Weekly commentary

BlackRock.

February 13, 2023

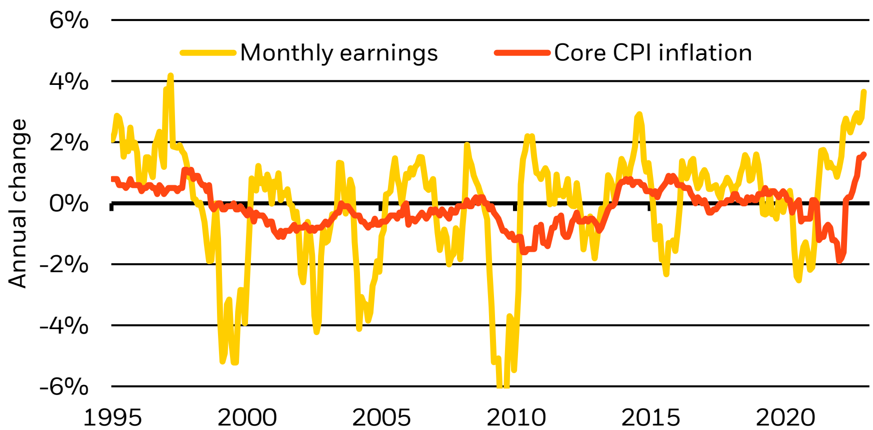
Preparing for Japan central bank shift

- The Bank of Japan looks set to change its ultra-loose policy as inflation takes root. We see spillover risks to global yields, risk appetite and Japanese stocks.
- Global stocks fell last week and U.S. Treasury yields rose across the curve as markets partly priced out Federal Reserve rate cuts later in the year.
- The U.S. CPI is due this week. The December core CPI was revised up sharply last week, showing it hadn't slowed nearly as much as first reported.

Japan's economy is starting to look like its developed market (DM) peers at least in one way: Inflation is beginning to take root after having been long missing in action for decades. Yet the Bank of Japan's ultra-loose monetary policy remains, including a cap on bond yields that requires sizable bond purchases. We think a policy change could come at any moment – scrapping the cap risks pushing global yields higher and reducing risk appetite. We cut Japanese stocks to underweight.

Inflation comes to Japan

Japanese wages and core CPI inflation, 1995-2023



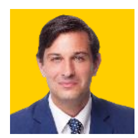
Source: BlackRock Investment Institute, with data from Haver Analytics and Refinitiv Datastream, February 2023. Notes: The chart shows core CPI inflation, excluding food, non-alcoholic beverages and energy (Western core). The earnings line is based on the three-month moving average.

Inflation – long missing in Japan – has reached four-decade highs on a weaker yen and higher energy prices. Crucially, that's now feeding into higher wages. See the chart. We think that paves the way for the BOJ to roll back policies that by its own measures may have achieved their goal: to foster a sustained rise in inflation toward its 2% target that is underpinned by wage growth. The BOJ's monetary easing went further than other major central banks with relentless bond buying to cap yields and large-cap stock purchases. Governor Haruhiko Kuroda has led the effort as one part of former Prime Minister Shinzo Abe's fight against deflation, dubbed "Abenomics." With wages rising by the most in decades, the BOJ can start winding down these policies. Yet doing so is unlikely to be easy without stirring market volatility. We see any Japanese yield spike from scrapping yield curve control as a global risk that could drive other yields higher and hit risk appetite.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute



Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock **Investment** Institute

Speculation is rising on what a BOJ leadership change in April will mean for policy. Kuroda's last meeting as governor will be March 10. But we think who succeeds is less important than the fundamental issue: a nearing shift in policy. Regardless of who takes over, we think the wage and inflation dynamics at play mean the current policy stance has likely run its course. Policy changes could come in different forms. The BOJ could widen the band on its 10-year bond yield target again – market pricing not impacted by the cap is already up to 0.5% higher than that limit. We also think the BOJ could abandon its yield curve control at any moment. That would push yields higher and stoke interest rate volatility. It would put the BOJ on track to stop bond purchases – it owns over half of outstanding Japanese government bonds – potentially let its balance sheet shrink as bonds mature and push up policy rates.

