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# **ETF Strategy**

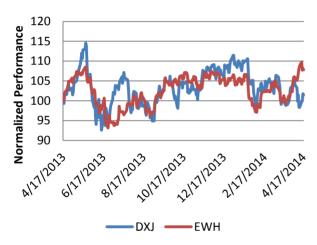
## Japan discount to H.K. signs of closing?

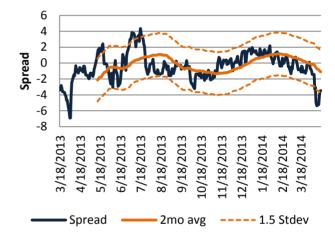
Market Commentary 17 April 2014

### **DXJ/EWH** spread starts to tighten

In our monitoring of liquid ETF pairs that have shown a mean-reverting (cointegrated) relationship over the past year, DXJ (WisdomTree Japan Hedged Equity) and EWH (iShares MSCI Hong Kong) stood out as one pair that had significantly diverged in the past few weeks. Recently, the spread between the two has started to tighten, suggesting the statistical relationship between the pair could be heading back to its near-term average.

Exhibit 1: Spread between DXJ and EWH has diverged from historical mean



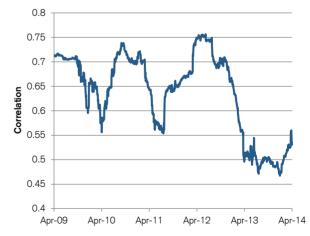


Source: Credit Suisse Trading Strategy

#### Trade Idea

- Buying DXJ and shorting EWH (using a ratio of 2.4 EWH to 1 DXJ) would take advantage of the spread between the pair reverting to its historical average.
- If the spread reverts to its one year mean, the pair would return 6.9%. More conservatively, if it returned to its 2 month average spread, the pair would return 5.4%.
- The big risk is that Japan and Hong Kong continue to drift apart. While long-term correlations between Japan and Hong Kong have historically ranged from 60-70%, it has recently has been closer to 55%. If the two have indeed fundamentally diverged, the spread could continue to widen if sentiment remains more favorable towards Hong Kong. To mitigate risk, we would suggest stop loss limits, a maximum trade duration (e.g. one month), and monitoring the moving average of the spread to see if the relationship is changing.
- Note that DXJ is not a traditional market cap weighted index tracking Japan. It invests in dividend paying companies in Japan while hedging the Yen relative to the US dollar.

Exhibit 2: Rolling correlation between Japan and Hong Kong



Source: CS Trading Strategy

For complete information regarding the ETFs mentioned in this report, please refer to the prospectus for each fund found on the respective ETF provider's website.

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