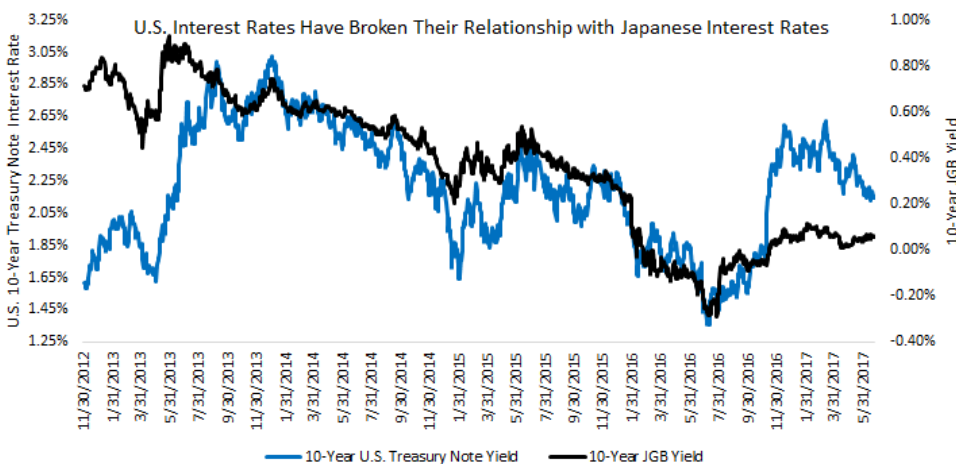
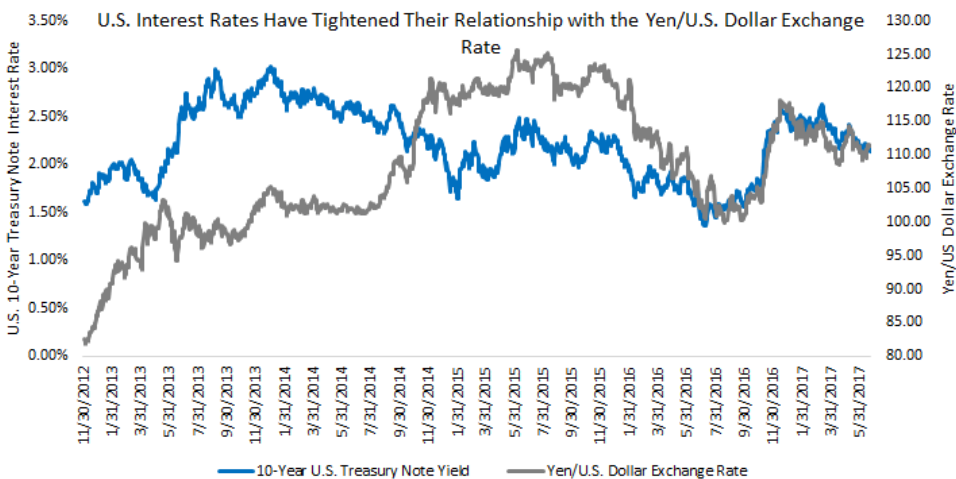
One of the most interesting manifestations of the Bank of Japan's policy becomes visible when considering the [relative valuation](#) of [Japanese government bonds \(JGBs\)](#) versus equities. A classic methodology would be the Fed Model, comparing equity [earnings yields](#) to 10-Year government bond yields. The key: high earnings yields (low [price-to-earnings \(P/E\) ratios](#) is another way to say this) and low 10-Year government bond yields.<sup>5</sup>

- Even though [10-Year Treasury note](#) interest rates are still historically low, the U.S. has seen earnings yields dropping due to very strong equity performance. Equities have therefore become more expensive compared to bonds. Whereas five years ago, the U.S. earnings yield was more than 5 percentage points higher than bond yields, today it has fallen to half those levels.<sup>6</sup>

- The German 10-Year government bond—shown to represent the largest market in the [eurozone](#)—is also historically low in terms of its yield, with the European Central Bank (ECB) continuing its bond-buying program at least for now. The spread between German equities ([MSCI Germany Index](#)) and German bonds is 2 percentage points higher than the U.S. and just a touch lower than where it was five years ago. Notably, five years ago, Germany was at the same spread as the U.S., so perhaps this too represents an opportunity on relative value.<sup>7</sup>
- In terms of this depiction of the Fed Model, Japanese equities clearly stand out. Here we show two versions—one focused on the broad Japanese equity market ([TOPIX](#)) and one focused on exporters (the [WisdomTree Japan Hedged Equity Index](#)). Both look attractive compared to the U.S. and Germany, but with a yen that's closer to 110 than 120 against the U.S. dollar, as well as geopolitical rumblings, Japan's exporters have the least expensive relative valuation.

