

**WisdomTree
RESEARCH**

**THE WisdomTree JAPAN
EQUITY INDEX ETF (JAPN):
CANADA'S ALTER EGO**

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Of the G7 nations, perhaps no two complement each other quite like Canada and Japan. It is a peculiar case that Japan is a natural portfolio hedge for Canadians specifically, and the reason for that is the stark contrasts between the two economies.

Consider the construct of Japanese commerce and compare it to Canada. Unlike Canada, with its continent-sized landmass, Japan has always had to look outward for natural resources. For example, while Canadian fuel is more than one-quarter of its merchandise exports,¹ Japan is unique in that it has essentially no oil, gas or much of anything else that comes from the ground, aside from agricultural goods.

The MSCI Canada Index is thus more than 20% allocated to the energy sector, while MSCI Japan is just 1.1% energy.² The WisdomTree Japan Hedged Equity Index is even bolder, with just 0.2% in the sector, a rounding error from zero.³ Frankly, Japan doesn't have Suncor, Enbridge, TransCanada, Canadian Natural Resources or any of the 16 others that make up the MSCI Canada Energy Index. It has only JXTG, Inpex and two others—and all are largely unknown outside Japan.

The contrasts continue. An economy with little in the way of natural resources makes itself rich on technical know-how. While Ottawa's coffers are bolstered by oil sands wealth, Japan stays rich by staying ahead of the curve in manufacturing efficiency. For example, although its population is only about three times the size of Canada's, Japan will close 2018 with 44,000 industrial robots, about 10 times Canada's 4,500.⁴ No surprise then that WisdomTree's Japan Index has more than one-third of its exposure in industrials and information technology, two sectors that combine to less than 12% of MSCI Canada.

Also, although Ontario is known for auto parts suppliers, namely Magna and Linamar, Canada doesn't have the big automobile companies that we see in the U.S., Germany, China and Japan. Japan prides itself on the auto sector, with global mainstays including Toyota, Honda, Nissan, Suzuki and Mitsubishi representing the face of the country's corporate image.

While a company like Magna would not cheer on an oil price rise, its \$21.2 billion market capitalization accounts for only 1.2% of the MSCI Canada Index, an amount that pales in comparison to the mid-single-digit weights of both Suncor and Enbridge, which ache for higher fossil fuel prices. Unlike Suncor, Japan's industrial behemoths, of course, want nothing more than to see the oil price slide.

In short, Canada is the oil long, Japan the short. One sells umbrellas and hopes for rain while the other sells sunscreen.

At WisdomTree, one of our tag lines is to "take the currency out of a foreign country" when we talk about an overseas equity ETF that hedges the currency. But in the case of unhedged JAPN, maybe what we should be saying is to "take oil biases out of equity portfolios." JAPN is the vehicle that can give Canadian investors core Japanese equities with a natural hedge against Canada's oil problem.

¹ Source: Rosamond Hutt, "Which Economies Are Most Reliant on Oil?" World Economic Forum, 5/10/16. Data by Bruegel.

² Sources: MSCI, WisdomTree, as of 6/19/18. Later references to the same indexes and its sub-indexes also from this source.

³ Source: WisdomTree, as of 6/19/18.

⁴ 2018 estimate by the International Federation of Robotics (IFR) 2017 Industrial Robotics Report.

THE OTHER SIDE OF THE CARRY TRADE

Investing in Japan brings up another complement to Canada, and it may even be more important than the sector mix: the yen's tendency to rally in risk-averse times while the Canadian dollar is treated in completely opposite fashion.

While Japan's economy is cyclical, some may say hypercyclical, that is not the case with the currency. The yen is among the most liquid of the currencies for the carry trade, which is when an investor borrows in a low-yielding country to invest in a domicile that offers higher interest rates. When investors are feeling aggressive and are unconcerned with risk, they easily borrow yen, sending it lower, placing the capital in higher-yielding countries such as Australia and Canada. That action forces AUD and CAD higher. When risk enters the picture, those trades are reversed as investors receive margin calls. The moves can be fast and furious.

To create an exhibit that is digestible in size, we sought a collection of a handful of months in the last generation that were characterized by the most extreme moves up and down in market fears. A VIX volatility change of +/-7 points inside one calendar month accomplishes that objective, with 10 up months of that magnitude and nine down during this century.

In figure 1, we see the change in CHF, USD, JPY, GBP and EUR⁵ relative to CAD in the "risk on" and "risk off" environments. The best performer of those five relative to CAD appears in green, with the color morphing to red for the worst performer.

Start with the top half of the table, when risk was abating. Notice in the green-to-red color coding that even the green ones, which performed best relative to CAD, were the best of a bad bunch, often registering losses. That's because when fear is abating and "risk is on," CAD is frequently a reflexive strong performer, often the strongest—stronger than CHF, USD, JPY, GBP and EUR.

Take, for example, October 2011, when the VIX fell 13 points, yet even the best performer of the five forex choices was still negative relative to CAD. That type of month, where all the listed currencies fell relative to CAD, occurred frequently. So-called "animal spirits" are fortuitous for CAD.

Notice that, of the non-CAD currencies during those "happy" months, the EUR and GBP were often the best performers relative to CAD, while the one with a lot of red and orange was the yen. When risk was "on," JPY was not. It has zero green shades in the top half of the table.

⁵ Swiss franc, U.S. dollar, Japanese yen, British pound sterling and euro.

