Rebounding fundamentals in Japan

After the worst year of outflows from Japanese equity ETFs in a decade, market sentiment, flows and earnings estimates have been on the rebound. Japanese equity ETFs have seen over $2BN of inflows in the last six months, while year-to-date flows have been concentrated into currency-hedged ETFs. The iShares Currency Hedged MSCI Japan ETF (HEWJ), accounts for more than 95% of the total Japan ETF inflow this year.¹

Investors may be positioning for a weaker yen, but in 2017 the yen has been one of the strongest major currencies in the world, which could potentially hurt returns if it continues. While the market may be expecting a weaker currency, in fundamental terms, some stock analysts do not see current yen levels as a threat to earnings, where the stronger global demand picture has been a bigger driver. Importantly, valuations are still reasonable for Japan when compared with global benchmarks.

Yen weakness

The yen spent the majority of early 2016 as a safe haven, strengthening as the global picture became bleak, and remaining strong through multiple stimulus measures from the Bank of Japan (BoJ). However, BoJ policy shifts at the end of the summer to target yields and buy “unlimited” Japanese government bonds (JGBs) at fixed rates have worked to weaken the yen. Moreover, relatively steeper yield curves in the US post-election have served to widen the difference in interest rates between the US and Japan, which has further catalyzed yen weakness.

Japanese equities and a weaker yen

Summary

A global reflationary upswing has some analysts revising Japanese earnings higher, boosted by stronger demand and a stable-to-weaker yen.

Continued accommodative policies from the Bank of Japan as well as Fed rate hikes are likely to support a weaker yen over time, which may help sustain this rally.

While many risks remain, these factors and lower valuations underscore why investors should consider an allocation to Japan.
Attractive valuations

Throughout the Abenomics period, Japanese stocks have traded at a discount to global markets. The discount reflects a range of challenges facing the Japanese government: persistent deflation, the need for structural reforms, as well as an impending labor force cliff approaching the aging nation. Equities rallied strongly in the years when monetary policy was effective, but have lost some momentum recently. If reflations is helping fiscal and monetary policy globally to regain efficacy, and global growth is strengthening, this could create a new dynamic which may be beneficial for Japanese equities.

Relative valuations

12-Month Forward Price/Earnings Ratios (Japan vs. MSCI World)

<table>
<thead>
<tr>
<th>Year</th>
<th>MSCI Japan</th>
<th>MSCI World</th>
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<tbody>
<tr>
<td>2013</td>
<td>12</td>
<td>16</td>
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<tr>
<td>2014</td>
<td>14</td>
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<tr>
<td>2016</td>
<td>18</td>
<td>20</td>
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<td>2017</td>
<td>20</td>
<td>22</td>
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</tbody>
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Source: Thomson Reuters, as of 4/24/2017
Notes: Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Conclusion

Positive sentiment toward Japan equities is now accompanied by expectations of yen weakness, but this is not the primary driver - reflations and stronger growth may be more powerful. Diminished risks to global trade and potential rising protectionism have provided a further boost, but remain risks worth monitoring. Japanese earnings estimates are rising to near all-time highs, and BoJ equity purchases, rising corporate share buybacks and dividend payouts are additional positives for growth. If this momentum were combined with renewed yen weakness, it could be time to consider hedged Japanese equities.

Related iShares Funds

EWJ  iShares MSCI Japan ETF
HEWJ iShares Currency Hedged MSCI Japan ETF
DEWJ iShares Adaptive Currency Hedged MSCI Japan ETF

Visit www.iShares.com or www.BlackRock.com to view a prospectus, which includes investment objectives, risks, fees, expenses and other information that you should read and consider carefully before investing.

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