We see global implications of a BOJ policy shift. A gravitational pull among developed market bond yields increases the risk of a global spillover, in our view – especially if Japanese investors cut their large foreign bond holdings. We see the jolt from a BOJ policy shift as another driver of higher term premium, or the compensation investors demand for holding long-term government bonds. We think the risk of further rises in global yields could dampen global risk sentiment. The policy change could put the BOJ on course with a larger trend by major central banks to boost yields rather than depress them. The BOJ would then join the quantitative tightening push, with the Federal Reserve doing so now and European Central Bank soon.

These risks prompt us to downgrade Japanese stocks to underweight. Monetary policy uncertainty and the sensitivity of Japan's economy to the slowdown in other major economies spur the change. Declining earnings growth estimates already reflect some risks from slowing growth – we expect Japan's export sector to suffer. But we do see the positive undercurrents of corporate reform, a result of one of the economic initiatives in Abenomics known as the "third arrow." Japan has become a more shareholder-friendly market, in our view, with companies boosting share buybacks and dividends. We prefer unhedged Japanese equity exposures for foreign investors given the policy risks – and we also favor sectors that stand to benefit from automation, digitalization and tourism.

Bottom line: We see a BOJ policy shift driving the risk for higher global yields. That reinforces why yield is back – and why we tactically prefer short-term government bonds and credit for income. We downgrade Japanese stocks on policy uncertainty and a worsening economic environment. We prefer emerging market stocks on a relative basis to DM equities.

Market backdrop

Global stocks fell last week and U.S. Treasury yields rose across the curve as markets partly priced out Fed rate cuts later in the year. We think the risk asset pause shows we're at a critical crossroads. The messages from Fed officials last week were more clearly about not being done in fighting inflation. Fed Chair Jerome Powell last week stressed the inflation fight will "take quite a bit of time." We think policy rates could stay higher for longer than the market expects.

Assets in review

Selected asset performance, 2023 year-to-date return and range

Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Feb. 9, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

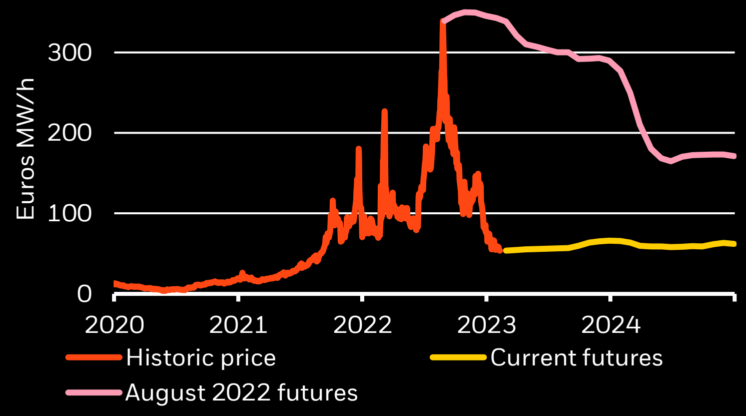
Macro take

Europe's energy shock is easing. Gas prices have fallen sharply. A mild winter, combined with measures to reduce demand, are keeping gas storage levels relatively high. Markets now expect mid-2023 gas prices to be around 75% lower than had been expected in mid-2022. See the yellow line versus the pink line in the chart. Yet the average gas price last year was around triple the 2021 average – high enough to cause the euro area economy to slow to a crawl in the second half of 2022.

We think the energy shock will still hurt activity this year but by no more than it did at the end of last year – so it shouldn't be a drag on economic growth now versus then. European Central Bank (ECB) rate rises will do that. We see the ECB raising rates further to above 3% – the highest since August 2008 – and starting to reduce its holdings of government bonds. That monetary tightening is poised to pull the euro area into recession this year, in our view. Read more in our latest macro perspectives.