Figure 1: Currency Movements vs. CAD, "Risk On" and "Risk Off"

	Month	VIX Start	Vix End	Chg.	CHF	USD	JPY	GBP	EUR	CHF Rank	USD Rank	JPY Rank	GBP Rank	EUR Rank
Fear Abating	Dec 2008	55.3	40.0	-15.3	11.68%	-1.69%	3.53%	-6.49%	8.34%	1	4	3	5	2
	Oct 2011	43.0	30.0	-13.0	-1.32%	-4.71%	-6.08%	-1.64%	-1.35%	1	4	5	3	2
	Jul 2010	34.5	23.5	-11.0	0.15%	-3.21%	-1.01%	1.60%	3.23%	3	5	4	2	1
	Nov 2001	33.6	23.8	-9.7	-1.38%	-0.97%	-1.76%	-3.11%	-1.44%	2	1	4	5	3
	Oct 2015	24.5	15.1	-9.4	-3.21%	-1.75%	-2.34%	0.13%	-3.26%	4	2	3	1	5
	Oct 2002	39.7	31.1	-8.6	-1.91%	-1.79%	-2.35%	-2.01%	-1.42%	3	2	5	4	1
	Apr 2003	29.2	21.2	-7.9	-2.83%	-2.54%	-3.18%	-1.54%	-0.10%	4	3	5	2	1
	Apr 2009	44.1	36.5	-7.6	-5.47%	-5.37%	-5.05%	-2.28%	-5.51%	4	3	2	1	5
	Feb 2015	21.0	13.3	-7.6	-5.20%	-1.70%	-3.50%	0.73%	-2.53%	5	2	4	1	3
	May 2009	36.5	28.9	-7.6	-2.17%	-8.47%	-5.33%	0.07%	-2.17%	3	5	4	1	2
Rising Fear	Sep 2001	24.9	31.9	7.0	4.38%	1.81%	1.16%	3.23%	1.68%	1	3	5	2	4
	Sep 2002	32.6	39.7	7.1	3.46%	1.82%	-1.00%	2.99%	2.25%	1	t	5	2	3
	Jul 2007	16.2	23.5	7.3	1.81%	0.11%	3.96%	1.23%	1.16%	2	5	1	3	4
	Jul 2011	16.5	25.3	8.7	6.07%	-0.85%	4.08%	1.49%	-1.55%	1	4	2	3	5
	May 2010	22.1	32.1	10.0	-4.25%	2.61%	5.52%	-2.30%	-5.01%	4	2	1	3	5
	Sep 2011	31.6	43.0	11.3	-4.73%	7.43%	6.85%	3.02%	0.06%	5	1	2	3	4
	Aug 2015	12.1	28.4	16.3	0.29%	0.37%	2.61%	-1.42%	2.45%	4	3	1	5	2
	Sep 2008	20.7	39.4	18.7	-1.80%	0.07%	2.58%	-2.17%	-3.92%	3	2	1	4	5
	Oct 2008	39.4	59.9	20.5	10.38%	13.91%	22.76%	2.80%	2.92%	3	2	1	5	4

Sources: Bloomberg, WisdomTree. All currency moves relative to CAD. Data set is monthly, 12/31/1999–5/31/2018.

But it flips in fearful months. JPY is heavily "green" when panic set in, and consistently so. Also, generally speaking, blindly owning anything other than CAD was a better option than being stuck in Canada when fear gripped the markets. It makes sense. When panic sets in, think about what assets often get sold heavily: oil sands, base metals, big dividend payers. These things are as Canadian as hockey. Most of the time, what gets bought by the panicked market is the yen, in size.

THE EQUITY EXPERIENCE TOO

Figure 2 shows the three largest panics in Canadian equities since the Global Financial Crisis. Canada is plotted against the G7 economies, with MSCI Japan listed in both local and CAD terms, with green-to-red coding again. The last two lines show MSCI Japan in both JPY and CAD so that we can assess the currency-hedging decision.

Notice that when investors hedged JPY, two of the three swoons witnessed the Japanese market hurting even more than Canada. But notice the other line item—MSCI Japan in CAD—the experience of the Canadian investor in Japanese equities without the currency hedge. That one is consistently green. Just as we witnessed in figure 1, which captured many of the same months contained in this table, Japan was the haven for Canadians when times were tough.

Figure 2: Country Performance, Big 3 Drawdowns in Canadian Equities				
	Currency	06/18/2008 - 03/09/2009	03/04/2011 - 10/04/2011	04/15/2015 - 01/20/2016
MSCI Canada	CAD	-48.10%	-20.96%	-21.98%
MSCI U.S.	CAD	-34.42%	-6.16%	4.93%
MSCI UK	CAD	-43.17%	-12.63%	-8.00%
MSCI Germany	CAD	-46.27%	-24.74%	-6.58%
MSCI France	CAD	-42.16%	-23.23%	-1.27%
MSCI Italy	CAD	-54.54%	-29.86%	-6.48%
MSCI Japan	CAD	-31.67%	-9.80%	1.22%
MSCI Japan	JPY	-50.87%	-22.81%	-16.06%

Sources: Bloomberg, WisdomTree. Global financial crisis through 5/31/18.

THE JAPN ETF IN PORTFOLIOS

Despite the country's C\$4.7 trillion market capitalization, more than three times Canada's C\$1.8 trillion value, Japan is sometimes neglected at the portfolio level. When Canadians talk about or act on "overseas" investments, that often means turning attention south of the border. And while U.S. equities are a key component of the global mix, no country serves the diversifying purpose for Canadian portfolios quite like Japan. Its construction is a natural gift that is specific to Canadian eyes. Using JAPN strategically, in eyebrow-raising quantity, may be just the type of thoughtful and insightful portfolio action that can help mitigate the pain from Canada's exposure to the vagaries of oil price and petrocurrency movements.

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