Earnings growth allows us to take a step beyond simply measuring the valuation of equities versus bonds, taking stock of a different indicator of company fundamentals. Over the past 12 months, it's clear that Japanese exporters and German equities have been strong, compared to Japan's broad market and the United States.

**If U.S. Interest Rates Cooperate, the Yen Can Unlock Japan's Equity Opportunity**



Sources: WisdomTree, Bloomberg. Period begins 11/30/12 to coincide with beginning of Abenomics' influence on Japan's markets.

Another great visual depiction of the BOJ's impact on markets is the shift from a high [c](#)

orrelation between movements in Japan and U.S. 10-Year government interest rates to a high correlation between movements in U.S. 10-Year government interest rates and the yen/dollar exchange rate.

Since the September 21, 2016, shift in BOJ policy to cap its long-bond rate near zero,<sup>8</sup> rising interest rates in the U.S. have led to a weaker yen (and vice versa for falling interest rates in the U.S.). Effectively, the BOJ has broken the correlation between the Japanese 10-Year interest rate and that of the U.S., forcing the U.S. interest rate moves to show up in movement of the yen.

### A Few Questions to Conclude

If we put U.S. equities, German equities, Japanese equities and Japanese exporters side by side over the last year, which performed the best? The interesting answer: Japanese exporters, even though we just saw that they have the least expensive relative valuation. Certainly a risk scenario to Japan is the U.S. 10-year drifting down, which could cause the yen to rise back toward 100. But with a view that U.S. rates will head higher with the unwinding of the Fed's balance sheet, Japan is an unloved recipient of global flows in the last 18 months and has a market that is seeing improved fundamental strength and attractive relative prices. We'd advocate global investors re-engage with Japan.

<sup>1</sup>Source: "The Foreign Securities Investment into Japan Stocks Net Flows Year-to-Date (YTD)," reported weekly by the Ministry of Finance, accessed through Bloomberg.

<sup>2</sup>Source: Bloomberg. YTD 2017 is from 12/31/16 to 6/16/17. Comparisons shown from 2013 onward to indicate the period after the election of Prime Minister Shinzo Abe and the Abenomics period in Japan.

<sup>3</sup>Refers to the S&P 500 Index.

<sup>4</sup>As of the 9/21/16 implementation of its current policy of yield curve control, BOJ had also committed to continuing its purchase of equity market ETFs at a rate of approx. 6 trillion yen per year.

<sup>5</sup>Source for all bullets is Bloomberg.

<sup>6</sup>As of 11/30/12, the earnings yield of the MSCI Germany Index minus the 10-Year German government bond yield was 5.30%. As of 6/23/17, this value was 4.63%.

<sup>7</sup>As of 11/30/12, the earnings yield of the MSCI Germany Index minus the 10-Year German government bond yield was 5.30%. As of 6/23/17, this value was 4.63%.

<sup>8</sup>Source: "New Framework for Strengthening Monetary Easing: 'Quantitative and Qualitative Monetary Easing with Yield Curve Control,'" Bank of Japan, 9/21/16.

### Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

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](http://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

**Monetary policy**: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Normalization**: The process by which a policy or action returns to its historically normal levels.

**Balance sheet**: refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new position.

**Risk premium**: Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

**Relative value**: The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.

**Japanese Government Bond (JGB)**: A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

**Earnings yield**: The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

**Price-to-earnings (P/E) ratio**: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**10- Year Treasury**: a debt obligation of the U.S. government with an original maturity of ten years.

**Eurozone (EZ)**: Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

**MSCI Germany Index**: Index weighted by float-adjusted market capitalization designed to measure the performance of the German equity market.

**Tokyo Stock Price Index (TOPIX)**: A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

**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.