European gas prices retreat

European natural gas prices and futures, 2020-2024



Forward-looking projections may not come to pass. Sources: BlackRock Investment Institute and Intercontinental Exchange, with data from Refinitiv Datastream, February 2023. Notes: The chart shows the Dutch TTF (Title Transfer Facility) gas price, a European benchmark gas price (orange line) and market futures prices of gas as of August 2022 (pink line) and Feb. 9, 2023 (yellow line).

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- That damage is building. In the U.S., it's most evident in rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- In Europe, the hit to incomes from the energy shock is amplified by tightening financial conditions.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think they will halt rate hikes once the economic damage becomes clear.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- The case for investment-grade credit has brightened, in our view. We think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower yields. Agency mortgage-backed securities can also play a diversified income role. Short-term government debt also looks attractive at current yields.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer investment-grade credit over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The cycle of outsized rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. Even with a recession coming, we think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

Feb. 14	U.S. CPI inflation; UK jobs data
Feb. 15	UK inflation; U.S. retail sales; U.S. and euro area industrial production; Japan trade
Feb. 16	U.S. housing starts

The market's focus is on January U.S. CPI inflation – specifically on core services inflation, the most affected by tight labor markets and higher wages. December core CPI was revised up sharply last week, showing it hadn't slowed nearly as much as first reported. We're also looking for ongoing signs of economic damage in U.S. retail sales and industrial production.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, February 2023

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks look set to overtighten policy – we see recessions looming. Corporate earnings expectations have yet to fully reflect even a modest recession.
Credit	+2	+1	Strategically, we are significantly overweight global investment grade on attractive valuations and income potential given higher yields. We turn neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're also overweight investment grade and neutral high yield. We prefer to be up in quality. We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
Govt bonds	-1	-1	The underweight in our strategic view on government bonds reflects a big spread: max underweight nominal, max overweight inflation-linked and an underweight on Chinese bonds. We think markets are underappreciating the persistence of high inflation and the implications for investors demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds as we see term premium driving yields higher, yet we are neutral short-dated government bonds as we see a likely peak in pricing of policy rates. The high yields offer relatively attractive income opportunities.
Private markets	-1	—	We're underweight private growth assets and neutral on private credit, from a starting allocation that is much larger than what most qualified investors hold. Private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class not suitable for all investors.

Note: Views are from a U.S. dollar perspective. 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 information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, February 2023

Underweight | **Neutral** | **Overweight** | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare.
	United States	-1	We are underweight. The Fed is set to raise rates into restrictive territory. Earnings downgrades are starting but don't yet reflect the coming recession.
	Europe	-1	We are underweight. The energy price shock and policy tightening raise stagflation risks.
	UK	-1	We are underweight. We find valuations expensive after their strong relative performance versus other developed markets thanks to energy sector exposure.
	Japan	-1	We go underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	China	Neutral	We are neutral. Activity is restarting, but we see China on a path to lower growth. Tighter state control of the economy makes Chinese assets riskier, in our view.
	Emerging markets	Neutral	We are neutral. Slowing global growth will weigh on EMs. Within the asset classes, we lean toward commodity exporters over importers.
	Asia ex-Japan	Neutral	We are neutral. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
	Short U.S. Treasuries	Neutral	We are neutral. We remain invested in the front end due to attractive income potential.
	Global inflation-linked bonds	+1	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
	European government bonds	-1	We are underweight the long end. We expect term premium to raise long-term yields and high inflation to persist. Rate hikes are a risk to peripheral spreads.
	UK gilts	-1	We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.
	China government bonds	Neutral	We are neutral. Policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
	Global IG credit	+2	We are significantly overweight. High quality corporates' strong balance sheets imply IG credit could weather a recession better than stocks.
	U.S. agency MBS	+1	We are overweight. We see the asset class as a high-quality exposure within a diversified bond allocation. Soaring U.S. mortgage rates boost potential income.
	Global high yield	Neutral	We are neutral. We prefer up-in-quality credit exposures amid a worsening macro backdrop.
	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices yet it is vulnerable to rising U.S. yields.
	Emerging local currency	Neutral	We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
	Asia fixed income	Neutral	We are neutral amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee